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Invested in America

By Electronic Mail To: rule-comments@sec.gov

July 5, 2011

Ms. 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; Release No. 34-64352; File No. S7-15-11 (the "Release")

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] welcomes this opportunity to comment on the amendments to rules and forms under the Securities Exchange Act of 1934 (the "Exchange Act") proposed by the Securities and Exchange Commission (the "Commission" or the "SEC") in the Release. The Commission proposed these amendments to implement Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[2] which requires federal agencies to review "any regulation . . . that requires the use of an assessment of the credit-worthiness of a security . . ." and to "modify any such regulations . . . 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." Section 939A also requires federal agencies "to establish to the extent feasible, uniform standards of credit-worthiness for use by each such agency. . ."

In order to implement Section 939A, the Release proposes to remove references to credit ratings in several Exchange Act rules: (i) Rules 101 and 102 of Regulation M, (ii) Rule 15c3–1, (iii) Rule 15c3–3 and (iv) Rule 10b–10. In addition, the Release requests comment on alternative standards of credit-worthiness for purposes of the definitions of "mortgage related security" and "small business related security" in Exchange Act Sections 3(a)(41) and (53) to replace the credit rating references deleted by Congress in Section 939(e) of the Dodd-Frank Act.

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. 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 www.sifma.org.

[2] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

Two of the proposals set forth in the Release are of particular interest to SIFMA.[3] The Release proposes to remove references to credit ratings from Rules 101 and 102 of Regulation M, which generally prohibit issuers, selling security holders and distribution participants from purchasing securities that are the subject of a distribution while that distribution is in progress. Rules 101(c)(2) and 102(d)(2) of Regulation M (the "Regulation M Exemptions") presently exempt non-convertible debt, non-convertible preferred stock and asset-backed securities from these purchase prohibitions if such securities are rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO"). The Release proposes to instead exempt such securities from the purchase prohibitions if the prospective purchaser determines the security in question satisfies certain tests intended to identify securities that are less prone to the type of market manipulation that Regulation M seeks to prevent. Such determination would be required to be subsequently verified by an independent third party.

In addition, the Release proposes to remove references to credit ratings in Exchange Act Rule 15c3–1(the "Net Capital Rule"), pursuant to which commercial paper and non-convertible debt and preferred stock qualify for reduced "haircuts" if they are highly rated and meet certain other criteria.[4] In place of the credit rating criteria, the Commission proposes to provide that a security would qualify for a lower haircut if a broker-dealer determines the security has only a "minimal amount of credit risk" based on written policies and procedures designed to assess credit-worthiness.

SIFMA's Credit Rating Agency Task Force (the "Task Force") has commented on similar SEC proposals with respect to the Regulation M Exemptions and the Net Capital Rule.[5] In its previous comment letters, the Task Force did not support elimination of credit ratings as eligibility criteria for purposes of the Regulation M Exemptions or the Net Capital Rule. We

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3 SIFMA endorses the Commission's proposed changes to Rule 15c3–3 and Rule 10b–10. We expect to comment on the standards of credit-worthiness for the Exchange Act definitions of "mortgage related security" and "small business related security" in a separate letter.

4 More specifically, Rule 15c3–1(c)(2)(vi)(E) permits broker-dealers to apply a reduced haircut to "any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, and which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and is rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations," Rule 15c3–1(c)(2)(vi)(F)(1) generally permits broker-dealers to apply reduced haircuts to "nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest and which are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations," and Rule 15c3–1(c)(2)(vi)(H) permits broker-dealers to apply reduced haircuts to "cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which is rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations and which are not in arrears as to dividends."

5 *See* Letter from Deborah A. Cunningham and Boyce I. Greer, Co-chairs, SIFMA Credit Rating Agency Task Force, to Florence E. Harmon, Acting Secretary, dated Sep. 4, 2008 ("SIFMA I"); and Letter from Sean C. Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Elizabeth M. Murphy, Secretary, dated Dec. 8, 2009 ("SIFMA II").

believed and continue to believe that credit ratings constitute a valuable component of a holistic credit risk and liquidity analysis. The input of an independent third party NRSRO provides an objective minimum floor for the subjective credit risk determinations of various market participants, thus enhancing the stability and conformity of such assessments and providing certainty to market participants as to whether their practices comply with Exchange Act rules.

We recognize, however, that Section 939A requires the Commission to remove references to credit ratings in its regulations to the extent such regulations require the use of an assessment of credit-worthiness, and to substitute standards of credit-worthiness as the Commission deems appropriate. In this regard, we appreciate the Commission's emphasis on fulfilling the mandate of Section 939A while simultaneously minimizing the extent to which the rule changes affect the scope of financial instruments covered by the relevant provisions of the existing rules or otherwise alter the actions of market participants.[6]

SIFMA reiterates the concerns expressed in its prior comment letters regarding the potential impact of replacing objective rules with standards premised on the subjective determinations of market participants. Such measures could result in considerable uncertainty on the part of market participants as to whether their assessments would be deemed to comply with the new rules. In our comments below, we suggest steps that could be taken to improve the subjective analysis required under the proposed amendments to the Net Capital Rule. We also suggest an alternative approach to determining eligibility for the Regulation M Exemptions based on objective factors.

## I. Removing References to Credit Ratings in Rules 101 and 102 of Regulation M (Market Manipulation Rules)

Regulation M generally prohibits issuers, selling security holders and distribution participants from purchasing securities that are the subject of a distribution while that distribution is underway. The current Regulation M Exemptions provide that non-convertible debt securities, non-convertible preferred securities, and asset-backed securities rated by at least one NRSRO as investment grade are not subject to such purchase prohibitions. This is premised on the belief that such investment-grade securities are less vulnerable to manipulation because they trade primarily on the basis of yield spread to comparable securities and are generally fungible with other similarly rated securities. As discussed below, the debt markets have

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6 *See*, *e.g.*, Release, 76 Fed. Reg. 26550, 26552 (May 6, 2011) (to be codified at 17 C.F.R. pts. 240, 242 and 249) ("The Commission, in proposing alternatives to credit ratings, is seeking generally to neither narrow nor broaden the scope of financial instruments that would qualify for the benefits conferred in the existing rules while, at the same time, fulfilling the statutory mandate in Section 939A of the Dodd-Frank Act."); *id*. at 26553-54 (discussing proposals related to Net Capital Rule: "any significant change in practice by broker-dealers, whether because of potential compliance costs, difficulties in applying the proposed criteria or minimal credit risk standard, or other factors, that results in a change in the general allocation of such securities in proprietary accounts could have unintended consequences. Accordingly, the Commission is interested in receiving comment on the potential impact of the proposed amendments on the capital markets generally, and on capital raising efforts by issuers of the affected types of securities specifically, and on how any potential effect could be mitigated or eliminated.").

evolved to such an extent that this rationale today supports extending Regulation M Exemptions eligibility to all non-investment grade debt securities.

The Commission proposes to implement Section 939A by attempting to "codify the subset of trading characteristics of investment-grade non-convertible debt securities, non-convertible preferred securities, and asset-backed securities, that make them less prone to the type of manipulation that Regulation M seeks to prevent."[7] The Release proposes that these fixed-income securities would be entitled to the Regulation M Exemptions if a person seeking to rely on the exemption determines that the securities: (i) are liquid relative to the market for that asset class; (ii) trade in relation to general market interest rates and yield spreads; and (iii) are relatively fungible with securities of similar characteristics and interest rate yield spreads. Those seeking to rely upon the exemption would further be required to obtain a verification of this determination by an independent third party.

In 2008, the Commission had proposed to remove references to NRSRO ratings from the Regulation M Exemptions and instead exempt non-convertible debt, non-convertible preferred stock and asset-backed securities of well-known seasoned issuers and asset-backed securities registered on Form S-3.[8] Many commenters, including SIFMA, opposed these changes in part because they would have altered the scope of issues and issuers entitled to the Regulation M Exemptions and because we believed that basing the exemptions on credit ratings was a superior approach.[9] However, now that the Dodd-Frank Act requires removal of references to credit ratings, we believe an approach that, like the Commission's 2008 proposal, employs objective standards used for other purposes in the marketplace is the best alternative to the current rule. We further believe an objective standard would fulfill the Commission's mandate under Section 939A while resulting in less market disruption and fewer burdens to market participants than the vague and subjective standards of the proposed rule set forth in the Release.

Determination of whether a security satisfies the criteria proposed in the Release is a highly subjective exercise that does not lend itself to clear answers. The absence of an objective rule would result in considerable uncertainty among market participants as to whether their subjective determinations would be deemed to comply with the new rules. The time required to conduct the subjective evaluation and obtain a third-party verification would also be inconsistent with the rapid turnaround that characterizes the modern fixed-income market. For these reasons, we do not believe persons seeking to rely on the Regulation M Exemptions would be able to demonstrate satisfaction of the standard in a sufficiently timely or certain manner. Consequently, we would expect adoption of the proposed standard to result in more offerings pursuant to Rule 144A ("Rule 144A") under the Securities Act, and thus exempt from Regulation M, which runs

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[7] *Id*. at 26559.

[8] *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, SEC Rel. No. 34-58070, 73 Fed. Reg. 40088 (July 11, 2008).

[9] *See, e.g.*, SIFMA I, 13-14.

contrary to the expressed goal to encourage the use of registered offerings that the Commission sought to achieve in connection with its 2005 reform of the securities offering process.[10]

Certain aspects of the proposed standard seem especially problematic. The Release does not define what constitutes an "asset class" for purposes of the proposed requirement that a security exempted from Regulation M be determined to be "liquid relative to the market for that asset class." This can only lead to a divergent application of the requirement as market participants each create their own class definitions. In addition, it seems that only half of any class of securities could qualify for the Regulation M Exemptions under the proposed standard due to the need to be liquid "relative to the market for that asset class." This would result in many investment-grade securities that are presently eligible for the exemption no longer being eligible if those securities were not as actively traded as other investment-grade securities, even though based on the Commission's own acknowledgment since 1975, such securities are not susceptible to manipulation.[11] Furthermore, the proposed liquidity standard would exclude widely followed securities that are currently eligible for the Regulation M Exemptions simply because they may trade infrequently relative to the market for their asset class, even though such securities are not particularly vulnerable to market manipulation because they trade based on general market interest rates and yield spreads. More generally, we believe that tests based on the trading activity of specific fixed-income securities are difficult to apply and would be unreliable indicators of whether a fixed-income security is susceptible to the sort of manipulation targeted by Regulation M because fixed-income securities of well-known issuers may not trade actively day to day.[12]

While Regulation M currently exempts a class of fixed-income securities based on its general characteristics, the proposed exemptions instead focus on the specific attributes of individual fixed-income securities. This represents a dramatic change that would negatively impact the conduct of market participants. Because the first part of the proposed test focuses solely on the liquidity of the individual security, certain offerings that currently qualify for the Regulation M Exemptions may lose eligibility.

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10 *See* Securities Offering Reform, SEC Rel. Nos. 33-8591; 34-52056; IC-26993; FR-75, 70 Fed. Reg. 44722, 94 (August 3, 2005) ("Providing flexibility for registered offerings may encourage issuers to raise capital through the registration process instead of through private placements.").

11 *See* Letter from Robert C. Lewis, Associate Director, the Division of Market Regulation, the Commission to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975). The Commission has indicated it seeks to avoid narrowing the scope of securities entitled to the Regulation M Exemptions. *See* Release, 76 Fed. Reg. at 26560 ("The Commission intends by this proposal generally to except the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2) without referencing credit ratings.").

12 We are not suggesting that tests based on trading activity are inappropriate with respect to equity securities, which tend to trade much more frequently and do not trade on the basis of yield spread from general market interest rates.

For example, an investment-grade issuer may want to make a series of offerings of its fixed-income securities. (The issuer could prefer multiple smaller offerings over one large offering to match its funding needs or the desires of its target investor class.) The application of Regulation M would need to be considered since the outstanding securities would be covered securities with respect to the subsequent reopenings.[13] Today, Regulation M would not be a concern because the securities are investment grade and therefore exempted. Under the amendments proposed by the Release, however, it would be necessary to consider in each offering whether the outstanding securities are liquid relative to the market for their asset class. Since they were initially issued in a relatively small size and may be only lightly traded, they may fail that test, thereby causing the purchase prohibitions to apply. To avoid the application of Regulation M, the issuer may instead issue the same securities in a single large offering to make the application of Regulation M less likely, or change the terms of each subsequent issuance so that the outstanding securities are not covered securities (which would also prevent the securities from being fungible with each other and reduce their liquidity). Each of these alternatives would be a distortion of funding activity that does not exist under the current standard.

Furthermore, the size of a particular securities offering and the amount of trading in a specific security is not a reliable indicator of whether a class of security is vulnerable to market manipulation such that the Regulation M purchase prohibitions should apply. If an issuer has substantial outstanding securities and is well-known in the market, the size of particular offerings does not affect whether securities comprising such offering are vulnerable to manipulation, and it should not affect eligibility for the Regulation M Exemptions.

The third part of the proposed test, which would condition eligibility for the Regulation M Exemptions on the determination that a security is "relatively fungible with securities of similar characteristics and interest rate yield spreads," is also of concern. The Release notes that "being 'relatively fungible' for these purposes would not require that the security, for example, be deliverable for a purchase order for a different security, but rather that a portfolio manager would be willing to purchase the security in lieu of another security that has similar characteristics (*i.e.*, yield spreads, credit risk, etc.)."[14] Given that yield spreads in one industry may not be representative of yield spreads of other industries, it is unclear how relative fungibility could be reliably measured or when the characteristics of securities are "similar." Furthermore, one could not definitively answer the question of whether "a portfolio manager would be willing to purchase the security in lieu of another security that has similar characteristics"[15] because portfolio managers may have views on one industry that differ from their views on another industry. Portfolio managers may also differ in their views as to the

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13 A "reopening" is an offering of an additional principal amount of fixed-income securities that are identical to securities that are already outstanding. Securities issued in reopenings have the same CUSIP and are fungible with the outstanding securities. In this example, each offering after the initial one would be a "reopening."

14 Release, 76 Fed. Reg. at 26560.

15 *Id.*

similarity of securities and whether they would be willing to purchase a given security in lieu of another security with similar features. The requirement in this part of the proposal essentially asks market participants to determine what a reasonable portfolio manager would do, which is too subjective a judgment for any market participant to make.

Market participants that exercise reasonable judgment in conducting the analysis could reach different conclusions about whether a security qualifies for the Regulation M Exemptions under the standard proposed by the Release. As each person seeking to rely on the Regulation M Exemptions would be required to make its own assessment under the proposed exemptions, it is possible that different participants in the same securities distribution could arrive at divergent conclusions as to whether the security qualifies. As a result, firms may either take a more conservative approach to the determination for fear that their analysis will be second-guessed if another firm reaches a contrary conclusion, or take a more aggressive approach to the determination in order to remain competitive. In either case, application of the standard would be influenced by factors not relevant to whether a security is susceptible to market manipulation.

In addition, SIFMA believes the added costs and administrative burdens associated with the proposal could inhibit capital formation by delaying access to the capital markets and increasing the expense of securities offerings. Under the proposal, firms would not only be obligated to devote resources to assessing whether securities satisfy the standard, they would also be required to enlist independent third parties for purposes of the verification requirement.[16] The verification process would likely entail the provision of nonpublic information to a verifier that may be a competitor to the firm seeking to rely on the exemption. Third parties may be reluctant to provide verifications on an expedited basis for fear of liability to regulators or private party litigants arising from their role as verifiers. Moreover, because verifiers will likely charge a fee for their services, such costs would be passed on to issuers, thus increasing the cost of accessing the capital markets.

Because of the difficult judgments inherent in application of the proposed standard as well as the burdens of obtaining third-party verification, adoption of amendments proposed by the Release would create a "speed bump" to the process of capital formation. The added costs and delay resulting from the need to assess whether a security meets the standard and the need to verify such determinations make it unlikely that issuers will be able to access the capital markets as efficiently as they do under the current rule. Accordingly, we believe the estimated average time and cost burdens set forth in the Release understate the potential impact of the proposal on securities offering participants.[17]

In the interest of avoiding the problems associated with a subjective standard, we suggest an objective approach that, like the standard the Commission proposed in 2008, makes use of

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16 We note that the proposal does not specify what constitutes an "independent" third party for purposes of the verification requirement.

17 *See* Release, 76 Fed. Reg. at 26570.

standards applied for other purposes in the marketplace. We propose that a non-convertible debt security, a non-convertible preferred security or an asset-backed security would qualify for the Regulation M Exemptions (i) if the security is registered on Form S-3, Form F-3 or Schedule B or (ii) if the issuer of the security is eligible to file a registration statement on Form S-3, Form F-3 or Schedule B.[18] This standard effectively identifies issuers with a high likelihood of having a substantial existing securities market that are subject to the continuous scrutiny of investors, financial analysts, members of the financial media and other market participants. As the Commission noted in support of its 2008 proposal, the fixed-income securities of such issuers

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18 In Security Ratings, SEC Rel. No. 33-9186; 34-63874, 76 Fed. Reg. 8946 (Feb. 16, 2011), the Commission proposed to remove the existing Form S-3 and F-3 transaction eligibility requirement permitting issuers to register primary offerings of non-convertible securities if they are rated investment grade by at least one NRSRO. The Commission proposed to replace this condition with a standard modeled on the test of "well-known seasoned issuer" ("WKSI") status of Rule 405 under the Securities Act. Under this proposed transaction eligibility test, Form S-3 and F-3 would be available to register primary offerings of non-convertible securities "if the issuer has issued (as of a date within 60 days prior to the filing of the registration statement) for cash at least $1 billion in non-convertible securities in offerings registered under the Securities Act, other than common equity, over the prior three years." *Id*. at 8949. SIFMA commented on this proposal in its Letter from Sean Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Elizabeth M. Murphy, Secretary, dated March 18, 2011 ("SIFMA III").

In SIFMA III, we indicated that the Commission's proposed standard for Form S-3 and F-3 eligibility in lieu of the investment-grade standard need not be as stringent as that employed to determine WKSI status. In both the context of Form S-3 and F-3 eligibility as well as that of eligibility for the Regulation M Exemptions, we believe the standard should be relaxed such that determination of whether the $1 billion threshold is met would include: (i) offerings of non-convertible securities in the previous three-year period pursuant to Rule 144A; (ii) non-convertible securities issued in registered exchange offers for securities previously issued under Rule 144A in the same three-year period, except (in order to avoid double-counting) exchange offers for securities that were previously issued under Rule 144A within the same three-year period and that are permitted to be included in the calculation of eligibility as described in (i); and (iii) US dollar denominated securities sold under Regulation S as part of an offering also eligible to be sold to US investors under Rule 144A. In addition, the test would include not only non-convertible debt securities of an issuer subsidiary, but also such securities issued by its parent and all other direct and indirect majority-owned subsidiary affiliates that would satisfy the criteria set forth above.

SIFMA also supports an additional eligibility test based on an issuer having at least $1 billion in total outstanding fixed-income securities at the time of issuance of a relevant security. This test would include the types of fixed-income securities described in the preceding paragraph. We believe this test is required in addition to the test set forth above because certain issuers that issue in substantial volume do so with irregular frequency such that they would not meet the threshold in a three-year period. The benefits of Form S-3 and F-3 and the Regulation M Exemptions should be available for issuers with substantial outstanding debt that enjoy a wide following in the marketplace regardless of whether they happen to have issued $1 billion in debt in the past three years. See SIFMA III for further detail regarding SIFMA's suggested approach to determining Form S-3 and F-3 eligibility and the reasons for our suggestions.

We note that other commenters to the Commission's Form S-3 and S-3 proposal have suggested lower eligibility thresholds for Forms S-3 and F-3. *See* Letter from Cleary Gottlieb Steen & Hamilton LLP to Ms. Elizabeth M. Murphy, Secretary, dated March 28, 2011 (proposing a threshold in the range of $250 million); Letter from Davis Polk & Wardwell LLP to Ms. Elizabeth M. Murphy, Secretary, dated March 25, 2011 (proposing a $500 million threshold). We believe the Regulation M Exemptions should cross-reference to eligibility for Forms S-3 and F-3 based on the standard ultimately adopted by the Commission in lieu of the current investment-grade standard for use of those forms.

should be less susceptible to manipulation due to their fungibility, yield-based trading and the issuers' wide industry following.[19] Moreover, as this standard will be based on objectively-determined eligibility tests that will be used for other purposes in the marketplace, they should be easily applied by those that need to rely on the Regulation M Exemptions.[20] We believe this approach will promote market efficiency by maintaining a clear objective standard that issuers, distribution participants and their affiliated purchasers can employ to determine the scope of permissible activity.[21]

We recognize that this proposal would result in the exemption of some securities that do not qualify for the current Regulation M Exemptions (and may not exempt some securities that are currently exempt). For example, non-investment grade debt that satisfies the standard we have proposed would be eligible for the Regulation M Exemptions although it is not under the current rule. In this regard, we note that since the advent of the predecessor to the Regulation M Exemptions, there has been a dramatic expansion in the debt markets, including the market for non-investment grade debt. The market in non-investment grade debt is now significantly larger than the investment grade debt market was when the predecessor exemption for investment grade debt was adopted over 25 years ago.[22] As a result, non-investment grade debt with a substantial existing securities market now trades in a manner very similar to that of investment-grade debt at the time the exemptions were adopted. At a minimum, the Commission's rationale for exempting investment-grade debt from Regulation M applies to non-investment grade debt that meets the standard we propose.[23]

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[19] 73 Fed. Reg. 40095-96.

[20] *Id*.

[21] At a minimum, the Commission should exempt non-convertible debt securities, non-convertible preferred securities and asset-backed securities that are issued by an issuer that is (i) a WKSI, (ii) eligible to register those securities on Form S-3 or F-3 under the standard ultimately adopted by the Commission to replace the current investment-grade standard (with the securities being distributed counted toward any numerical threshold in such standard) or (iii) eligible to file a shelf registration statement on Schedule B.

[22] According to Thomson Reuters, issuances of all investment-grade non-convertible corporate debt, medium term notes and Yankee bonds (excluding all securities with maturities of one year or less and certificates of deposit) totaled $27.0 billion in principal amount in 1983, the year in which the exemption for investment-grade nonconvertible debt in Exchange Act Rule 10b-6 was adopted. Such issuances increased by approximately 2,859% to a total of $798.9 billion in 2010. Issuances of all non-investment grade non-convertible corporate debt, medium term notes and Yankee bonds (excluding all securities with maturities of one year or less and certificates of deposit) totaled $5.6 billion in principal amount in 1983, and increased by approximately 4,612% to a total of $263.9 billion in 2010. Put differently, the amount of non-investment grade debt issued in 2010 is nearly ten times the amount of investment-grade debt issued in 1983. The size of the present day market in non-investment grade debt securities is such that it would be difficult to manipulate the price of non-investment grade debt securities that meet the Regulation M Exemptions eligibility standard we have suggested.

[23] In light of the liquidity of today's fixed-income market, the Commission could reasonably conclude that fixed-income securities should not be subject to the anti-manipulation provisions of Regulation M, and thus determine to exempt all such offerings from Regulation M. SIFMA would support such an exemption.

For responses to certain more specific questions posed by the Commission regarding the proposed amendments to the Regulation M Exemptions, please refer to Appendix A attached hereto.

## II. Removing References to Credit Ratings in the Broker-Dealer Net Capital Rule

The Release proposes that a broker-dealer would be permitted to apply reduced haircuts to commercial paper, non-convertible debt and preferred stock that meet certain conditions and have "only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains and enforces to assess credit-worthiness."[24] The Release notes that a broker-dealer assessing credit risk could consider, to the extent appropriate, the following factors:

- Credit spreads;
- Securities-related research;
- Internal or external credit risk assessments (including by rating agencies, irrespective of NRSRO status);
- Default statistics;
- Inclusion on an index;
- Priorities and enhancements;
- Price, yield and/or volume; and
- Asset class-specific factors (*e.g.*, in the case of structured finance products, the quality of the underlying assets).

The Release states that the "range and type" of factors considered would depend on the specific securities being reviewed and asks whether the list of specific factors should be expressly incorporated into the Net Capital Rule.[25]

Although we do not object in principle to the approach proposed by the Release, we think it will be very important for the Commission to recognize that a broker-dealer could reasonably design policies and procedures for determining the credit risk associated with a position in a security that are adapted not only to characteristics of the security itself (as implied by the commentary in the Release) but also to the size of the position and the purpose for which the

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[24] Release, 76. Fed. Reg. at 26576.

[25] *Id*. at 26552-53.

position is acquired or held by the broker-dealer. Adopting (or enforcing) amendments to the rule that fail to recognize this fact would be inconsistent with the manner in which broker-dealers make markets in debt securities and would put smaller firms at a significant competitive disadvantage.

A significant number of large broker-dealers have sophisticated internal credit review functions. The primary purpose of such functions is, of course, to manage risk. In addition, these functions are used by broker-dealers that are subsidiaries of bank holding companies to comply with certain federal regulations applicable to such entities. The development and implementation of a sophisticated credit review function is expensive, and likely out of reach for a small or medium-sized broker-dealer. A rule that requires the application of a sophisticated credit review of the sort used for counterparty credit risk to all fixed-income securities positions as a prerequisite for taking a reduced haircut would effectively prohibit small and medium-sized broker-dealers (that are not subsidiaries of bank holding companies) from applying the reduced haircuts, and place them at a severe competitive disadvantage.

Even the largest broker-dealers, with greatest resources in their credit review functions, do not conduct an individualized credit review of all issuers, much less all fixed-income securities issued by all issuers. Even where a broker-dealer conducts an internal review of the credit-worthiness of a security, such review is not updated continuously, and it would be unrealistic to expect a broker-dealer's credit risk assessments to be updated each time the firm performs Net Capital Rule compliance calculations. A broker-dealer may not have a current internal credit risk assessment on hand at the time it is asked to make a bid for a security. Fixed-income market-makers, however, are generally expected to quote a market in a fixed-income security when requested by a customer. While a fixed-income market maker in a large broker-dealer may, in theory, be able to submit to its credit review function any security on which it is asked to bid, the amount of time required for a thorough review in accordance with the sophisticated practices used for counterparty credit risk analysis would not be consistent with the speed of today's fixed-income marketplace. Moreover, where a relatively small amount of the firm's capital is involved, or where the position is not expected to be held for a significant amount of time, a thorough and individualized credit review may not be an appropriate use of the firm's resources. In these cases, even the most capable broker-dealer could reasonably apply a less sophisticated credit review to the security.

We believe policies and procedures reasonably designed for determining whether a fixed-income security has only a minimal credit risk could base the determination solely on a small number of objectively determinable factors (*e.g.*, internal or external credit ratings and yield spreads) under circumstances where (i) the position in the security is acquired on a short term basis (*e.g.*, as part of an underwriting or market-making business) and is not held for a long period or (ii) the firm's position in securities of the relevant issuer is immaterial in relation to the firm's capital. Such policies and procedures would represent a reasonable allocation of the limited resources of the broker-dealer's credit review function, and they could also be implemented by small and medium-sized broker-dealers that lack the resources necessary to conduct a sophisticated credit review. We ask the Commission to expressly recognize that a broker-dealer's policies and procedures for determining that a security has only a minimal amount of credit risk may be designed in this fashion, in order to provide guidance to broker-dealers (and to those responsible for examining broker-dealers and enforcing the Net Capital Rule).

For responses to certain more specific questions posed by the Commission regarding the proposed amendments to the Net Capital Rule, please refer to Appendix B attached hereto.

## III. Conclusion

We very much appreciate the Commission's consideration of the views expressed in this letter. We believe the Release contains a number of ideas that are helpful and practical in light of the rule changes the Commission is making to comply with Section 939A. We urge the Commission to consider our specific proposals above for refining the Commission's proposed approach to the Net Capital Rule haircuts and the Regulation M Exemptions. We believe these suggestions would significantly decrease the extent to which implementation of the Commission's mandate under Section 939A would disrupt the market and result in added costs, delay and uncertainty for market participants.

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We thank the Commission for the opportunity to comment in advance of its rulemaking in this area. Should you have any questions regarding our comments, please do not hesitate to contact the undersigned at (202) 962-7400 or via email at kbentsen@sifma.org or David Aman of Cleary Gottlieb Steen & Hamilton LLP at 212-225-2262.

Sincerely,

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner

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## Appendix A

The following respond to certain questions posed by the Commission with respect to the proposed amendments to the Regulation M Exemptions:

*Q1. 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? What specific trading activities that currently occur pursuant to the exception would then be prohibited during the restricted period because no other exception is available? What are the advantages and disadvantages of such trading activities? Should the Commission explicitly except any such specific activities in lieu of providing a generic exception for investment grade nonconvertible debt securities, nonconvertible preferred securities, and/or asset-backed securities? What benefits or challenges would this approach create?*

A. We do not believe the Commission should eliminate the Regulation M Exemptions completely. Securities offering participants rely on the Regulation M Exemptions routinely in the context of "reopenings" (*i.e.*, issuances of additional fixed-income securities that are wholly fungible with outstanding securities). Reopenings serve a valuable purpose in the marketplace. They enhance market liquidity by increasing the size of issuances and enable issuers to maintain the maturity profiles of their outstanding debt. Any changes to the Regulation M Exemptions that eliminate eligibility for such issuances could distort financing decisions as issuers elect to conduct offerings of separate securities solely for the purpose of avoiding the purchase prohibitions of Regulation M. This would reduce efficiency for both issuers and investors.

*Q2. Should the Commission expand the exception to cover all nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities? What activities would then be allowed that were previously prohibited under Rules 101 and 102 of Regulation M? Would these new activities have any manipulative risk? Why or why not?*

A. In light of the substantial growth of the fixed-income securities market, we believe the Commission could reasonably conclude that the Regulation M Exemptions should apply to all non-convertible debt, non-convertible preferred and asset-backed securities. We believe the risk of manipulative activity is substantially mitigated by the size and depth of today's fixed-income market.

*Q3. Are the proposed standards an appropriate substitute for credit ratings in this context? Would the proposal capture the same type and quantity of securities that fall within the current Rule 101(c)(2) and Rule 102(d)(2) exceptions? What effect(s), if any, would the proposed modifications to the current exception have on the markets for nonconvertible debt, nonconvertible preferred and asset-backed securities?*

A. We believe the proposed standards would effectively exclude from the Regulation M Exemptions certain securities that are eligible for the exemptions under the current rules (for example, investment-grade debt that is not traded frequently). We further believe that adoption of the proposal would result in increased use of Rule 144A offerings due to the added costs and burdens to market participants resulting from the proposed standard.

*Q4. Please discuss whether and to what extent investors rely upon the current Rule 101(c)(2) and 102(d)(2) exceptions for investment grade nonconvertible and asset-backed securities when making a decision to invest in such securities. Please also discuss whether, given that Rules 101 and 102 of Regulation M are directed at distribution participants, issuers, and selling securities holders, Rules 101 and 102 of Regulation M pose any danger of undue reliance on NRSRO ratings.*

A. As noted in SIFMA I and as quoted in the Release,[26] "Regulation M is primarily directed at the actions of the issuers of securities and the investment banks that underwrite them; in contrast, the investors that the Commission is concerned with are not users of Regulation M." We continue to believe that investors generally are unaware of the Regulation M Exemptions and are not unduly relying on the references to NRSRO ratings in the Regulation M Exemptions.[27]

*Q5. Is the Commission's position (expressed at the time the exception was initially adopted) that preferred securities are generally fungible with similar quality preferred securities still valid? Has the market for preferred securities changed to the extent that these securities are no longer generally fungible with similar quality preferred securities? If so, to what extent has the market changed? Rules 101(c)(2) and 102(d)(2) of Regulation M currently except investment grade nonconvertible preferred securities. Is this exception still relevant in the current marketplace for preferred securities? What would be the potential adverse consequences if preferred securities were no longer excepted from Rules 101 and 102?*

A. We do not believe that the market for preferred securities has changed to an extent that such securities are no longer generally fungible with similar quality preferred securities. Such securities continue to trade primarily on a spread over general market interest rates.

*Q6. Should the Commission, in lieu of the third party verification requirement, require that any person seeking to rely on the exception disclose in the offering documents relating to the distribution: (1) that the person is relying on the relevant exception; (2) that the person has undertaken diligent review and, utilizing the factors identified in this proposal, reasonably concluded that the security meets the proposed factors; (3) the factors identified in the proposal and used by the person to make its conclusions; and (4) that the person or affiliated purchasers will be purchasing or bidding during the restricted period (if that is in fact the case)? Would this approach also address concerns about the cost and effectiveness of independent third party verification and have the added benefit of full disclosure to investors? Would this approach present costs that do not arise under the current exceptions? What other representations should*

[26] Release, 76 Fed. Reg. at 26559, note 66.

[27] *See* SIFMA II at 2-3.

*be included in the offering documents if this approach is taken? What benefits would this approach provide? What other concerns could this approach raise?*

A. Should the Commission determine to adopt its proposed approach, we do not believe that such disclosure should be required. Such a requirement could give rise to liability under Section 11 of the Securities Act if a party were to determine itself eligible for the Regulation M Exemptions and such determination were subsequently deemed incorrect by regulators. Because the proposed standard is difficult to apply, the prospect of potential liability for an incorrect determination and (probably more significant) the spectre of litigation asserting incorrect determinations would serve to further discourage reliance on the Regulation M Exemptions.

*Q7. Should the Commission except nonconvertible debt securities and nonconvertible preferred securities based on trading volume and outstanding relevant securities of the issuer? For example, the Commission could except nonconvertible debt securities where the issuer has at least $1 billion in outstanding debt and the trading volume of the outstanding debt securities of that issuer equaled or exceeded 100% turnover over a six month period, excluding trading by persons claiming the exception. This would have the benefit of establishing a bright line standard and is similar to the actively-traded securities exception found in Rule 101, but may except a different universe of securities, be difficult to determine for securities that are hard to value, and would not be available to securities of new issuers. What benefits would this approach provide? What other concerns could this approach raise? Would such an exception tailored for nonconvertible preferred (referencing $1 billion outstanding equity and trading volume of the issuer's nonconvertible preferred securities) be appropriate? What other changes would need to be made in order to make the exception available to preferred securities generally? Are there different numerical thresholds that are better able to replicate the universe of currently excepted nonconvertible debt securities and preferred securities? If the Commission replaced the current criteria with a volume test, how much effort on the part of intermediaries would be required to demonstrate that a volume threshold was met? How difficult would it be for financial intermediaries to gather volume statistics? What would the range of associated costs be? If it was necessary under the volume test to exclude trading by persons subject to Rules 101 or 102, would that information be available to financial intermediaries? Are there other numerical tests of this type that would be more appropriate? How would this approach address potential conflicts of interest involving the issuer, selling shareholder, distribution participant, or affiliated purchaser?*

A. Although we believe a test based on issued and outstanding debt is superior to the current proposal, we do not believe such a test should include a trading volume component. As noted above, trading volume is an imperfect indicator of whether fixed-income securities are vulnerable to manipulation; fixed-income securities of some large, well-followed issuers that are not susceptible to manipulation may nevertheless not trade actively day to day.

*Q8. Please comment generally on any relevant changes to the debt markets since Regulation M was adopted in 1996 and how these developments should affect the Commission's evaluation of the proposed amendments.*

A. We believe the dramatic expansion of the investment-grade and non-investment grade debt markets significantly ameliorates concerns that such securities are vulnerable to market manipulation. These developments provide a basis for considering the exemption of all fixed-income securities from Regulation M as well as all fixed-income securities offerings that satisfy the standard we propose in this letter.

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**Appendix B**

The following respond to the Commission's request for comments in response to particular questions regarding the proposed amendments to the Net Capital Rule:

*Q1. Do broker-dealers that would be subject to the proposed amendments either already have processes in place for determining credit-worthiness of commercial paper, non-convertible debt, and preferred stock or have the financial sophistication and the resources necessary to adopt such processes without undue effort or expense? Are there particular types of broker-dealers that would not be capable of meeting this new standard without undue hardship? In what ways and to what extent, if any, would establishing and implementing procedures for determining credit-worthiness in lieu of using a credit rating disproportionately impact medium-sized and smaller broker-dealers? Commenters who believe that medium-sized and smaller broker-dealers would be disproportionately affected by these amendments, should describe the firms that would be adversely impacted, as well as provide suggestions as to how the proposal could be amended to accommodate them.*

A. A number of broker-dealers have access to credit analysis functions that could be applied to generate internal credit analyses of debt instruments. Some of these firms apply the Commission's Alternative Net Capital ("ANC") approach for computing capital requirements, and some are subsidiaries or affiliates of financial institutions regulated as banks or bank holding companies. We believe a large number of smaller and medium-sized broker-dealers do not have processes for generating internal credit analyses that could be applied to debt securities, and that even the largest broker-dealers do not have access to internally generated analyses of all or nearly all issuers and securities. We further believe the cost and complexity of developing a credit evaluation infrastructure covering many issuers and securities may be beyond the means of many broker-dealers. Finally, we believe the burden on small and medium-sized broker-dealers would be significantly reduced if the proposed amendment were to be interpreted (as suggested above) to permit policies and procedures that base the credit risk analysis solely on a small number of objectively determinable factors (*e.g.*, internal or external credit ratings and yield spreads) under circumstances where (i) the position in the security is acquired on a short term basis (*e.g.*, as part of an underwriting or market-making business) and is not held for a long period or (ii) the firm's position in securities of the relevant issuer is immaterial in relation to the firm's capital.

*Q2. With respect to the factors a broker-dealer could consider, would the use of these factors in lieu of credit ratings reduce undue reliance on a third party's assessment of credit risk? To what extent, if any, is there a risk that undue reliance will shift from relying on a credit rating to relying on some other third party assessment of credit-worthiness?*

A. We believe many broker-dealers rely upon both publicly available credit ratings and trading spreads to assess the market's perception of an issuer's credit standing. It is not clear that there are readily available alternatives to credit ratings to support the market-making and underwriting businesses. In particular, the market-making business is a minute-by-minute business, and we are not aware of an alternative source of immediately available credit analysis. We do not believe reliance on these factors in the context of an underwriting or market-making business, or with respect to positions that are relatively immaterial in relation to the broker-dealer's capital should be regarded as "undue" – in these circumstances, it is reasonable for a broker-dealer to rely on a small number of objectively determinable factors.

*Q3. What is the potential impact of moving from an objective standard to a more flexible standard? Is there the potential that a broker-dealer's evaluations of credit-worthiness may be second-guessed? If so, how might the prospect of being second-guessed impact a broker-dealer's evaluation of minimal credit risk and the appropriate haircuts to take for purposes of the broker-dealer's net capital calculation?*

A. As noted in our prior comment letter, absent objective standards that offer both consistent application of the rules and the assurance of a stable minimum floor for risk assessments, less risk-averse broker-dealers might use their increased discretion to take an aggressive approach to credit risk determinations, thereby increasing investors' risk of loss and decreasing investor confidence.[28] Because the consequences of inadequate net capital include an immediate suspension of business and possible liquidation, this risk is particularly acute with respect to firms experiencing financial difficulty — the very firms for which correct application of the Net Capital Rule is most important.

We are also concerned that both regulatory bodies and others would review or second-guess credit analyses by broker-dealers. We would expect that the uncertainty resulting from the proposals may serve to diminish the willingness of broker-dealers to assume risk positions. We therefore believe it is important (i) to provide the guidance suggested above, which recognizes that reasonable policies and procedures to determine that a security has only a minimal amount of credit risk may rely on a relatively small number of objective factors in certain circumstances, and (ii) to emphasize that examinations for compliance by broker-dealers with the Net Capital Rule's requirements for the reduced haircuts should focus on the reasonableness of the policies and procedures established to assess credit-worthiness.

*Q4. If broker-dealers establish and implement procedures for determining credit-worthiness, some broker-dealers may determine that a security qualifies for a reduced haircut when it would not have qualified for a reduced haircut under the current NRSRO standard. Alternatively, some broker-dealers may determine that a security does not qualify for a reduced haircut when the security would have qualified for a reduced haircut under the current standard. Describe the potential impact on capitalization and the efficient allocation of capital under these two scenarios and the likelihood of each occurring. In addition, with respect to the first scenario, describe the potential impact on the objective of Rule 15c3–1, which, among other things, is to protect investors by enabling a broker-dealer, if the firm experiences financial difficulty, to be in a position to meet all obligations to customers and counterparties and*

[28] *See* SIFMA I at 5.

*generate resources to wind-down its operations in an orderly manner without the need of a formal proceeding.*

A. As discussed above (in our response to Q3), the proposed approach may be vulnerable to abuse by firms experiencing financial difficulty or other firms that wish to take an aggressive approach to Net Capital Rule compliance. As a result, in the first scenario, the proposed standard may increase the likelihood that a firm would be unable to wind down in an orderly manner without the need of a formal proceeding. With respect to the second scenario, uncertainty regarding application of the proposed standard may lead broker-dealers to determine that a security does not qualify for a reduced haircut when the security would have qualified for a reduced haircut under the current rule. This could diminish broker-dealers' willingness to make markets and underwrite securities that do not clearly qualify for reduced haircuts under the proposed rule, which could reduce market liquidity for such securities while lowering the yields of instruments that clearly satisfy the proposed standard.

*Q5. What are the risks of using internal processes to make credit determinations and how could these risks be addressed? For example, would broker-dealers be likely to adopt procedures that minimize the credit risk associated with a particular security in order to minimize capital charges? How could this risk be addressed?*

A. The risks associated with relying upon internal credit analyses stem from the potential that internal analyses would be less comprehensive than publicly available credit ratings and that such analyses may be influenced by factors not relevant to credit risk. In addition, the use of subjective internal assessments of credit quality may lead to inconsistent determinations among firms insofar as some firms would consider a security to present a minimal amount of credit risk while others viewed the security as not meeting the standard. As a result, some firms may be willing to make markets in a security while others are not. See also our response to Q3.

*Q6. Are there other factors a broker-dealer should use when determining credit-worthiness? Should the Commission mandate that broker-dealers consider each factor in this release when assessing a security's credit risk? Should the list of factors be included in the text of Rule 15c3–1?*

A. Because the factors relevant to a determination of credit risk may vary in significance over time and may vary depending on the broker-dealer, issuer or security, we do not believe the specific factors should be included in the rule itself. Basel II contains a number of factors to be included within credit analyses, and we would view these standards as particularly appropriate for evaluating longer term credit exposures (*e.g.*, over-the-counter derivatives and bank loans), although not necessarily short-term market-making or underwriting positions. We believe broker-dealers who use or have access to credit review processes developed in part to comply with Basel standards for purposes of the Commission's ANC regime, or the regulation of a parent bank holding company, should be permitted to use those processes for the credit analysis of significant long-term investments in fixed-income securities. (Where a broker-dealer relies on a credit analysis performed by its parent bank holding company's credit review function, we believe it would be appropriate for the Commission to leverage the bank regulators' review and examination of that function, rather than duplicate such review or examination.) As discussed above, we believe a simpler methodology could be appropriate for purposes of evaluating trading positions that are relatively small or that the broker-dealer expects to turn over within a short period of time.

*Q7. Should the Commission place conditions on the ability of a broker-dealer to outsource factors related to the determination of credit-worthiness to a third party? If the determination of factors related to credit-worthiness is outsourced, how can the Commission determine that the outsourced determination meets the proposed standard?*

A. We believe a broker-dealer should be permitted to rely on credit review conducted by a parent or an affiliate in accordance with a credit review function subject to examination by a bank regulator. In addition, as the Commission's proposal recognizes, an appropriate credit review could consider third party credit ratings; such consideration should not be viewed as "outsourcing," even in circumstances where the broker-dealer's credit analysis appropriately relies on only a small number of objective factors (*e.g.*, the third party credit ratings and yield spreads).

*Q8. How often should a broker-dealer be required to update its assessment of a specific security to ensure the broker-dealer's determination of credit-worthiness remains current? Should the rule contain a requirement that the assessment be updated after a specific period of time? Should the Commission limit the ability of a broker-dealer to outsource the monitoring of its determination of credit-worthiness?*

A. We believe the frequency of review for a specific issuer or security should be a function of a number of factors, including, *e.g.*, the size and purpose of the broker-dealer's position in the fixed-income security, the volatility of business conditions within the relevant industry, the amount of fixed-income securities issued, and the frequency with which the securities trade. As to whether the Commission should limit the ability of a broker-dealer to outsource the monitoring of its determination of credit-worthiness, please see our response to Q7.

*Q9. Should the Commission require that the persons responsible for developing a broker-dealer's internal processes and applying them to possible positions in individual securities for purposes of the Net Capital Rule be separate from employees who make proprietary investment decisions for the broker-dealer?*

A. The separation of a broker-dealer's credit review function and its trading or investment functions could reduce the incentives to assess Net Capital Rule compliance in an aggressive manner. We believe most larger firms currently assign responsibility for credit risk management to senior officers outside their trading or investment units, such as their chief financial officer or chief administrative officer.

*Q10. What would be the appropriate level of regulatory oversight of a broker-dealer's credit determination processes? Should the Commission describe in more detail how examiners will examine these processes? How should a broker-dealer be able to demonstrate to regulators the adequacy of the processes that it adopts and that it is following them?*

A. The degree of regulatory oversight should be a function of the nature of the broker-dealer's credit exposures. If, for example, the broker-dealer conducts only a market-making business in corporate debt obligations, relatively little oversight may be necessary. If, on the other hand, the broker-dealer conducts an over-the-counter derivatives business, more extensive oversight may be warranted. We note that many of the broker-dealers carrying the largest fixed-income inventories are subsidiaries of bank holding companies, and, in that context, the credit review functions supporting these broker-dealers are subject to extensive supervision by the Federal Reserve Board and other banking regulators. We recommend that the Commission attempt to leverage the review and examination work performed by these other regulators. In addition, further detail regarding how examiners will review broker-dealers' credit assessment functions would assist firms in making advance determinations as to whether their practices comply with the new rule.

*Q11. Should the Commission require the securities industry self-regulatory organizations to set appropriate standards for broker-dealers to use in evaluating credit-worthiness and evaluating individual positions in commercial paper, non-convertible debt, and preferred stock for net capital purposes?*

A. We believe the Commission should coordinate the development of the relevant rule sets between the Commission's staff and the self-regulatory organizations in order to minimize the risk of broker-dealers becoming subject to incompatible regulatory requirements.

*Q12. Should the Commission require broker-dealers to create and maintain records of credit-worthiness determinations? If so, what records should be required to be maintained and how should they be described in a rule? Are there standard records that are used when making credit-worthiness determinations that the Commission could require broker-dealers to keep? Are there other measures the Commission could consider to reduce the risk that broker-dealers will adopt inadequate processes or fail to adhere to them?*

A. Given the volume of trading activity at many broker-dealers, it would be impractical and unnecessary to require the retention of records of individual credit risk determinations made in the ordinary course where, in accordance with reasonable policies and procedures for assessing credit-worthiness, the determinations are based on a small number of objective factors; these determinations could be easily reconstructed from the objective factors themselves. The Commission should require only the retention of the policies and procedures established to assess credit-worthiness, and records of the results of judgments made in accordance with these policies and procedures where a sophisticated credit analysis is conducted on the basis of a larger number of factors.

*Q13. Rather than referencing a list of factors that broker-dealers could consider, should the rule reference a single or limited set of factors (e.g., credit spreads)? Could a simpler approach adequately capture the risks of holding the full range of securities covered by the rule?*

A. A single or limited set of factors may not be appropriate given that the factors relevant to credit risk may vary in significance over time. The Commission should indicate that the factors in the rule are not a required or exhaustive list. At the same time, as suggested above, we believe the Commission should acknowledge that (i) a broker-dealer's policies and procedures may rely on a small number of objective factors to review positions that are small relative to the broker-dealer's net capital or intended to be held for a relatively short time and (ii) where a sophisticated credit analysis is appropriate (*e.g.*, for a significant, long term investment in a fixed-income security), policies and procedures that comply with the Commission's ANC regime or that comply with Basel II standards and are subject to supervision by bank regulators, can be used to determine whether the position represents only a minimal amount of credit risk.

*Q14. Are there alternate and more reliable means of establishing credit-worthiness for purposes of the Net Capital Rule? Please include detailed descriptions.*

A. We are not aware of any alternate and more reliable methods.

*Q15. Should the Commission define "minimal amount of credit risk"? Commenters who believe the Commission should define this term should include a detailed description of what should be included in the definition.*

A. Because the concept of minimal credit risk is highly dependent on the characteristics of a security and the broker-dealer that holds it, it may be difficult to create a meaningful definition of "minimal amount of credit risk" that accounts for the variety of contexts in which it would apply. If the Commission elects to define the term, we believe it should consider the following (among other factors) in formulating its definition: (i) the credit-worthiness of the issuer of the security (or the counterpart to the derivative transaction), (ii) the size of a transaction and the resulting exposure to an individual issuer (in terms of the duration of the exposure and the size of the position), (iii) whether the obligation is secured or unsecured, (iv) whether the obligation is intended to be traded in the short term or held as a longer term investment and (v) whether the obligation is a corporate bond, a long term obligation or an over-the-counter derivative.