Invested in America

May 23, 2022

By Electronic Mail (rule-comments@sec.gov)

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Release No. 34-94499; File No. S7-11-22
Removal of References to Credit Ratings from Regulation M

Ms. Countryman:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC or Commission) proposed amendments to remove credit rating references from Rules 101 and 102 of Regulation M (Proposal),[2] in accordance with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA).[3]

Rules 101 and 102 of Regulation M currently contain identical exceptions from the rules' prohibitions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are in each case rated investment grade by at least one nationally recognized statistical rating organization (NRSRO).[4] As stated in the 1996 Regulation M

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1 SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

2 SEC Release No. 34-94499, 87 FR 18312 (March 30, 2022) (*available at* https://www.govinfo.gov/content/pkg/FR-2022-03-30/pdf/2022-06583.pdf).

3 Section 939A of the DFA requires the SEC to, among other things, remove any references to credit ratings from its regulations and to instead "substitute in such regulations such standard of credit-worthiness" as the SEC determines to be appropriate. The SEC had issued two prior proposals to remove references to credit ratings from the provisions of Regulation M – one in 2008, prior to the DFA, and one in 2011, following the DFA. *See* SEC Release No. 34-58070, 73 FR 40088 (July 11, 2008) ("2008 Reg M Proposal") (*available at* https://www.sec.gov/rules/proposed/2008/34-58070fr.pdf) and SEC Release No. 34-64352, 76 FR 26550 (May 6, 2011) (*available at* https://www.sec.gov/rules/proposed/2011/34-64352fr.pdf). Neither proposal was adopted.

4 *See* Rules 101(c)(2) and 102(d)(2) of Regulation M.

adopting release, these exceptions (commonly referred to as the "investment grade exceptions") reflect the SEC's longstanding view that securities meeting the exceptions' criteria trade "on the basis of their yields and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation."[5] SIFMA member firms have long relied upon the investment grade exceptions in connection with qualifying distributions of fixed income securities (*e.g.,* in connection with "sticky deals" and "re-openings" of debt issuances). We are unaware of any manipulative issues associated with such reliance, and the SEC does not assert any such manipulation concerns in the Proposal. Nonetheless, SIFMA understands the SEC's position that the DFA requires the removal of all credit rating references from Regulation M[6] and appreciates the SEC's continued efforts to find a workable and appropriate alternative to the current exceptions.

As further discussed herein, SIFMA is of the view that:

- The proposed "probability of default" exception for nonconvertible debt securities and nonconvertible preferred securities should be replaced with an exception for such securities to the extent they are offered pursuant to an effective registration statement filed on: (i) Form S-3; (ii) Form S-4; (iii) Form F-3; (iv) Form F-4; or (v) Form F-10, *provided that* in the case of an offering registered on Form F-10, the offering also meets the transactional requirements of General Instruction I.B.2. of Form F-3

- Additional broker-dealer recordkeeping obligations are not warranted

- Rule 102 should continue to include a counterpart exception under Rule 102(d)(2), applying the same standards as used for purposes of the exceptions under Rule 101(c)(2)

I. INTRODUCTION

The SEC's Proposal would replace the current investment grade exception in Rule 101 with two alternative exceptions: one for nonconvertible debt and nonconvertible preferred securities (collectively, "Nonconvertible Securities") and the other for asset-backed securities.

While the exceptions differ dramatically in the complexity of their criteria, the SEC notes that each is intended to capture a universe of securities generally similar to those eligible under the current investment grade exception — that is, securities that are less susceptible to manipulation because they trade based on their yield and creditworthiness. The Proposal does not dispute the longstanding, fundamental principle that investment grade rated Nonconvertible Securities and asset-back securities "are less likely to be subject to manipulation because they are traded on the basis of their yields and credit ratings rather than the identity of the particular

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5 SEC Release No. 34-38067, 62 FR 520, 527 (January 3, 1997) ("Reg M Adopting Release"). This fundamental principle dates back to a 1975 no-action letter. Proposal, 87 FR at 18315 (*citing* Letter from Robert C. Lewis, Associate Director, Division of Market Regulation, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975)).

6 Proposal, 87 FR at 18317 n.71 (rejecting prior commenters' claims that the SEC has flexibility to retain the credit rating references in Regulation M).

issuer."[7] Indeed, the Proposal notes that this principle "continues to serve in part as the basis for the proposed amendments to Rule 101."[8]

Given the complexity of the proposed new standard for Nonconvertible Securities, the SEC is also proposing a new recordkeeping requirement for broker-dealers relying upon the exception — an additional obligation that could be avoided if the standard were simplified and the availability of the exception were independently verifiable through publicly available information. In addition, and without citing any apparent evidence of abuse by those relying upon the current investment grade exception to Rule 102, the SEC has declined to propose any alternative standard of creditworthiness under Rule 102. Instead, the SEC is proposing to eliminate the exception altogether, based on the unsupported assertion that persons subject to Rule 102 have less need for the exception and greater incentive to manipulate.

SIFMA has a number of concerns regarding the Proposal. After reviewing the current Proposal and revisiting the SEC's prior proposals, SIFMA believes a fusion of the SEC's current and prior proposals may represent the best alternative for moving forward. In this regard, the following objectives are of paramount concern to SIFMA member firms:

- as with the current investment grade exceptions, the goal should be to identify a universe of securities that trade primarily on the basis of yield and creditworthiness, such that they are less susceptible to manipulation;
- the alternative exceptions should be crafted to capture as many of the securities covered under the existing investment grade exceptions as possible (erring on the side of over-inclusion rather than under-inclusion);
- to ease administration and avoid the risk of errors or anomalies in application, the alternative exceptions should be based upon a uniform, predictable, and straightforward standard that is independently verifiable and not susceptible to conflicting outcomes; and
- the exceptions should serve to encourage (rather than discourage) offerings to be made on a registered basis.

With these objectives in mind, and for the reasons discussed below, SIFMA recommends replacing the "probability of default" standard for Nonconvertible Securities under proposed new Rule 101(c)(2)(i) with the use of a Form S-3/F-3 standard, similar to the Form SF-3 standard used for asset-backed securities under proposed new Rule 101(c)(2)(ii). This standard would further SIFMA's goals of simplicity, objectivity and certainty. The ability to readily and independently verify the availability of the exception would ease the burden on *all* involved – not only SIFMA member firms but also the examination and enforcement staff of the SEC and self-regulatory organizations (SROs). It would also provide greater legal certainty to the affected issuers and any selling securityholders. The S-3/F-3 standard would also obviate the need for any additional recordkeeping requirements for broker-dealers, as the availability of the exception

[7] Proposal, 87 FR at 18316.

[8] *Id.*

would (similar to the Form SF-3 standard for asset-backed securities) be readily verifiable through a review of the issuer's EDGAR database filings.

SIFMA also encourages the SEC to retain counterpart exceptions under Rule 102(d)(2), applying the same standards as used for purposes of the exceptions under Rule 101(c)(2). In this regard, SIFMA notes that the DFA calls for substitute standards of creditworthiness – not the elimination of exceptions based on such standards. In the absence of evidence of abuse by issuers, selling securityholders and their respective affiliated purchasers, Rule 102(d)(2) should continue to contain an exception comparable to that afforded under Rule 101(c)(2). Indeed, the continued availability of such an exception would be important to broker-dealers that are affiliated with an issuer but that are not, for whatever reasons, serving as an underwriter or other participant in connection with the distribution.

II. DISCUSSION OF COMMENTS

A. The Proposed Alternative Exception for Nonconvertible Debt and Nonconvertible Preferred Securities (Proposed Rule 101(c)(2)(i))

SIFMA recognizes that Regulation M has more limited application to distributions of Nonconvertible Securities and asset-backed securities. Nonetheless, member firms continue to rely upon the investment grade exceptions in connection with distributions of qualifying fixed income securities – *e.g.,* in the context of "sticky deals" and "re-openings" of debt issuances.

The SEC is proposing to replace the exception for investment-grade rated Nonconvertible Securities with an alternative standard of creditworthiness that is based on a measure of the issuer's probability of default. Specifically, the SEC is proposing to except Nonconvertible Securities of issuers for which the probability of default, estimated as of the pricing date and over the horizon of 12 calendar months from such date, is less than 0.055%, as determined and documented in writing using a "structural credit risk model." The Proposal would define a "structural credit risk model" as "any commercially or publicly available model that calculates the probability that the value of the issuer may fall below a threshold based on an issuer's balance sheet."

The SEC believes the proposed standard would capture "most" of the securities that qualify under the existing investment grade exception.[9] The Proposal also references the SEC's understanding that distribution participants currently use such commercially or publicly available models to measure and manage credit risk.[10]

1. Concerns Related to the Current Proposal

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9 Proposal, 87 FR at 18319. More specifically, the Proposal estimates that the 0.055% probability of default threshold would capture approximately 90% of Nonconvertible Securities that qualify under the current investment grade exception. *Id.* at 18330. By contrast, as noted in the Proposal, "a higher threshold of 0.5% is estimated to capture about 98.6% of investment grade securities." *Id.* at 18334.

10 *Id.* at 18319.

While SIFMA appreciates the SEC's efforts, we have a number of significant concerns regarding the proposed new standard under Rule 101(c)(2)(i).

To begin with, commercially or publicly available structural credit risk models are not used by SIFMA member firms in the context of evaluating whether to underwrite a security. The diligence exercise undertaken in connection with securities offerings is focused on the adequacy and accuracy of the disclosure. It does not involve a mathematical calculation of the probability that the issuer will default on the securities being issued, particularly in the case of securities with investment grade ratings. While we believe that most of our member firms do not use them for other purposes either, to the extent such models are used at all, they serve merely as a supplement to member firms' own proprietary credit analysis as part of their decision making on whether to extend a loan or other credit. Although SIFMA appreciates the intent to provide firms with flexibility in choosing which structural credit risk model to use, member firms are concerned that this could: (i) lead to different underwriters coming to different conclusions on the availability of an exception from Regulation M based on which credit model they use; (ii) contribute to inefficiencies, confusion and dissension among distribution participants; and/or (iii) lead to accusations that firms are engaged in results-oriented "cherry picking" of the models they use (even though the selected model for a particular deal may be dictated by other considerations, including the preferences of the lead underwriter or issuer).

The complexity of the proposed probability of default calculations would also create a heightened risk for errors and impose additional regulatory burdens. Indeed, the complexity of the calculations appears to be driving the proposed new recordkeeping requirement for broker-dealers relying upon the exception, a requirement that could be avoided if the rule used a simplified standard that was readily verifiable through publicly available information. These same complexities and associated risks and burdens could also drive more deals to the private markets – *e.g.,* as Rule 144A transactions, with or without registration rights – where the distribution participants and issuer would be able to rely upon the "Rule 144A" exceptions under Rules 101 and 102, respectively. This result would be contrary to the SEC's objective of encouraging public offerings registered under the Securities Act of 1933, as amended ("Securities Act").

2. <u>SIFMA's Proposed Alternative Exception</u>

In light of the foregoing concerns and in furtherance of the core objectives previously identified, SIFMA recommends that proposed Rule 101(c)(2)(i) be amended to except from the prohibitions of Rule 101: "nonconvertible debt securities and nonconvertible preferred securities that are offered pursuant to an effective registration statement filed on: (i) Form S-3 (17 CFR 239.13); (ii) Form S-4 (17 CFR 239.25); (iii) Form F-3 (17 CFR 239.33); (iv) Form F-4 (17 CFR 239.34); or (v) Form F-10 (17 CFR 239.40), *provided that* in the case of an offering registered on Form F-10, the offering also meets the transactional requirements of General Instruction I.B.2. of Form F-3."

The use of this standard is desirable because, among other things, it would: (i) provide a straightforward, uniform standard that is familiar to both issuers and distribution participants alike; (ii) align with how the SEC addressed the DFA-related removal of references to investment grade ratings from the eligibility criteria for use of the Securities Act forms;[11] (iii) promote the conduct of offerings on a registered basis by limiting the exception to qualifying registered offerings; (iv) afford predictability and facilitate planning around the offering process; (v) avoid complex calculations that could lead to errors or differing results, depending upon the particular structural credit risk model used; (vi) allow the availability of the exception to be readily and independently verified through a review of the issuer's EDGAR database filings, which would minimize additional regulatory burdens and obviate the need for any additional broker-dealer recordkeeping obligations; (vii) ease the burden on *all* involved – not only SIFMA member firms but also the examination and enforcement staff of the SEC and SROs; and (viii) provide greater legal certainty to the affected issuers and any selling securityholders.

Prior to 2011, Forms S-3 and F-3 included a transactional eligibility requirement permitting issuers to register Nonconvertible Securities on these forms if the securities were rated investment grade by at least one NRSRO (*i.e.*, the same criteria as apply under the current investment grade exceptions under Regulation M). Following the 2011 DFA-related amendments eliminating the forms' references to credit ratings, under General Instruction I.B.2, the forms are now available to register primary offerings of Nonconvertible Securities if:

- the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) at least $1 billion in non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act, over the prior three years; or
- the issuer has outstanding (as of a date within 60 days prior to the filing of the registration statement) at least $750 million of non-convertible securities, other than common equity, issued in primary offerings for cash, not exchange, registered under the Securities Act; or
- the issuer is a wholly-owned subsidiary of a well-known seasoned issuer ("WKSI") as defined in Rule 405 under the Securities Act; or
- the issuer is a majority-owned operating partnership of a real estate investment trust ("REIT") that qualifies as a WKSI.[12]

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11 *See* SEC Release No. 33-9245, 76 FR 46603 (August 3, 2011) (*available at* https://www.sec.gov/rules/final/2011/33-9245fr.pdf).

12 *See* General Instruction I.B.2. to Forms S-3 and F-3. Of course the issuer would also need to satisfy the registrant eligibility requirements identified in General Instruction I.A. to the forms. It is worth noting that the SEC twice prior to revising the Form S-3 and F-3 eligibility standards proposed to replace the forms' transactional investment grade rating eligibility criteria with a WKSI-related standard (*i.e.,* "non-convertible securities to be offered for cash by or on behalf of a registrant, provided the registrant, as of a date within 60 days prior to the filing of the registration statement . . . has issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the [Securities] Act"). *See* SEC Release No. 33-8940, 73 FR 40106 (July 11, 2008) and SEC Release No. 33-9186, 76 FR 8946 (February 16, 2011). However, commenters (including SIFMA) criticized the approach as unnecessarily restrictive, and the SEC ultimately adopted the more flexible standard summarized above. *See* SEC Release No. 33-9245, 76 FR at 46605 (August 3, 2011).

In adopting this new standard, the SEC concluded that it would capture a universe of issuers substantially similar to those previously eligible under the investment grade standard. Specifically, based upon a review of Nonconvertible Securities issued in the United States from January 1, 2006 through August 15, 2008, the SEC estimated that only four companies that had previously been eligible to use Forms S-3 and F-3 would be ineligible under the revised standard, as adopted. It also estimated that only 16 issuers that had previously used Form S-1 would become newly eligible to use Form S-3 and Form F-3. Thus, the SEC estimated that the new S-3/F-3 standards "would result in a net increase of 12 additional issuers becoming eligible to use Form S-3 and Form F-3."[13]

In connection with the DFA-related amendments to the transactional eligibility requirements for Forms S-3 and F-3, the SEC also made conforming amendments to Forms S-4 and F-4. Specifically, the SEC amended the eligibility criteria in General Instruction B.1(a)(ii)(B) to Forms S-4 and F-4 to include Nonconvertible Securities offered pursuant to such forms where "the requirements of General Instruction I.B.2. of Form S–3 [or Form F-3, in the case of a registrant seeking to use F-4] have been met for the securities to be registered on this registration statement."[14]

In addition, and although Form F-10 does not itself incorporate the transactional eligibility criteria of General Instruction I.B.2. to Form F-3, SIFMA believes the exception in Rule 101(c)(2)(i) should, as it is today, be equally available to Canadian issuers that register their Nonconvertible Securities offerings on Form F-10. To this end, and to align eligibility for the exception to the Form S-3/F-3 criteria, SIFMA recommends that the exception also include Nonconvertible Securities offerings pursuant to an effective registration statement filed on Form F-10, *provided that* the offering also meets the transactional requirements of General Instruction I.B.2. of Form F-3.

Rules 101 and 102 of Regulation M govern securities offerings that rise to the level of a Regulation M "distribution," and the criteria for satisfying the investment grade exceptions to Rules 101 and 102 are the same as those that were previously applicable under the investment grade transaction eligibility requirements for Forms S-3 and F-3. Beyond the consistency and clarity the Form S-3/F-3 standard would afford, SIFMA believes the use of this standard for purposes of Regulation M is logical and would appropriately capture a universe of Nonconvertible Securities generally comparable to those that are currently eligible under the investment grade exception.

While this standard would admittedly allow some amount of high yield issuers to be eligible for the exception, SIFMA believes that this an acceptable compromise in light of the benefits the standard otherwise affords, as outlined above. In particular, SIFMA prefers the S-3/F-3 standard over both the previously proposed WKSI standard, as well as the currently proposedly probability of default standard, because it provides greater flexibility while remaining

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[13] SEC Release No. 33-9245, 76 FR at 46609 (August 3, 2011); *see also* SEC Release No. 33-9186, 76 FR at 8950 n.58 (February 16, 2011) (discussing the methodology used by the staff in conducting its review).

[14] *See* General Instruction B.1(a)(ii)(B) to Forms S-4 and F-4; *see also* SEC Release No. 33-9245, 76 FR 46603 (August 3, 2011).

a straightforward standard that is readily and independently verifiable. If the standard is too complex or restrictive it is likely to drive Nonconvertible Securities offerings to the private (*e.g.,* Rule 144A) market, a result that would be contrary to the SEC's objectives.

Nonetheless, to the extent the SEC believes the Form S-3/F-3 standard, alone, is too permissive for purposes of Regulation M, SIFMA proposes the following alternatives, in order of preference:

a. <u>Form S-3/F-3 Standard With Certain Additional Conditions</u>

If the SEC believes the Form S-3/F-3 standard would be too permissive on its own, SIFMA would recommend that the exception *not* be available for Nonconvertible Securities that meet the S-3/F-3 standard if the terms of those securities include both (i) a "limitation on restricted payments covenant" and (ii) a "limitation on sales of assets and subsidiary stock covenant." These two covenants are typically associated with non-investment grade debt securities and are almost never used in investment grade debt securities. The addition of this condition should serve to exclude most of the issuers who, although not previously eligible to rely on the investment grade exception, might otherwise be picked up by the S-3/F-3 standard. For this purpose, SIFMA would propose that these terms be defined as follows:

- "Limitation on restricted payments covenant" means a covenant or undertaking that expressly restricts an issuer [or guarantor][15] from paying dividends or making similar distributions on its equity capital stock (or similar equity securities, in the case of a non-corporate issuer [or guarantor]), unless (i) certain financial and other conditions are satisfied or (ii) one of a limited set of specified exceptions to the restriction is applicable. A covenant or undertaking that incidentally or indirectly has the effect of restricting any such payment, but that does not expressly provide for such restriction, shall not constitute a limitation on restricted payments covenant.

- "Limitation on sales of assets and subsidiary stock covenant" means a covenant or undertaking that expressly restricts an issuer [or guarantor] from selling assets, including the capital stock of subsidiaries, unless (i) certain specified conditions are satisfied, including receipt of fair value and application of proceeds, or (ii) one of a limited set of specified exceptions to the restriction is applicable. A covenant or undertaking that incidentally or indirectly has the effect of restricting any such sale, but that does not expressly provide for such restriction, shall not constitute a limitation on sales of assets and subsidiary stock covenant.[16]

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15 The exact language of the covenant definitions will depend upon how the SEC staff defines certain terms, including "issuer."

16 For examples of detailed covenant language, see "Model Negotiated Covenants and Related Definitions," by the Committee on Trust Indentures and Indenture Trustees, ABA Section of Business Law, published in The Business Lawyer, Aug 2006, Vol 61, No. 4 beginning at p. 1439 ("Limitation on Restricted Payments" begins at p. 1509, and "Limitation on Sales of Assets and Subsidiary Stock" begins at p. 1518). For the avoidance of doubt, the definition of "Limitation on Sales of Assets and Subsidiary Stock" for the Regulation M exception should not be read to apply to separate covenants that address merger and consolidation. *See, e.g.*, *id.* (the discussion of "Merger and Consolidation" begins at p. 1537).

SIFMA believes that incorporating this additional covenant-based condition to the Form S-3/F-3 exception should substantially reduce, if not eliminate altogether, the extent to which non-investment grade debt issuances would be eligible for the exception.

b. Modified Version of the Previously Proposed WKSI Standard

In 2008, the SEC proposed to replace Regulation M's exception for investment grade-rated Nonconvertible Securities with an exception that would require the issuer of the Nonconvertible Securities to meet the requirements of a WKSI, as defined in Rule 405 under the Securities Act, but only if such issuer also meets the requirements of paragraph (1)(i)(B)(*1*) of that definition.[17] In other words, the exception would have been limited to WKSIs that, as of a date within 60 days of the applicable determination date, have "issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the [Securities] Act." In addition, by virtue of paragraph (iii) of the WKSI definition, the proposed exception would have been unavailable to any distribution participant engaged in a distribution of Nonconvertible Securities of an "ineligible issuer," regardless of the underlying basis for ineligibility and any related nexus to the principles upon which Regulation M's investment grade exception is based.

In revisiting the SEC's 2008 proposal in light of the DFA and the SEC's current Proposal, SIFMA believes a modified version of the 2008 proposal would be preferable to the currently proposed probability of default standard,[18] although substantially less desirable than the Form S-3/F-3 standard previously discussed. In particular, SIFMA believes the previously proposed WKSI standard is overly restrictive by (i) placing undue emphasis on the aggregate principal amount of non-convertible securities the issuer has issued over the previous three years, and (ii) rendering the exception unavailable in connection with any distribution of Nonconvertible Securities of an ineligible issuer. Neither of these criteria have any direct bearing on whether the securities of such issuer trade "on the basis of their yields and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation."[19]

SIFMA believes the Form S-3/F-3 standard is more appropriate because it recognizes several different means of qualifying under the transactional requirement, only one of which is

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17 *See* 2008 Reg M Proposal, 73 FR 40088 (July 11, 2008).

18 SIFMA previously criticized the SEC's 2008 proposal to replace the investment grade exceptions with a WKSI standard. *See* Letter from Deborah A. Cunningham and Boyce I. Greer, Co-Chairs of the SIFMA Credit Rating Agency Task Force, to Ms. Florence E. Harmon, Acting Secretary of the SEC (Sept. 4, 2008) (*available at* https://www.sec.gov/comments/s7-17-08/s71708-13.pdf) and Letter from Sean C. Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Ms. Elizabeth M. Murphy, Secretary of the SEC (December 8, 2009) (*available at* https://www.sec.gov/comments/s7-17-08/s71708-26.pdf). However, that proposal predated the DFA. In the intervening years and because retaining the existing investment grade exceptions is no longer an option, SIFMA has revisited the prior proposals.

19 *See* Reg M Adopting Release, 62 FR at 527. This fundamental principle dates back to a 1975 no-action letter. Proposal, 87 FR at 18315 (citing Letter from Robert C. Lewis, Associate Director, Division of Market Regulation, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975)).

based upon the aggregate principal amount of non-convertible securities issued over the preceding three years. Nonetheless, if the SEC prefers a WKSI-based standard over SIFMA's preferred Form S-3/F-3 standard, we would recommend that the SEC, at a minimum, modify the previously proposed WKSI standard so that the exception is also available to: (i) a WKSI that meets paragraph (1)(i)(A) of the WKSI definition (*i.e.*, a WKSI that, as of a date within 60 days of the applicable determination date, has a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of $700 million or more); and (ii) a non-WKSI to the extent it is carved out of the WKSI definition solely by virtue of the application of clauses (1)(v), (vi) or (ix) of the definition of "ineligible issuer" under Securities Act Rule 405. These so-called "bad actor" criteria for ineligible issuer status have no bearing on whether the securities of such issuer trade "on the basis of their yields and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation."[20]

c. <u>Modified Version of the Currently Proposed Probability of Default Standard</u>

If the SEC insists on moving forward with a probability of default standard that uses a structural credit risk model, SIFMA strongly recommends that the SEC modify the exception to: (i) specify a particular structural credit risk model to be used by all parties, thereby ensuring uniformity and consistency in analysis and application across the industry; (ii) increase the probably of default percentage to capture the maximum amount of issuers eligible under the current investment grade exception, erring on the side over-inclusion (*e.g.,* a probability default standard of at least 0.5%); and (iii) similar to the approach taken with respect to ADTV calculations, permit the probability of default calculations to be made within 10 calendar days prior to the pricing of the offering, thereby affording distribution participants adequate time to adjust their market activities as necessary.

In particular, and for the reasons previously discussed, SIFMA believes it is important for the exception to use a single, uniform standard to be applied in all circumstances. This would help avoid: (i) different underwriters coming to different conclusions on the availability of an exception from Regulation M based on which credit model they use; (ii) inefficiencies in connection with the offering process, including confusion and dissension among distribution participants; and (iii) accusations that firms are engaged in results-oriented "cherry picking" of the models they use (even though the selected model for a particular deal may be dictated by other considerations, including the preferences of the lead underwriter or issuer).

In addition, SIFMA is concerned that the proposed 0.055% probability of default standard (which is estimated to capture only approximately 90% of the securities currently eligible for the investment grade exception)[21] is too restrictive. As previously noted, SIFMA believes the proposed new exceptions should be crafted to capture as many of the securities covered under the existing investment grade exceptions as possible. To this end, and while SIFMA generally disfavors the use of a probability of default standard, we would, at a minimum, recommend that any exception be based upon a 0.5% probability of default standard, which

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20 *See* Reg M Adopting Release, 62 FR at 527.
21 Proposal, 87 FR at 18330.

(according to the SEC's data and calculations) should capture approximately 98.6% of the securities currently eligible for the investment grade exception.[22]

Finally, we note that requiring the probability of default calculations to be made as of the date of pricing is unworkable and could delay the pricing of an offering in the case of a re-opening (*e.g.*, if the calculations fall short of the defined standard). It would be very damaging to the issuer to launch a re-opening, subsequently determine that there is no exception under the probability of default calculation, and then have to extend the pricing of the offering by at least one (or five) business days. This would not only significantly chill investor confidence but would also expose the issuer to at least one (or five) business day(s) of market risk. Therefore, if the SEC moves forward with a probability of default standard, the calculations should, at a minimum, be permitted to be made within a specified duration of time in advance of pricing (*e.g.*, within 10 days prior to pricing, such as used for ADTV calculations) in order to provide adequate time to adjust any market activities (and to timely submit any necessary Regulation M-related notifications, to the extent applicable).

B. The Proposed Alternative Exception for Asset-Backed Securities (Proposed Rule 101(c)(2)(ii))

Noting that the eligibility requirements for Form SF-3 were designed to "help ensure a certain 'quality and character' in light of the requirement to reduce regulatory reliance on credit ratings,"[23] the SEC is proposing to replace the exception for investment-grade rated asset-backed securities with a proposed new exception in Rule 101(c)(2)(ii) for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3.

SIFMA appreciates the straightforward nature of the Form SF-3 standard, which allows all interested parties to easily determine whether the exception is available and supports its adoption. As discussed above, SIFMA recommends that the SEC adopt a similarly straightforward and uniform standard for Nonconvertible Securities.

C. Proposed New Recordkeeping for Broker-Dealers Relying on the Nonconvertible Securities Exception Under Proposed Rule 101(c)(2)(i)

The SEC is proposing a new recordkeeping requirement for broker-dealers under Exchange Act Rule 17a-4. Specifically, proposed new Rule 17a-4(b)(17) would require broker-dealers relying on the Nonconvertible Securities exception in Rule 101(c)(2)(i) to maintain a record of the written probability of default determination required by the rule. The record would be required to be maintained for at least three years, the first two in an easily accessible place. The Proposal notes that the proposed new requirement is intended to aid the SEC and SROs in their oversight of broker-dealers that are distribution participants or affiliated purchasers and relying on the exception. The SEC is not proposing any new recordkeeping requirements associated with reliance on the proposed new asset-backed security exception, presumably

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22 Proposal, 87 FR at 18334.

23 Proposal, 87 FR at 18321 (*citing* SEC Release No. 34-72982 (September 4, 2014) (Regulation AB II Adopting Release) (*available at* https://www.sec.gov/rules/final/34-38067.txt)).

because the appropriateness of reliance is readily discernible from the SEC's own records and the availability of an issuer's EDGAR database filings.

SIFMA is not in favor of the proposed "probability of default" standard under proposed Rule 101(c)(2)(i) and would strongly encourage the SEC to adopt a more uniform, straight-forward approach, similar to that used for asset-backed securities under proposed Rule 101(c)(2)(ii). In particular, SIFMA recommends the use of a Form S-3/F-3 standard. Using such a standard would have the added benefit of obviating the need for any additional broker-dealer recordkeeping obligations, as the availability of the exception (similar to that asset-backed securities under Rule 101(c)(2)(ii)) would be readily and independently verifiable through a review of the issuer's EDGAR database filings.[24] As previously noted, the adoption of a straight-forward and independently verifiable standard, without the need for additional recordkeeping requirements, would ease the burden on *all* involved — not only SIFMA member firms but also the examination and enforcement staff of the SEC and SROs. Consistent with its recommended approach under Rule 101(c)(2)(i), SIFMA therefore believes that the adoption of additional broker-dealer recordkeeping obligations should be unnecessary.

Finally, even if the SEC were to move forward with a probability of default standard, SIFMA does not believe that additional specific recordkeeping requirements are warranted. SIFMA member firms are already subject to extensive recordkeeping requirements and understand that they will need to be prepared to defend their reliance upon the exception. To this end, firms should continue to have flexibility in determining the precise nature and types of records they make and retain for such purpose, just as they do for purposes of the various other exceptions to Rule 101 of Regulation M.

D. Proposed Elimination of the Investment Grade Exception Under Rule 102(d)(2)

In lieu of proposing an alternative standard of creditworthiness under Rule 102(d)(2), the SEC instead is proposing to simply eliminate the investment grade exception to Rule 102. Although the SEC does not identify any specific concerns regarding issuers' (and selling security holders') historical reliance on the investment grade exception, the SEC reasons that elimination of the exception is appropriate, based upon an unsupported assertion that these parties have less need for an exception and a greater incentive to manipulate.

SIFMA disagrees with the SEC's proposed approach. As the SEC notes in the Proposal, Section 939A of the DFA requires the SEC to, among other things, remove any references to credit ratings from its regulations and to instead "substitute in such regulations such standard of credit-worthiness" as the SEC determines to be appropriate. In the absence of any evidence of historical abuse associated with reliance upon the investment grade exception to Rule 102, SIFMA believes the SEC should retain a counterpart exception under Rule 102(d)(2), applying the same standards as used for purposes of the exceptions under Rule 101(c)(2). Indeed, the continued availability of such an exception would be important to broker-dealers that are

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[24] This would appear to also be true if the SEC were to move forward with a modified version of the S-3/F-3 standard or a WKSI-related standard.

affiliated with an issuer but that are not, for whatever reasons, serving as an underwriter or other participant in connection with the distribution.

III. CONCLUSION

SIFMA appreciates the opportunity to comment on the Commission's proposed amendments to Rules 101 and 102 of Regulation M. We respect the pressure Section 939A of the DFA places upon the SEC and support the efforts to identify a workable alternative. SIFMA believes, however, that the considerations identified in Section I must remain paramount. In particular, it is essential that the proposed exceptions be based on a uniform, predictable and straightforward standard that is independently verifiable and not susceptible to different outcomes.

Consistent with these objectives, SIFMA reiterates its recommendation to replace the "probability of default" standard in proposed Rule 101(c)(2)(i) with the substantially more straightforward standard of Nonconvertible Securities offered pursuant to an effective registration statement on Form S-3, Form S-4, Form F-3, Form F-4 or Form F-10, provided that for Nonconvertible Securities registered on Form F-10, the offering also meets the transactional requirements of General Instruction I.B.2. of Form F-3. This standard is familiar to issuers and distribution participants alike, would better align with the approach taken under proposed Rule 101(c)(2)(ii) of Regulation M with respect to asset-backed securities (as well as the approach taken under the Securities Act), would afford greater predictability, simplicity and objectivity in connection with the offering process and would further the SEC's objective of encouraging the conduct of offerings on a registered basis. The straightforward nature of the standard would also obviate the need for any additional broker-dealer recordkeeping requirements and would ease the burden on all involved, including the examination and enforcement staffs of the SEC and SROs.

SIFMA appreciates your consideration of our views and would welcome the opportunity to further discuss our comments with the SEC staff if it would be helpful to do so.

Sincerely,

Joseph P. Corcoran

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Securities Industry and Financial Markets Association
Managing Director & Associate General Counsel

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The Hon. Allison Herren Lee, Commissioner
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