



## Dodd-Frank Act Rulemaking Update: SEC Proposal for Removal of Certain References to Credit Ratings in Rules 101 and 102 of Regulation M

On April 27, 2011, the U.S. Securities and Exchange Commission (the “SEC”) proposed amendments to five rules and one form under the Securities Exchange Act of 1934 (the “Exchange Act”) to remove all references to credit ratings and substitute alternative standards of creditworthiness.<sup>1</sup> Under the amendments as proposed, credit ratings references in Exchange Act Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, and Rule 10b-10, and Exchange Act Form X-17A-5, Part IIB, would be removed and, in certain cases, replaced with new criteria as required by Section 939A of the Dodd-Frank Act.<sup>2</sup> In conjunction with this rulemaking, the SEC also proposes to amend Exchange Act Rule 17a-4 relating to broker-dealer recordkeeping.

The SEC also requested comment on proposed potential alternative standards of creditworthiness for purposes of Exchange Act Section 3(a)(41),<sup>3</sup> which defines the term “mortgage related security” and Section 3(a)(53),<sup>4</sup> which defines the term “small business related security,” for the credit rating references deleted by Congress in Section 939(e) of the Dodd-Frank Act.<sup>5</sup>

We discuss the background and proposed amendments to Rules 101 and 102 of Regulation M below.

### Background

Section 939A of the Dodd-Frank Act requires the SEC to review (i) any regulation that requires the use of an assessment of the creditworthiness of a security and (ii) any reference to or requirement in such regulations regarding credit ratings, and modify them to remove those references and substitute standards of creditworthiness the SEC determines to be appropriate.<sup>6</sup> The SEC’s proposed rules, if adopted, would remove the references to credit ratings in Rules 101(c)(2) and 102(d)(2) of Regulation M and replace them with new standards relating to the trading characteristics of covered securities.

<sup>1</sup> SEC Release No. 34-64352; File No. S7-15-11 (April 27, 2011), available at: <http://sec.gov/rules/proposed/2011/34-64352.pdf>

<sup>2</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Pub. L. No. 111-203 § 939A(a)(1)-(2) and (b).

<sup>3</sup> 15 U.S.C. § 78a(3)(a)(41).

<sup>4</sup> 15 U.S.C. § 78a(3)(a)(53).

<sup>5</sup> Dodd-Frank Act, *supra* note 2, § 939(e).

<sup>6</sup> Dodd-Frank Act, *supra* note 2, § 939A(a)(1)-(2) and (b).

## Proposed Amendments to Rules 101 and 102 of Regulation M

Regulation M prohibits activities that could artificially influence the market for a covered security.<sup>7</sup> Rules 101 and 102 of Regulation M prohibit issuers, selling security holders, underwriters, and other distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a covered security during the applicable restricted period.<sup>8</sup> Rules 101(c)(2) and 102(d)(2) except from their respective provisions “investment grade nonconvertible and asset-backed securities,”<sup>9</sup> which are nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one nationally recognized statistical rating organization in one of its generic rating categories that signifies investment grade.<sup>10</sup>

The SEC’s proposed amendments replace the references to credit ratings in Rules 101(c)(2) and 101(d)(2) with new standards relating to trading characteristics of investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities. Those securities will be excepted from Rules 101 and 102 if they:

- are liquid relative to the market for that asset class;
- trade in relation to general market interest rates and yield spreads; and
- are relatively fungible with securities of similar characteristics and interest rate yield spreads.

## Proposed New Standards

### *Liquid Relative to the Market for that Asset Class*

To determine whether nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities are liquid relative to the market for their respective asset class, the following factors could be considered:

- size of the issuance;
- the percentage of the average daily trading volume by persons other than the persons seeking to rely on the exception;
- the number of market makers in the security being distributed other than the persons seeking to rely on the exception;
- overall trading volume of the security;
- the number of liquidity providers who participate in the market for the security;
- trading volume in similar securities or other securities of the same issuer;
- overall liquidity of all outstanding debt issued by the same issuer;
- how quickly an investor could be expected to sell the security after purchase; and
- in the case of asset-backed securities, the liquidity and nature of the underlying assets.

The list of proposed factors is illustrative and the SEC does not intend it to be exhaustive or mutually exclusive.

<sup>7</sup> 17 C.F.R. §§ 242.101 *et. seq.* (March 4, 1997).

<sup>8</sup> Regulation M, *supra* note 7, §§ 242.101(a) and 242.102(a).

<sup>9</sup> Regulation M, *supra* note 7, §§ 242.101(c)(2) and 242.102(d)(2).

<sup>10</sup> *Id.*

### *Trade in Relation to General Market Interest Rates and Yield Spreads*

Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities also would need to trade at prices that are primarily driven by general market interest rates and spreads applicable to a broad range of similar securities to qualify for the proposed exception. As a result, the exception is limited to securities that trade in relation to changes in broader interest rates (based on their comparable yield spreads), and securities that trade in relation to issuer-specific information or credit quality would not qualify. The SEC also noted that it would be more difficult for market participants to determine that the security trades in relation to changes in broader interest rates if it trades in an idiosyncratic fashion based primarily on its specific characteristics such that the traded price could not readily be compared to similar issuers.

### *Relatively Fungible with Securities of Similar Characteristics and Interest Rate Yield Spreads*

In order for a security to be relatively fungible (in terms of trading characteristics) under the proposed amendments, a portfolio manager would be willing to purchase it in lieu of another security with similar characteristics such as yield spreads and credit risk. However, the security need not be deliverable for a purchase order for a different security and it need not be completely fungible for all purposes with another security with similar characteristics in order to satisfy this standard.

## **Evaluation Under the Proposed Standards**

A person seeking to rely on the exception must determine that the specific nonconvertible debt, nonconvertible preferred, or asset-based security being distributed meets the proposed standards using reasonable factors. Persons are required to exercise reasonable judgment in conducting their analysis, and the determination must be subsequently verified by an independent third party. However, sole reliance on a third party's determination without any further analysis would not be considered to be based on reasonable judgment. Persons seeking to rely on the exception must demonstrate compliance with the requirements of the proposed amendments. If adopted, these proposals will require significant changes in the operations of underwriters and other distribution participants.

### *Independent Third-Party Verification*

To obtain the third-party verification required by the SEC's rules as proposed, the person seeking to rely on the exception must make a reasonable determination of the independence and qualification of the third party for this purpose, based on the third party's relevant professional background, experience, knowledge, and skills. The SEC cautions that counsel to, and other affiliates of, the underwriter or issuer would not meet the independence requirement under the rules.

## **Request for Comments**

The SEC's purposes for the proposed revised exceptions from Rules 101 and 102 of Regulation M for nonconvertible debt, nonconvertible preferred, and asset-backed securities is to address Section 939A of the Dodd-Frank Act, as well as to place the responsibility for determining the availability of the exception on the participants bringing the security to market. The proposed standards are an attempt to codify the subset of trading characteristics of investment grade nonconvertible debt, nonconvertible preferred, and asset-backed securities that make them less prone to the type of manipulation that Regulation M prohibits; however, they are not intended as measures of or proxies for assessments of credit risk, or to provide substitute criteria for whether or not a security would be considered investment grade. The SEC intends by its proposal generally to except the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2), without referencing credit ratings.

The SEC seeks public comment on the proposed rules by July 5, 2011. In addition to comments on the proposed standards, the SEC is interested in whether and in what circumstances issuers, selling security holders, distribution participants, and their affiliated purchasers rely on the current exception for investment grade securities, including with respect to specific activities, and whether it serves a continuing purpose with respect to nonconvertible debt and asset-backed securities. The SEC is also soliciting comments as to whether the current investment grade exception should be eliminated or, alternatively, whether it should be expanded to except from Rules 101 and 102 all nonconvertible debt, nonconvertible preferred, and asset-backed securities (or some subset thereof). The SEC seeks comments generally on any relevant changes to the debt markets since Regulation M's adoption in 1996 and how those developments should affect the SEC's evaluation of the proposed amendments.

This rule proposal, together with the recent proposals to amend references to credit ratings in other rules and forms under the Securities Act of 1933, the Exchange Act, and the Investment Company Act of 1940,<sup>11</sup> should satisfy the requirements of Section 939A of the Dodd-Frank Act.

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<sup>11</sup> See SEC Release Nos. 33-9186; 34-63874; File No. S7-18-08 (February 9, 2011); SEC Release Nos. 33-9193; IC-29592; File No. S7-07-11 (March 3, 2011); SEC Release No. 34-64514; File No. S7-18-11 (May 18, 2011).