

May 23, 2022

Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-0609

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

Dear Ms. Countryman,

We are officers of the International Institute of Law and Finance (“IILF”),<sup>1</sup> a non-profit, non-partisan institution dedicated to promoting independent research, academic papers, teaching, discussion, and public policy initiatives in law and finance. Our comments relate to Release No. 34-94499 (the “Proposed Rules” or the “Release”), the proposed rules on removal of references to credit ratings from Regulation M, a set of prophylactic anti-manipulation rules prohibiting activities that could “artificially influence the market for an offered security.”<sup>23</sup> We thank the Commission for the opportunity to comment on the Proposed Rules.

At the outset, we applaud the Commission for its efforts to remove references to credit ratings from securities regulation. This specific Release relates to the “Investment Grade Exceptions” in Rules 101 and 102 of Regulation M.<sup>4</sup> These exceptions reflect the Commission’s view that credit-worthiness is “a good proxy for manipulation risk since securities issued by firms with sound credit-worthiness trade primarily on yield and maturity and not on issuer-specific characteristics that may increase pricing uncertainty.”<sup>5</sup> Currently, these exceptions reference credit ratings, and with this Release, the Commission has taken an important step by re-proposing amendments<sup>6</sup> to remove these references.<sup>7</sup> The Release is part of the Commission’s

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<sup>1</sup> See <https://iillawfin.org> for a description of our mission and our role. As described more fully on the IILF website, we receive compensation for our IILF activities, including drafting this letter.

<sup>2</sup> Release, at 7. Regulation M is “designed to preserve the integrity of the securities markets as independent pricing mechanisms.” *Id.*

<sup>3</sup> See *id.*

<sup>4</sup> These exceptions apply to securities rated investment grade by at least one nationally recognized statistical rating organization (“NRSRO”). See Release, at 3.

<sup>5</sup> Release, at 64.

<sup>6</sup> The Commission has previously considered rules to remove credit ratings references in 2008 and 2011, but neither proposal was adopted. See Release, at 8-14.

<sup>7</sup> The Release is focused on eliminating the “Investment Grade Exceptions” from Rules 101 and 102, which include “exceptions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are rated by at least one NRSRO, as that term is used in Rule 15c3-1 under the Exchange Act, in one of its generic rating categories that signifies investment grade.” See Release, at 6.

broader effort to comply with Section 939A of the Dodd-Frank Act, which requires removal of references to credit ratings in regulations.<sup>8</sup>

Specifically, we support the Commission's proposal to replace the current "Investment Grade Exception" for nonconvertible securities covered by Rule 101 with an alternative standard of credit-worthiness based on the probability of default of an issuer. Below we provide some details regarding the bases for our support, and we address some of the Commission's questions about the alternative standard based on probability of default. We also support the Commission's proposal to eliminate the "Investment Grade Exception" in Rule 102 and not replace it with an alternative standard. We see removal of credit ratings without providing an alternative standard as a viable approach in some scenarios. However, we do not support a new exception in Rule 101 for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3.<sup>9</sup> We explain our reasoning below.

We want to emphasize two overarching points in response to several questions and comments in the Release. First, we agree with the Commission that the estimated probability of default of a debt security is and should be a central component of the analysis of the credit risk (along with expected return in the event of default and, when relevant, default correlation). These factors, not credit ratings, should be the focus of sound regulatory policy, just as they are factors for good investment policy. The Commission's proposed use of probability of default in the Release is an important shift in the right direction.

Second, we believe market participants are capable of reliably estimating probability of default, not only using the "structural credit risk models" referenced in the Release, but also using other statistical models, as well as market measures of credit risk, including debt security prices and yields, credit spreads, and, to the extent they are available, other credit risk measures such as credit default swap spreads. We encourage the Commission in its final rules to reference market measures of credit risk as part of the estimation of probability of default.<sup>10</sup>

The Commission's previous efforts to remove references to credit ratings faced opposition from some market participants. To the extent certain market participants assert that they are not able to reliably estimate the probability of default on a debt security using any of a variety of statistical models and market measures, that inability is strong evidence that the security should not fall within an exception to Regulation M.<sup>11</sup>

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<sup>8</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 780). For a discussion of the Dodd-Frank reforms related to credit rating agencies, see Aline Darbellay & Frank Partnoy, *Credit Rating Agencies under the Dodd-Frank Act*, 30 BANKING & FINANCIAL SERVICES POLICY REPORT 1, 2 (2011); Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATION LAW (Claire A. Hill & James L. Krusemark eds. 2012).

<sup>9</sup> See Release, at 17.

<sup>10</sup> To the extent the Commission views market measures as potentially too volatile or potentially manipulable, an approach such as a rolling average of market measures is a promising alternative.

<sup>11</sup> It could also be evidence that those market participants are not in a position to trade or hold that specific security.

We understand that the Release is limited to Regulation M, but we are encouraged by the Commission’s focus on probability of default as an alternative estimate that can and should be referenced more broadly as the Commission continues to comply with the Dodd-Frank Act’s requirement to remove references to credit ratings. We are also heartened by the Commission’s broader work on compliance with Congressional mandates, including those in the Dodd-Frank Act. As the Commission states, “[t]he economic benefit of the proposed amendment is that it may contribute to the Dodd-Frank Act goals of reducing perceived government endorsement of NRSROs and over-reliance on credit ratings by market participants in Regulation M by removing the relevant reference to credit ratings.”<sup>12</sup>

## **Background**

As the Release notes in its economic analysis, the exceptions to Regulation M are based on credit-worthiness. The Commission sensibly views securities with low credit risk as also having low manipulation risk.<sup>13</sup> More broadly, the Release articulates what has been empirically demonstrated for decades: estimated probability of default is a superior measure of credit-worthiness than letter ratings provided by for-profit organizations.

It is worth pausing briefly to describe historically how the Commission arrived at the decision to defer to credit rating agencies with respect to credit-worthiness distinctions, particularly those that turn on whether securities are rated “investment grade” (meaning a rating category of BBB/Baa or higher). This kind of regulatory reliance on credit rating agencies has a long history, dating back to the mid-1970s, when the Commission began creating “regulatory licenses”—essentially “licenses” to comply with regulation—by referencing credit ratings in various ways, a practice that led to credit ratings becoming simultaneously more profitable and less informative.<sup>14</sup> The binary “investment grade” determination has proven especially pernicious, and has been a significant part of financial market inefficiencies for decades. This history underscores the wisdom of the Release.

Long before credit ratings became infamous in popular culture following the financial crisis of 2008, academics have recognized that regulatory reliance on credit ratings distorts the securities markets.<sup>15</sup> Before the introduction of regulation that referenced credit ratings, the

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<sup>12</sup> Release, at 71.

<sup>13</sup> See Release, at 63 (“Such issues were presumed to have low probability of default and were thus considered to have low pricing uncertainty and low manipulation risk.”).

<sup>14</sup> See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 628-36 (1999). The decline in the informational value of credit ratings was associated with the increase of regulatory licenses: as credit ratings became more important in regulation, they became less important for informational purposes.

<sup>15</sup> See, e.g., GILBERT HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE: AN APPRAISAL OF THEIR EFFECTIVENESS 6 (1938) (discussing the history of credit ratings and the increased reliance on ratings in the aftermath of the 1929 market crash); W. BRADDOCK HICKMAN, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE (1958) (analyzing default rates based on different ratings categories); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. at 628-36 (1999) (discussing the early academic literature on credit rating agencies). See Frank Partnoy, *What’s (Still) Wrong with Credit Rating Agencies*, 92 WASH. L. REV. 1407 (2017) for a broader discussion.

credit rating business was small and relatively unprofitable.<sup>16</sup> The paradox of the growth of credit ratings has been that as they became increasingly important, they declined in informational value.<sup>17</sup> Credit ratings also played a central role in the creation of complex asset-backed financial instruments, including both cash and synthetic collateralized debt obligations, or CDOs.<sup>18</sup> Throughout this time, credit rating agencies have relied on crude mathematical models to generate letter ratings that did not accurately account for key risks, including, as noted above, probability of default, expected recovery in the event of default, and default correlation.<sup>19</sup>

As government investigations ultimately found, the credit rating agencies were central villains in the financial crisis. For example, the Financial Crisis Inquiry Commission called the ratings agencies “key enablers of the financial meltdown.”<sup>20</sup> The U.S. Senate Permanent Subcommittee on Investigations concluded: “Inaccurate AAA credit ratings introduced risk into the U.S. financial system and constituted a key cause of the financial crisis.”<sup>21</sup> The Commission

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<sup>16</sup> See Partnoy, *Siskel and Ebert*, 77 WASH. U. L.Q. at 636-48.

<sup>17</sup> See Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 61 (Brookings Institution Press 2006, Yasuyuki Fuchita and Robert E. Litan, eds.). Scholars have long been skeptical about whether credit ratings have informational utility. See, e.g., Valentin Dimitrov, Darius Palia, & Leo Tang, *Impact of the Dodd-Frank Act on Credit Ratings*, 115 J. FIN. ECON. 505, 506 (2015) (finding that after the Dodd-Frank Act credit rating agencies issued lower ratings, gave more false warnings, and issued downgrades that were less informative); Robert J. Rhee, *Why Credit Rating Agencies Exist*, 44 ECON. NOTES 161, 171 (2015) (arguing that credit rating agencies produce little new information, but simply play a sorting function); Mark J. Flannery, Joel F. Houston, & Frank Partnoy, *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2087 (2010) (documenting that credit default swap spreads incorporated information significantly more quickly than credit ratings).

<sup>18</sup> See Partnoy, *How and Why*, at 73-80. For earlier descriptions of the risks associated with highly-rated CDOs, see FRANK PARTNOY, *INFECTIOUS GREED: HOW RISK AND DECEIT CORRUPTED THE FINANCIAL MARKETS* 374-92 (2003) (warning about abuses in credit default swaps and CDOs and concluding that CDOs “posed even greater dangers to the global economy”); Comments of Frank Partnoy, Proposed Rule, Definition of Nationally Recognized Statistical Rating Organization, Release Nos. 34-51572, IC-26834, File No. S7-04-05, Jun. 9, 2005; Testimony of Frank Partnoy, Hearings before the United States House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, “Legislative Solutions for the Rating Agency Duopoly,” Jun. 29, 2005.

<sup>19</sup> See Partnoy, *How and Why*, *supra* note 13, at 78 (concluding that the “credit rating agencies are providing the markets with an opportunity to arbitrage the credit rating agencies’ mistakes” and that “[t]he problems with how CDO pricing models incorporate various measures of correlation among assets are even more troubling.”).

<sup>20</sup> FIN. CRISIS INQUIRY COMM’N, FINANCIAL CRISIS INQUIRY REPORT xxv (2011) (“We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.”).

<sup>21</sup> PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 6 (2011).

and the President’s Working Group on Financial Markets reached similar conclusions.<sup>22</sup> Again, it is worth reflecting on this history to underscore the importance and centrality of the Dodd Frank Act’s requirement that federal agencies replace regulatory references to credit ratings with “appropriate” substitutes.<sup>23</sup>

Notwithstanding the above recognition of how reliance on credit ratings in regulation has distorted the financial markets, it has proven difficult for the Commission to remove references to credit ratings.<sup>24</sup> Notably, the Commission has tried to remove references to credit ratings in Regulation M twice, first in 2008 and again in 2011. Both attempts generated opposition, and no viable alternatives. As the Release describes, the comments on these previous proposals were overwhelmingly from law firms and industry trade groups, and in particular, not from academics, who regrettably did not submit their views.<sup>25</sup> This comment letter, and IILF’s founding more generally, is intended to at least partially correct the previous absence of academic commentary on such important issues. With respect to earlier proposals, commentators emphasized the importance of bright-line standards, and, with this emphasis unrebutted, the Commission did not adopt rules based on either proposal. Instead, for more than a decade, the Commission did not comply with Dodd-Frank with respect to Regulation M. Fortunately, the Commission now seeks with this Release to comply with the requirements of Dodd-Frank, this time sensibly putting estimates of the probability of default at the center of its Proposed Rules.

### **Probability of Default as an Alternative to Credit Ratings**

With respect to nonconvertible securities, the Commission proposes to replace the NRSRO reference currently included in Rule 101(c)(2) with a standard utilizing a specified probability of default threshold based on “structural credit risk models.”<sup>26</sup> The Commission defines the term “structural credit risk model” for purposes of the proposed exception in Rule 101(c)(2)(i) as meaning 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.

We agree with the Commission that the expected probability of default can be independently determined by structural credit risk models based on observable market events and information available on a firm’s balance sheet, without reliance on an investment grade credit rating by an NRSRO. As the Release notes, “[p]robability of default can be used to identify securities that trade based on their yield and high credit-worthiness, similar to the

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<sup>22</sup> See U.S. SEC. & EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 12 n.8 (2008); THE PRESIDENT’S WORKING GROUP ON FIN. MKTS., POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1 (Mar. 2008).

<sup>23</sup> Dodd-Frank Act § 939A(a)(1)-(2), (b).

<sup>24</sup> It also continues to be difficult to resist making references to credit ratings. For example, although credit ratings were not explicitly included in Rule 2a-7’s definitions, the Commission more recently adopted a new requirement that a fund’s board disclose NRSRO ratings on Form N-MFP under certain circumstances. See SEC Form N-MFP Items C.10, 14-16 (referencing NRSRO ratings).

<sup>25</sup> See Release, at 10-14.

<sup>26</sup> Release, at 18.

Nonconvertible Securities that are excepted based on the existing Investment Grade Exception, and thus would be less susceptible to the manipulation that Rule 101 is designed to prevent.”<sup>27</sup>

However, we do believe the Commission should be wary of hardwiring structural credit risk models, or indeed any specific type of model, in its rules. As the Release notes, “Structural Credit Risk Models typically take the issuer balance sheet measures of debt obligations as given and estimate a probability of default based on the market value and volatility of the firm’s equity.”<sup>28</sup> But balance sheet measures are frequently inaccurate, and comparisons of market values to book values are subject to concerns about “garbage in, garbage out.” As the Release notes, there are other models, including “reduced-form models” that can be used to derive probability of default without using balance sheet inputs.<sup>29</sup>

In practice, market participants use a variety of statistical models to assess probability of default. It would be risky for the Commission to engage in “model preferencing,” as has been the case in some instances with respect to value-at-risk measures. Requiring a particular type of model could create a different category of “regulatory license,” potentially distorting the behavior of market participants in their estimations of probability of default, and discouraging further and alternative inquiries into the probability of default.

The Commission notes that “the use of a bright-line test, such as a probability of default of 0.055% as discussed below, should address the concern of some commenters that the exception will impose new costs and delays in the offering process and reduce the attractiveness of registered offerings.”<sup>30</sup> For example, the Release states: “Under the proposed amendment to Rule 101, the exception would be available to the Nonconvertible Securities of issuers for which the probability of default, estimated as of the day of the determination of the offering pricing and over the horizon of 12 calendar months from such day, is less than 0.055%, as determined and documented in writing by the distribution participant using a Structural Credit Risk Model.”<sup>31</sup> We believe the stated probability of default thresholds are in a reasonable range, but as described below, we believe it is not necessary to state a precise bright-line measure.

The Commission further states that “[a]n exception for asset-backed securities that is based on a probability of default threshold may be unfeasible due to the potential widespread inability of distribution participants and their affiliated purchasers to collect all of the information required to calculate the probability of default, such as the value and volatility of the assets underlying asset-backed securities.”<sup>32</sup> Here, we disagree. We believe market participants are able to estimate probability of default for these securities, not only using statistical models, but also based on market measures such as credit spreads. Asset-backed securities are traded

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<sup>27</sup> Release, at 23.

<sup>28</sup> Release, at 66.

<sup>29</sup> The Commission suggests that these alternative models “lack in rigorous theoretical justification as well as economic interpretation of the resulted relationships between the model inputs.” Release, at 23 n.77.

<sup>30</sup> Release, at 24.

<sup>31</sup> Release, at 25 (footnotes omitted).

<sup>32</sup> Release, at 36.

widely and have frequently quoted prices and credit spreads. It is straightforward to calculate probability of default based on these market measures.

The Release asks: “Should the Commission adopt an exception based on either the probability of default standard for Nonconvertible Securities or asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3 for Rule 102 instead of removing the Investment Grade Exception without substituting an alternative?”<sup>33</sup> To the extent the Commission receives comments that market participants on their own cannot make decisions and judgments about credit risk related to Rule 102, we believe an exception based on probability of default would be a viable alternative.

The Release asks: “Would a probability of default standard be appropriate for the exception for asset-backed securities? Are there models used to calculate a probability of default threshold (e.g., reduced-form models or structural models of credit risk) for asset-backed securities that would be relevant to consider based on the type of security involved? If so, what threshold should be included in the exception to Rule 101 for asset-backed securities? What benefits would this approach provide? What other concerns could this approach raise? How would this approach address potential conflicts of interest involving the distribution participant or affiliated purchaser?”<sup>34</sup> In our view, a probability of default standard is appropriate for asset-backed securities. Indeed, a probability of default standard based on market measures would have indicated that the exception to Regulation M no longer applied for certain debt securities during the months leading up to the collapse of Lehman Brothers in September 2008, and available data show that, if such a market measure-based standard had been in place, the exceptions to Regulation M would not have been available for debt securities as early as fall 2007.<sup>35</sup>

Finally, with respect to Rule 102, the Commission states that the existing exception should be eliminated without replacement.<sup>36</sup> We agree that this approach is appropriate in contexts where deference arguably should be made to independent decisions and judgment by market participants, without the crutch of reliance on credit ratings. In certain areas, it is appropriate to require market participants to make such decisions and judgments.

### **Other Alternatives**

The Commission calibrates the proposed probability of default threshold based on a 90th percentile estimate.<sup>37</sup> We suggest that instead the Commission reference more flexible alternatives in any final rules. For example, the probability of default threshold could vary annually on an ongoing basis depending on a similar analysis of more recent data going forward.

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<sup>33</sup> Release, at 47-48.

<sup>34</sup> Release, at 43.

<sup>35</sup> See Flannery, Houston & Partnoy, *Credit Default Swap Spreads*, 158 U. PA. L. REV. at 2087.

<sup>36</sup> Release, at 45.

<sup>37</sup> “The Commission calibrated the 0.055% threshold in the sample of nonconvertible fixed income securities so as to capture approximately 90% of the investment grade securities in our sample of nonconvertible fixed income securities (2436 distinct investment grade issues with probability of default below 0.055% out of 2710 total investment grade rated issues in the sample).” Release, at 68.

The Commission could peg the annual probability of default threshold based on an analysis of a sample of securities from the previous year.

As noted above, we also recommend that the Commission use market measures of credit risks, including yield to maturity and credit spreads as alternative approaches in the estimation of probability of default.<sup>38</sup> One of the stated advantages of the offered alternatives to credit ratings in the Release is the use of current estimates of value and volatility, estimates that are captured by market measures of credit risk as well.<sup>39</sup> Consistent with this finding, the Commission also could publish, or require publication of, default probability estimates that market participants derive from various models, along with default probabilities implied by both market prices and credit default swap spreads (to the extent those are traded for a particular issue). These estimates could be published not only for point estimates at a particular time, but also as rolling averages of default probabilities during a specified period of time (e.g., three months to one year). Accordingly, instead of one precise measure of probability of default, the measure could vary within a range.

We note that any final rules governing asset-backed securities also could reference expected recovery in the event of default and default correlation. One approach would be simply to require that in order to obtain an exception market participants would need to determine and document a conclusion that the credit risk associated with a security was “minimal” (or some other similar standard) based on these variables, without any requirement that they use a particular model. For example, the Release states that structural credit risk models are not appropriate for asset-backed securities,<sup>40</sup> and under the proposed rules some asset-backed securities would become ineligible to rely on the exception to Regulation M.<sup>41</sup> One alternative for such scenarios would be an exception based on market measures, which could be documented in the same way as would be required by the Release for estimated probability of default for other securities.

Finally, we note that including market measures of credit risk as potential alternatives could generate additional benefits while reducing costs. The Release notes that using probability of default could generate benefits from competition.<sup>42</sup> Final rules that reference market measures

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<sup>38</sup> The Commission states that an alternative would be to consider security characteristics, such as the “yield to maturity of the security during a past trading period.” Release, at 83.

<sup>39</sup> See Release, at 68-69 (“An advantage of using probabilities of default implied by Structural Credit Risk Models instead of NRSRO credit ratings is that these model-implied probabilities of default generally use current estimates of equity valuation and volatility, and hence incorporate most recent news affecting the valuation and perceived volatility of the firm. In contrast, credit rating agencies are generally slower than the market in updating credit ratings and outlooks and thus may reflect less up-to-date information.”).

<sup>40</sup> See Release, at 70 (“Under the proposed amendments, the Structural Credit Risk Models cannot, as a practical matter, apply to asset-backed securities due to the complexity of the structure of such instruments.”).

<sup>41</sup> See Release, at 78.

<sup>42</sup> For example, the Release states that “widely available estimates of the probability of default as well as an option of internal model estimation could lead to a more competitive environment as the requirement to rely on proprietary credit risk models of a small number of NRSROs is removed. The improved competition, market participation and efficiency ultimately should lead to more efficient capital formation as the access to and functioning of the relevant fixed income markets improves.” Release, at 80.



of credit risk could further increase such benefits. In addition, the likely compliance costs would be lower for a range of probability of default estimates, including estimates based on market measures of credit risk, as opposed to compliance costs associated with a requirement that market participants use only structural credit risk models.<sup>43</sup>

We thank the Commission for its consideration of our comments.

Respectfully,

/s/ Robert E. Bishop

Robert E. Bishop  
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UC Berkeley School of Law  
Center for Law and Business

/s/ Frank Partnoy

Frank Partnoy  
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<sup>43</sup> For example, the Commission estimates that annually distribution participants would spend nearly \$6.5 million each to comply with certain of the requirements. *See* Release, at 73.