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20 December 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934--File No. S7-15-11

Dear Ms. Murphy:

CFA Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal, "Removal of Certain References to Credit Ratings Under the Securities Act of 1934" (the "Proposal"). As we have indicated in prior letters, we support SEC action to amend requirements that expressly rely on the attainment of certain credit ratings.[2]

CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

In keeping with our past positions on securities rules that require certain ratings, we support efforts by the Commission to delete requirements in the Securities Exchange Act

[1] CFA Institute is a global, not-for-profit professional association of nearly 106,100 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom nearly 97,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

[2] See, e.g., letter from Kurt N. Schacht, CFA and Linda Rittenhouse to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission, *References to Credit Ratings in Certain Investment Company Act Rules and Forms* (File No. S7-07-11 (July 13, 2011).

Charlottesville Hong Kong London

560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA

434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

of 1934 that depend on obtaining the ratings of nationally recognized statistical rating organizations ("NRSROs").

Our support is based on the belief that statutory and regulatory requirements for a wide swath of the financial sector to rely on credit ratings created significant market distortions. Some investment firms saw the requirements as permitting them to outsource their investment due diligence to the NRSROs, regardless of their track records and without legal ramifications. The requirements also gave the NRSROs a captive market regardless of the quality of their ratings.

We also support increased disclosure requirements by investment firms about the basis of their investment decisions in lieu of the statutory and regulatory requirements to use credit ratings of an NRSRO.

Proposed Rule 15c3-1 Amendments

As noted below with respect to specific proposals, we support the new credit risk weighting structures that are being proposed to address counterparty risk (in lieu of specific credit ratings). However, we are concerned that use of these weightings alone do not adequately address the potential concentrations of risk with specific counterparties or those operating within the same business segment of industry. We encourage the Commission to address this area in its final rule.

Proposed Exceptions in Regulation M (Rules 101 and 102)

We support the proposed standards (as a replacement of reliance on credit ratings) as sufficiently designed to deter the type of manipulation that Regulation M seeks to prevent. While we support the use of third-party verifiers to review the determinations made by those relying on the exceptions, we encourage adding measures intended to increase the accountability of such verifiers.

Proposed Amendments to Rule 10b-10

We have concerns about the proposed approach that would no longer require broker-dealers to notify their customers that certain securities are unrated. We believe that such notification serves to encourage investors to evaluate the securities in which they are investing without undermining the overall intent to eliminate *reliance* upon ratings bestowed by NRSROs. We thus recommend that the requirement be retained.

Discussion

The SEC is directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") to remove references to credit ratings in the Securities

Exchange Act of 1934 (Exchange Act) and to substitute appropriate standards of creditworthiness. Through this proposal, the SEC is proposing those new standards.

In addition, Dodd-Frank has directed that references to credit ratings in Exchange Act sections 3(a)(41) (defining "mortgage-related security") and 3(a)(53) (defining "small business-related security") be deleted, with both areas needing to satisfy standards of creditworthiness by July 21, 2012—two years after enactment of the Act. The SEC is now seeking guidance on the approaches it should take.

I. Amendments to Rule 15c3-1 and Certain Appendices

A. Rule 15c3-1 (Net Capital Rule)

The Net Capital Rule sets the capital requirements that broker-dealers must maintain by performing two calculations: (1) computation of required minimum net capital; and (2), a computation of actual net capital. In performing the calculations, broker-dealers have been assessed certain "haircuts" for investment securities which are inversely based on the ratings given by at least two NRSROs. For example, commercial paper rated in one of the three highest rating categories received discounts of between zero percent and one-half of one percent. Nonconvertible debt securities received smaller discounts of between 2 percent and 9 percent, and preferred stock would be discounted 10 percent if these securities were rated in one of the four highest ratings.

The SEC is now proposing to provide a 15% haircut[3] on positions in all three of these categories unless broker-dealers establish, maintain and enforce policies and procedures to assess the liquidity and credit risks applicable to a security and that the investment "has only a minimal amount of credit risk." To make this assessment and claim a lower haircut, the proposal notes that broker-dealers "could consider" the following factors:

- Credit spreads;
- Securities-related research;
- Internal or external credit risk assessments;
- Default statistics;
- Inclusion on an index;
- Priorities and enhancements;
- Price, yield and/or volume; and
- Asset class-specific factors.

[3] The 15% haircut is the percentage applicable to most equity securities. For securities that do not have a ready market, the haircut is 100%.

We support the elements provided on this list, but we do not believe it includes everything that should be considered as part of a credit assessment. Given that this proposal deals with securities having different maturity schedules, we suggest that "term to maturity" be added to this list of factors. We believe that an assessment of the maturity, duration and other related risk factors is an important and necessary approach in evaluating the potential credit risk of a security.

We also believe that firms should consider the concentration of credit risk in the portfolio. While such issues may be relevant only in extreme market conditions, a concentration of risk with a specific issuer, industry or industry sector could amplify the effects of risk beyond what might occur in a more fully diversified portfolio and therefore could warrant a larger discount.

Finally, we are concerned that firms will take advantage of this leeway to apply lower "haircuts" to instruments than may be justified without a benchmark such as an NRSRO rating. Without verification, we fear that these firms will artificially ascribe low haircuts to certain instruments, thus allowing these firms to increase leverage and contribute to a systemically dangerous situation. Therefore, we urge the Commission to include provisions that ensure the internal risk calculations used by these firms are transparent to both regulators and the market. Firms should have to justify through these disclosures their haircut determinations by comparing them with external ratings such as NRSRO ratings, market data (such as yields and credit default swap data for similar instruments), or other recognized sources of credit information.

B. Amendments to Appendix A to Rule 15c3-1

Pursuant to Appendix A, broker-dealers will receive better treatment for their proprietary positions in "major market foreign currency" options than for other currencies. However, currently Appendix A references short-term debt in one of the two highest categories by at least two NRSROs in defining "major market foreign currency," which the Proposal seeks to remove. Instead, the definition would be modified to include only foreign currencies "for which there is a substantial inter-bank forward currency market."

We agree that the proposed definition is sufficient to allow broker-dealers to determine what currencies are "major market foreign currencies." More importantly, the existence of a substantial inter-bank forward currency market indicates market interest and the existence of market oversight and thus provides a strong indication of market sentiment about the quality of currencies within that definition.

Nevertheless, we encourage consideration of distinguishing between “major market foreign currencies” and all other currencies as helpful. We also suggest creation and publication of a list of major market foreign currencies based on the proposed definition, realizing that this list may need periodic updating. We believe that this approach will add a degree of clarity for providing the provisions of Appendix A.

C. Amendments to Appendix E to Rule 15c3-1

Appendix E essentially allows broker-dealers to use an alternative method for computing capital (alternative net capital or “ANC”) under which they must deduct net capital credit risk charges that take counterparty risk into consideration. The SEC is now proposing to eliminate language in Appendix E that refers to NRSRO ratings in counterparty risk determinations. Instead broker-dealers would have to apply a credit risk weight of 20%, 50%, or 150% with respect to exposures to counterparties based on internal credit rating calculations made by broker-dealers (a process they are already allowed to do under Appendix E). Broker-dealers who are applying to use ANC for the first time would have to seek approval of their methodologies from the SEC.

In general, we are supportive of the new risk weighting structure included in the Proposal. Such a structure recognizes that no two counterparties are the same and therefore may fall into different risk categories.

However, we are concerned about two issues. First, it does not consider the potential concentration of risk with a specific counterparty, or with a number of counterparties operating in the same business segment or industry. As noted above in our response to Rule 15c3-1 with regard to net capital, we are concerned that concentrations of risk within categories of counterparties or with individual counterparties may have the effect of amplifying problems that may develop. Consequently, we believe the Commission should consider ways to adjust such risk weightings on the basis of the concentrations of risk within certain categories.

Second, we are concerned that firms will take advantage of this leeway to apply low risk weights to all but the most illiquid and unmarketable of instruments. Therefore, we urge the Commission to include provisions that verify the internal risk calculations used by these firms are appropriate and recognizes the relevant risks of specific holdings. Without verification, we fear that these firms will artificially ascribe low risk weightings, thus allowing these firms to increase leverage and contribute to a systemically dangerous situation. To achieve this verification, firms should have to justify their internal ratings both to the Commission and in market disclosures by comparing them with external ratings such as NRSRO ratings, market data (such as credit default swap data for similar instruments), or other recognized sources of credit information.

D. Amendments to Appendix F to Rule 15c3-1

Similar to Appendix E, Appendix F allows OTC derivatives dealers an alternative approach for computing net capital deductions and applies certain counterparty factors (20%, 50% or 100%), based on either NRSRO ratings or the firm's internal credit ratings. Also in this case, dealers approved under Appendix F already are permitted to base their credit risk charges on internal credit ratings and have developed non-NRSRO models for calculating market and credit risk. The Proposal would eliminate references to NRSRO ratings and make conforming changes to the General Instruction to Form X-17A-5, which is the basic financial and operational report that OTC dealers must file with the SEC.

We suggest that the SEC apply counterparty factors along the lines of what is proposed for Appendix E to Rule 15c3-1 (e.g., 20%, 50% or 150% risk weights based on internal credit ratings to determine capital deductions). As noted above, we believe these risk weightings also should consider risk concentrations with specific counterparties or with different counterparties operating in the same business segment or industry. Also, we believe it unnecessary to consider requiring OTC derivatives dealers that have already been approved to use the Appendix to reapply to use internal credit ratings.

As noted above with regard to Appendix E, we believe these firms should have to justify their internal ratings through disclosure and comparison with external data sources. These could include NRSRO ratings, market yields, credit default market data, or other data from recognized and respected sources.

II. Exceptions for Investment Grade Nonconvertible and Asset-Backed Securities in Rules 101 and 102 of Regulation M

The goal of Regulation M is to maintain the integrity of the pricing of securities by deterring activities that would artificially influence the market. Rules 101 and 102 of Regulation M prohibit issuers, selling security holders, distribution participants and affiliated purchasers from purchasing or bidding for a covered security until after the applicable restricted period has passed. These rules currently provide exceptions for nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities with "investment grade" ratings.

To eliminate references to credit ratings per Dodd-Frank directives, the SEC is now proposing new standards for these exceptions that attempt to make these securities resistant to the type of manipulation that Regulation M seeks to prevent. The proposal would allow these securities exceptions from Rule 101 and 102 without needing an investment grade rating 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 spreads.

A firm relying on the Rule 101 and 102 exceptions would also have to obtain independent third-party verification to provide a check on the reasonableness of that determination.

The SEC believes that the current application of Rules 101 and 102 to debt securities is very limited and wonders if the exceptions afforded by these rules should even be continued for debt securities and asset-backed securities.

In response to questions raised in this release, absent a compelling reason, we see no reason why the exceptions from Regulation M should be removed altogether. Instead, we support the proposed new standards for the exemptions, as they appear to be reasonably focused at preventing the types of manipulation that the regulation seeks to deter. With respect to the third-party verifier, we do encourage measures aimed at increasing the accountability of such verifiers, such as possibly requiring such entities to register with the SEC in some capacity.

In keeping with that objective, we recommend that with regard to asset-backed securities, the determination that the securities meet the proposed standards be made by the depository or some other independent person in a similar position. This will inject a measure of objectivity/reliability that other alternatives may not.

III. Proposed Amendments to Rule 10b-10

Rule 10b-10 (customer confirmation rule) requires broker-dealers to provide customers with written notification at or before completion of a securities transaction, with certain information including date, time, identity and number of securities bought or sold, capacity in which the broker-dealers acted, yields on debt securities, compensation broker-dealer receives, etc.

A section of Rule 10b-10 requires broker-dealers to inform their customers if any securities, other than government securities, are unrated by an NRSRO. The intention of this section was to alert customers about the need for obtaining more information on the securities from the broker-dealers. The SEC is proposing to delete this requirement.

We have some concern about the investor protection concerns raised by the proposal to delete notification to investors that a security is unrated. Given that the types of securities that are unrated by NRSROs typically include small offerings, such a change may no longer signal to investors any need to investigate the quality of the securities being purchased.

Consequently, we recommend retaining the requirement in this instance. Merely notifying customers that securities are unrated does not undermine the objective of proposals to eliminate or reduce *reliance* upon the ratings. Specifically, retaining this requirement will alert investors that more investigation is warranted.

IV. Requests for Comment on Section 939(e) of Dodd-Frank

A. Exchange Act Section 3(a)(41) (Definition of Mortgage Related Security)

In this section of the Securities Act of 1933, Congress had defined a “mortgage-related security” as part of the Secondary Mortgage Market Enhancement Act (the “Mortgage Act”). The Mortgage Act sought to encourage private sector involvement in the secondary mortgage market by relaxing burdens affecting the selling of mortgage-backed securities by private-label issuers. This section defines a mortgage-related security as a “[s]ecurity that is rated in one of the two highest rating categories by at least one [NRSR0]” as a way to define which mortgage-related securities would qualify for the relaxation of filing requirements under the Act.

Before eliminating the existing references to credit ratings and proposing replacement standards, the SEC is asking for comments on potential alternatives.

One alternative the Commission is considering is to apply the “minimal amount of credit risk” standard that is being proposed with respect to the Net Capital Rule (see discussion above). One possible tension with this approach is that nonconvertible debt and preferred stock currently must be rated in one of the four highest rating categories to qualify under the Net Capital Rule, while a mortgage-related security that meets the definition in section 3(a)(41) requires a rating in the two highest rating categories.

From the investors' perspective, a more valuable metric for determining which bonds to include in this category of mortgage-related securities and one that should be disclosed to the market would be the weighted-average FICO score for the component loans in each pool, combined with a distribution of FICO scores. Such metrics would enable investors not only to determine the overall credit scores for borrowers in the pools, but also to recognize whether the loans in the pools are tightly compacted around that weighted-average, or widely dispersed. Ultimately, this information will provide a more objective picture of the quality of the loans in the pools while at the same time helping investors determine whether the implied objective of the "minimal amount of credit risk" standard is achieved.

B. Exchange Act Section 3(a)(53) (Small Business Related Security)

In this section of the Securities Act, Congress had defined "small business-related" securities as part of the Riegle Community Development and Regulatory Improvement Act of 1994 (the "Small Business Acts"). The Small Business Acts removed limitations on purchases of certain small business-related securities by national banks in order to increase access to capital for small businesses. Under the current law, small business-related securities must receive ratings in one of the four highest rating categories to qualify for benefits under the legislation.

Before proposing standards for determining creditworthiness to replace the reliance on credit ratings, the SEC is seeking public comment on viable approaches. One alternative it is considering is to apply the "minimal amount of credit risk" standard that is being proposed with respect to the Net Capital Rule.

With respect to objective measures that could be used to determine whether securities qualify as mortgage-related securities or small business-related securities, we suggest consideration of the following factors:

- Average loan-to-value for borrowers in secured borrowings
- Term to maturity of the security
- Regional concentrations of loans within the pools
- Loan category concentration of loans within the pools, such as loans secured with either commercial or residential real estate, commercial and industrial loans, or small business credit card loans

- Average debt-to-equity ratios for the loan pools supporting small business-related securities
- Guarantees for bond guarantors

We believe these additional factors will provide a more complete and useful picture in determining whether an offering of small business-related securities should benefit from inclusion in the category established by the Small Business Acts. In particular, this information will enable investors to make a more thorough assessment of the quality of the securities of interest, and the quality of the loan pools supporting the securities.

Conclusion

We recognize the challenges of replacing references to credit ratings with standards that adequately ensure the creditworthiness of instruments in question and generally agree with the approach taken in this proposal. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda L. Rittenhouse at linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht
Managing Director, Standards and
Financial Market Integrity
CFA Institute

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Director, Capital Markets Policy
CFA Institute