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Submitted via rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.W.
Washington, D.C. 20549-1090

Re: Release No. 34-64352 (File No. S7-15-11)

Ladies and Gentlemen:

This letter is submitted in response to the request for comments published by the Securities and Exchange Commission (the "Commission" or "SEC") in SEC Release No. 34-64352 (April 27, 2011) (the "Proposing Release"), with respect to proposed amendments to rules and forms under the Securities Exchange Act of 1934 (the "1934 Act") that would remove references to credit ratings by rating agencies (the "Proposal"). This rulemaking is mandated by Section 939A of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which requires that the SEC "remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness" as the SEC "determines to be appropriate for such regulations." This letter focuses solely on the proposed amendments to the exceptions provided for "investment grade nonconvertible and asset-backed securities" included in Rules 101 and 102 of Regulation M (the "investment grade securities exceptions").[1]

I. Background

In 2008, the SEC proposed to replace the investment grade securities exceptions in Rules 101(c)(2) and 102(d)(2) of Regulation M with an exception tied to non-convertible debt and preferred securities issued by a well-known seasoned issuer (a "WKSI") that, within the preceding three years, had issued at least $1 billion aggregate principal amount of such securities for cash in registered primary offerings (the "2008 Proposal").[2] As cited in footnote 65 of the Proposing Release, the Committee on Federal Regulation of Securities of the Section of Business

[1] Rules 101(c)(2) and 102(d)(2) provide exceptions for "Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are rated by at least one nationally recognized statistical rating organization, as that term is used in Rule 15c3-1 of the Securities Act, in one of its generic rating categories that signifies investment grade . . . ."

[2] Release No. 34-58070 (July 1, 2008); 73 FR 40088 (July 11, 2008).

Law of the American Bar Association (the "ABA") submitted a comment letter dated October 10, 2008 (the "2008 ABA Comment"), which opposed the SEC's 2008 Proposal because the proposed standard failed to track the qualities of securities resistant to manipulation as effectively as the current nationally recognized statistical rating organization ("NRSRO") rating-based standard, would impose the prohibitions of Regulation M on previously excepted investment grade rated securities that historically have proven to be less vulnerable to manipulation, and would create a new exception that would be available to issuers of high yield securities that are arguably more vulnerable to possible manipulation. The ABA strongly urged the SEC at that time to retain the current exceptions.[3]

However, in comparison to the current Proposal, I believe it preferable that the SEC adopt the 2008 Proposal as a more objective and workable standard with far fewer regulatory burdens. Nonetheless, I agree with the 2008 ABA Comment that the 2008 Proposal should be adopted only as an alternative to the investment grade securities exceptions.[4]

II. The Current Investment Grade Securities Exceptions Should Be Retained

The Commission should retain the current investment grade securities exceptions for the reasons described at pages 3-10 of the 2008 ABA Comment and incorporate by reference herein the ABA's detailed analysis of the effectiveness of the operation of the investment grade securities exceptions. In addition to the fact that the credit ratings by NRSROs have operated effectively and efficiently for some 36 years to distinguish offerings of debt, preferred and asset-backed securities that do not require the protections of Regulation M,[5] the credit rating process has been improved through the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act of 2006"), which established a registration and oversight program for NRSROs through self-executing provisions added to the Securities Exchange Act of 1934 (the "1934 Act") and implementing rules adopted by the Commission under the 1934 Act, as amended by the Rating Agency Act of 2006.[6]

Moreover, a number of provisions of the Dodd-Frank Act required reforms to NRSRO practices (*e.g.*, Title IX, Section 932 of Dodd-Frank requires NRSROs to make more extensive disclosures of their rating methodology, including estimates of probability of default and expected loss in the event of default) and, under Section 939B, imposed new liability on NRSROs and new standards related to controls on conflicts of interest. Pursuant to Title IX of Dodd-Frank, the SEC most recently on May 18, 2011 issued Release No. 34-64514 requesting comment on, among other things, whether to adopt rules that would prescribe factors an NRSRO must take into consideration

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[3] 2008 ABA Comment, at 16.

[4] 2008 ABA Comment, at 17.

[5] The staff's position on investment grade rated debt securities was first published in the *American Telephone and Telegraph Co.*, SEC No-Action Letter (Avail. Feb. 26, 1975). The staff's no-action position was later codified in the first adoption of SEC Rule 10b-6 in 1983. As stated in the 2008 ABA Comment, "[t]he Commission has not cited any precedent from the preceding 33 years that would suggest that the Commission's original rationale, carried forward in Rules 101 and 102 of Regulation M, was in any way unjustified

[6] See Pub. L. No. 109-291 (2006).

with respect to its internal control structure, proposing a new rule and form that would apply to providers of third-party due diligence services for asset-backed securities, and proposing amendments to existing rules and a new rule that would implement a requirement added by the Dodd-Frank Act that issuers and underwriters of asset-backed securities make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

Given the considerable enhancements to the credit rating process adopted by Congress and implemented by the Commission since 2006, I believe that the investment grade securities exceptions should be retained since the NRSRO credit ratings operate in the context of Regulation M as a reliable means to identify a category of securities with after-market trading characteristics that are resistant to manipulation rather than as an indicator of quality to investors. In summary, this is to recommend that the SEC continue to retain the investment grade securities exceptions because:

1. the exceptions have proved effective for some 36 years in protecting investors from the manipulation that Regulation M is intended to address;

2. the exceptions appropriately identify those debt, preferred and asset-backed securities that are fungible with similar securities and that trade on the basis of yield and spread to comparable securities, which are, therefore, resistant to the manipulation that Regulation M is intended to prevent;

3. the rating is issued by an independent third-party NRSRO that has been qualified and approved by the SEC and the rating is issued pursuant to procedures approved by the SEC;

4. the rating is obtained prior to the commencement of the offering; and

5. the rating is a clear and objective standard of compliance for the issuer, underwriters and regulators, thereby avoiding inadvertent noncompliance with Regulation M and FINRA Rule 5190 (the FINRA Regulation M notification rule).[7]

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[7] Similarly, the presence of investment grade ratings for nonconvertible debt, preferred and asset-backed securities has operated effectively since the 1970s to identify a category of securities offering that is exempt from: (1) filing and pre-offering review of the underwriting terms and arrangements by the Financial Industry Regulatory Authority, Inc. ("FINRA") under FINRA Rule 5110(b)(7)(A) and (B) (although such offerings must nonetheless comply with the substantive requirements of that rule); and (2) the requirement for a "qualified independent underwriter" (a "QIU") to conduct due diligence in an offering with a conflict-of-interest under FINRA Rule 5121(a)(1)(C). One of the concerns regarding the SEC's Proposal is that if the Proposal is adopted, the SEC may instruct FINRA to propose similar changes to Rules 5110 and 5121 which would, for the reasons stated herein, be unworkable as a practical matter and, thereby, eliminate long-standing exemptions from the costs associated with FINRA filings and with the participation of another broker/dealer as a QIU. Since the Proposal would require assessment of the after-market, when such trading market develops, the underwriters would not know if either exemption is available at the time a public offering subject to Rule 5110 is required to be filed with FINRA (which is required within one business day after a filing with the SEC). Therefore, FINRA members would be required to file otherwise exempt

III. The SEC Has Authority to Retain the Investment Grade Securities Exemptions Under Section 939A of the Dodd-Frank Act

Under Section 939A of the Dodd-Frank Act, the Commission is required to "remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness" as the Commission determines to be "appropriate for such regulations."[8] It is unclear whether the "as appropriate" language reflects the intention of Congress that each agency retains some flexibility to continue to rely on credit rating standards in appropriate situations. As reflected in the statement in the Proposing Release, Congress explained that Section 939A of Dodd-Frank is designed "[t]o reduce the reliance on ratings."[9] This explanation appears to indicate that the SEC is only required to "reduce" rather than "eliminate" entirely all references to credit ratings.

Given the significant reduction in reliance on ratings that will be implemented as a result of the SEC's prior and current rulemaking proposals, I believe that the SEC has the flexibility under Section 939A of the Dodd-Frank Act to conclude that the only viable approach is to retain the investment grade securities exceptions for purposes of Regulation M. Moreover, since the reliance on credit ratings in the investment grade securities exemption is for the purpose of distinguishing the category of debt, preferred and asset-backed securities that are less prone to manipulation during the security distribution, rather than as a quality indicator to investors, I believe that the Commission has an adequate policy basis under Section 939A to conclude that the investment grade securities exception should remain unchanged "as appropriate" for such regulation.

IV. Proposal to Adopt a New Standard for the Exceptions

The Commission has proposed a three-prong test to replace the current investment grade securities exceptions, which would require that each person seeking to rely on the exception (*i.e.*, the issuer and each broker/dealer participating in the distribution of the offering) determine that the (1) market for the security will be liquid relative to the market for that asset class; (2) the security will trade in relation to general market interest rates and yield spreads; and (3) the security will be relatively fungible with securities of similar characteristics and interest rate yield spreads (the "three-prong test exception"). Moreover, an independent third party would be required to verify the determination of the persons seeking to rely on the three-prong test exception and the Commission has proposed that the third-party verifier meet the qualification standards established by FINRA for QIUs under FINRA Rule 5121.

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offerings for review and any offering subject to Rule 5121 would be required to include a QIU (unless another exemption is available in both cases).

[8] Section 939A(b) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.

[9] *See* footnote 4, Proposing Release, which cites *Joint Explanatory Statement of the Committee of Conference*, Conference Committee Report No. 111-517, to accompany H.R. 4173, 864-879, 870 (Jun. 29, 2010).

I believe that the concept of an exemption based on an assessment by the issuer and each participating broker/dealer, as well as by a third-party verifier, of the liquidity, relative trading characteristics, and issue fungibility present in the immediate after-market for a debt, preferred or asset-backed security as such market is initiated and during the same time period that the restrictions of Regulation M remain applicable to the participating broker/dealers, is inherently flawed in implementation, costly and unduly burdensome to the extent that I anticipate that no issuer or broker/dealer would or can, as a practical matter, rely on the proposed three-prong test exception. Therefore, the adoption of the proposed three-prong test exception would effectively eliminate the availability of an exception for the category of debt and asset-backed securities from Regulation M that historically have not been vulnerable to manipulation.

A more detailed analysis of the issues raised by the Proposal follows.

A. An Assessment of the Immediate After-Market for a Security Does Not Replicate the Basis for the Current Investment Grade Securities Exceptions

The Proposing Release explains that "[t] proposed standards are an attempt to codify the subset of trading characteristics of investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that make them less prone to the type of manipulation that Regulation M seeks to prevent."[10] The reason such investment grade rated debt, preferred and asset-backed securities trade on the basis of yield and spread to comparable investment grade rated securities and are generally fungible with other, similarly rated securities is <u>because</u> of the investment grade rating that the security issue has received from a NRSRO. It would be difficult for the participating broker/dealers distributing such securities to sell such securities at an artificially high price that is not related to the current price of other similar, previously-issued investment grade rated securities trading in the secondary market at the time of the securities offering. Thus, it is not the immediate after-market trading characteristics of the specific issue that create the basis for the exemption, but rather the investment grade rating that places the securities in the larger secondary market of other similar investment grade rated securities thereby making the issuer resistant to manipulation of the offering price during the distribution.

Therefore, despite the Commission's effort to adopt a standard in lieu of an investment grade credit rating, it is the assignment of such a credit rating that <u>causes</u> the securities to trade on the basis of yield and spread to comparable securities and to be generally fungible with other,

[10] Proposing Release, at 26559. It is not clear that market liquidity of the specific issue of debt, preferred or asset-backed securities was a rationale for the investment grade securities exceptions in terms of the concepts of "liquidity" as they apply to equity securities. The 2008 ABA Comment did not reference the liquidity of the specific security when the ABA stated "The Commission's consistent rationale for the current exceptions (and their predecessors) has been that investment grade securities trade on the basis of yield and spread to comparable securities, and are generally fungible with other, similarly rated securities." Rather, because investment grade rated securities with similar terms are generally fungible, the securities would have a more liquid market as part of the over-all relevant debt, preferred or asset-backed securities market even though the market for the specific debt, preferred or asset-backed security may not generally be considered highly liquid. Further, in many cases, debt, preferred and asset-backed securities are privately placed, which would limit liquidity to qualified institutional buyers and in any event trading would likely be less frequent than in the case of an exchange-listed debt instrument.

similarly rated securities. In other words, the investment grade rating is a reliable "predictor" of these trading characteristics because the rating causes traders in the market to trade the securities in the same manner as other investment grade rated securities trading in the secondary market with similar terms.

B. Assessment of Compliance a Regulation M Exception Should Not Be Made After the Trading Market Commences

The explanation of the three criteria of the three-prong test exception indicates clearly that the SEC anticipates that persons seeking to rely on the exception will be required to make a determination as to whether the exception is available based on after-market trading, while the distribution is continuing.[11] Therefore, at the time that the offering commences, none of the affected parties will know whether the offering is subject to a restricted period and, as a result, the participating broker/dealers would be required to comply with Regulation M during the distribution until after-market trading commences and the determination is made. Theoretically, once such after-market trading commences, the issuer, participating broker/dealers and the third-party verifier may determine that the exception is available. It is only subsequent to that point, not prior thereto, that the exception would be available for the remaining time of the distribution. Thus, the proposed three-prong test exception would operate in a manner unlike any other exception from Regulation M in that the availability of the exception cannot be determined prior to the commencement of the offering, is determined during the actual distribution, and is available only for that part of the distribution period remaining after the determination is made. This structure presents so much complexity and imposes such extensive burdens on broker/dealers and on FINRA in providing oversight of Regulation M compliance, that I must strongly urge the SEC to retain the current investment grade securities exceptions.

The SEC states in the Proposing Release that "The Commission preliminarily believes that persons seeking to rely on the exception would be able to objectively demonstrate these three standards were met."[12] I believe that an "objective" determination based on after-market trading while the participating broker/dealers remain subject to Regulation M would be difficult, time-consuming and costly and unlikely to result in sufficient data from the first or second day of after-market trading to permit the parties to rely on the exception in the short time period available for the determination. Further, the participating broker/dealers that would usually be market-makers in the security cannot bid for and purchase the security as they remain subject to Regulation M restrictions until the issuer and each participating firm, as well as a third-party verifier, determines that the exception is available. As a result, I believe it unlikely that any issuer or broker/dealer would assume the responsibility for a determination that requires an analysis of after-market trading characteristics based on immediate after-market market data.

It is logical to anticipate that the costs for each such entity for the conduct of the after-market analysis and the exposure to liability for a different determination by FINRA or

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[11] Proposing Release, at 26559 - 26561.

[12] Proposing Release, at 26560.

Commission staff far outweigh the benefits of the three-prong test exception. The costs of the issuer, each participating broker/dealer and the third-party verifier will be in addition to the costs of the issuer in obtaining a rating from a NRSRO, which the issuer would obtain in any event. Further, the costs will be multiplied by the number of broker/dealers participating in the offering, as each firm must make its own determination of the availability of the exception.[13] It can also be anticipated that the third-party verifier will charge a substantial fee for its services.[14]

In comparison, the investment grade credit rating issued by a third-party NRSRO is a reliable, objective and efficient means for the issuer and broker/dealers participating in a debt or asset-backed securities offering and the regulators to determine the availability of the exception from Regulation M prior to commencement of the offering, while also ensuring that offerings of less-than-investment grade debt, preferred and asset-backed securities are subject to oversight for compliance with the prohibitions of Regulation M. The cost of such rating is borne solely by the issuer.

C. The FINRA "Qualified Independent Underwriter" Criteria are Not an Appropriate Standard for the Third-Party Verifier

The Proposing Release solicits comment on whether the third-party verifier of the availability of the three-prong test exception should be required to comply with the criteria for a QIU under FINRA Rule 5121(f)(12). The QUI criteria were developed specifically to establish standards for independence and knowledge of a FINRA member that would assume responsibilities for the conduct of due diligence in the context of a public offering of securities to address the presence of conflicts of interest experienced by another participating FINRA member. Such criteria are, therefore, focused on the experience, knowledge and liability that is consistent with the QIU's responsibility to conduct due diligence with respect to the disclosure in the prospectus or other offering document, including that the QIU must assume Section 11 liability under the Securities Act of 1933 for the offering. The experience and knowledge requirements require that the QIU demonstrate prior experience underwriting offerings similar in size and type to the offering with the conflict-of-interest. Such experience and knowledge of the underwriting process (and, therefore, the applicable rules and regulations) and the requirement that the party assume Section 11 liability, while impressive, are unnecessary and irrelevant in the context of the assessment of the availability of an exception from Regulation M. Instead, the proposed three-prong test exception requires knowledge of the relevant debt, preferred or asset-backed trading market. In particular, it is unduly burdensome to impose underwriter liability on such third-party verifier for the entire offering of securities, whereas it can be argued that such liability is consistent with a QIU's responsibilities for due diligence in the context of an offering with conflicts-of-interest that are sufficient to trigger the application of FINRA Rule 5121.

[13] *See* discussion below of the costs associated with FINRA Rule 5190, the Regulation M notification form, and the FINRA Regulation M monitoring program.

[14] Unlike a QIU, which generally does not charge a fee for serving as a QIU when the FINRA member is already participating in the offering, it can be anticipated that the third-party verifier will charge a fee for its services.

D. Adoption of the Proposal Would Increase Regulatory Burdens for FINRA Members and FINRA Related to Compliance With FINRA Rule 5160 and With Respect to the FINRA Regulation M Monitoring Program

FINRA Rule 5190 requires that FINRA members notify FINRA no later than the business day prior to the first complete trading session of the applicable Regulation M restricted period for a listed or unlisted security that is a "covered security" under Regulation M. FINRA members are not currently required to file a notification under FINRA Rule 5190 in the case investment grade rated debt, preferred and asset-backed securities offerings since such offerings can rely on the investment grade securities exception from compliance with a restricted perios under Regulation M.

If the SEC were to adopt the Proposal, FINRA members will be required to file a notification under Rule 5160 for the investment grade rated debt, preferred and asset-backed securities offerings that previously would have been exempted from this requirement because the FINRA members will not know if the proposed three-prong test exception is available until the trading market commences in the security and, in any event, Regulation M will apply to participating FINRA members until such a determination is made.

FINRA's Market Regulation Department has a program to monitor compliance with Regulation M by reviewing over-the-counter trading and quoting activity for prohibited purchases, bids or attempts to induce bids or purchases during the applicable restricted periods. As FINRA points out in FINRA Regulatory 08-74 (December 2008) ". . . FINRA must receive pertinent distribution-related information in a timely fashion to facilitate this component of its Regulation M compliance program."[15] For those FINRA members that may endeavor to comply with the proposed three-prong test exception, I believe that the ability of FINRA to adequately monitor compliance with Regulation M would be subject to significant increased burdens and related costs since FINRA will not know at the time of that the market commences for the offering whether the offering is subject to a restricted period but will only be informed of the exception after trading commences in the securities through what I anticipate would have to be a second filing by FINRA members. Since Regulation M restrictions would apply to the participating broker/dealers' trading until the determination is made that the exception is available, oversight of the trading of such investment grade rated debt, preferred and asset-backed securities trading would be unnecessarily complex to deal with pre-exception and post-exception transactions as well as oversight as to the reliability of the claim of exception.

Regardless of whether FINRA members would rely on the proposed three-prong test exception in an offering, FINRA will be required to monitor compliance with Regulation M in offerings of investment grade rated debt, preferred and asset-backed securities, which oversight would not be required under the investment grade securities exception. Such increased regulatory burdens and costs on FINRA members in making Rule 5160 filings and on FINRA in monitoring compliance with Regulation M in investment grade rated offerings of securities are unnecessary

[15] FINRA Regulatory 08-74 (December 2008), at 2.

and provide no further protection to investors that is not already provided by the investment grade rating.

V. SEC Requests for Comments

Following are responses to certain of the specific requests for comment included in the Proposing Release. This letter addresses many of the other requests for comment in the above comment on the proposed three-prong test.

1. The application of Rules 101 and 102 of Regulation M to debt securities is very limited, as compared to Rule 10b– 6. The Commission is interested in comment as to whether and in what circumstances issuers, selling shareholders, distribution participants, and their affiliated purchasers rely on the current exception for investment grade securities (including with respect to specific activities) and, in particular, whether this exception serves a continuing purpose with regard to nonconvertible debt and asset-backed securities.

Response: I believe that the investment grade securities exceptions serve a continuing purpose in the case of best-efforts offerings of debt, preferred and asset-backed securities, which may be sold over several days, and in the case of a "reopening" of an outstanding class of debt securities.[16]

2. The Commission further solicits comment as to whether, if the application of Rules 101 and 102 of Regulation M to debt securities is in fact quite limited as a practical matter, the current investment grade exception should be eliminated or, alternatively, whether it should be expanded to except from Rules 101 and 102 all nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities (or some subset thereof).

3. How often are these exceptions utilized where no other exception from Rules 101 or 102 of Regulation M exists?

4. Should the Commission remove the exception from Rules 101 and 102 of Regulation M for nonconvertible debt securities, nonconvertible preferred securities, and/or asset-backed securities completely? Why or why not?

RESPONSE to 2-4: I believe that it is important that Regulation M continue to apply to those issuances of less-than-investment grade debt, preferred and asset-backed securities that trade in a manner that is more similar to equity because there is greater variation in the trading price in relation to securities of other issuers with similar characteristics and interest rate spreads. Such high-yield issuances are considered to be more vulnerable to possible manipulation, unless the offering is conducted in reliance on Rule 144A or Regulation S.

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[16] *See*, Johnson and McLaughlin, *Corporate Finance and the Securities Laws*, Aspen Publishers, Third Edition, at 661.

I appreciate the opportunity to submit these comments.

Very truly yours,

Suzanne Rothwell

Suzanne Rothwell
Managing Member