BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

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; File No. S7-15-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules would remove certain references to credit ratings in the net capital rules under the Securities Exchange Act of 1934, in accordance with the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

In addition, the Release requests comment on possible standards of credit-worthiness that could replace references to credit ratings in the definitions of "mortgage related security" and "small business related security" contained in the Exchange Act. Those statutory references to credit ratings must be removed and replaced pursuant to Section 939(e) of the Dodd-Frank Act.

INTRODUCTION

As required by the Dodd-Frank Act, it is imperative that the rating agencies be removed from their current privileged and protected monopoly status as virtual prosecutor, judge, and jury of all things creditworthy. They have a track record of repeated failures to rate securities accurately, and further evidence of this pattern continues to emerge in the international arena, threatening another financial debacle in Europe and globally.

As the ongoing financial crisis in Greece demonstrates yet again, the financial world is being held hostage by credit rating agencies. Just as in 2008, when rating agency downgrades were a combustible accelerant to the financial and economic crisis, the current rating agency threats to downgrade their previous ratings of sovereign debt are again

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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wreaking havoc with the financial system, threatening the financial stability not only of a single nation, but also of the entire Eurozone and potentially the world.

It is unconscionable that the rating agencies are effectively dictating the terms of any resolution of the Greek debt crisis, since the current financial peril is largely of their own making. These very same agencies rated Greek and other weak sovereign debt as A+ for years. Yet the facts that have been publicly disclosed regarding Greece's actual economic circumstances over the past several years prove that the rating agencies' prior A+ ratings simply cannot have been accurate and cannot have properly evaluated Greece's financial condition.

It is easy to substitute "AIG" or "CDOs" for "Greece" in the prior paragraph and have a simple, but accurate, picture of one of the leading causes of the 2008 financial crisis. Then, as now, the rating agencies slapped top ratings on debt securities, issuers, and countries, but then the world discovered that those ratings had little, if any, basis. Yet, even after the house of cards built on this foundation of "top" ratings has come tumbling down, the rating agencies still retain their monopoly position and power, with business as usual.

This must stop and new, more reliable standards for creditworthiness must be established, as the Dodd-Frank Act mandated.

THE DODD-FRANK ACT

The Dodd-Frank Act represents a Congressional attempt to institute regulatory measures that will finally and effectively address the problems posed by credit ratings. The statute includes three fundamentally important reforms. First, it builds on the regulatory requirements that were implemented in the Rating Agency Act of 2006. The Dodd-Frank Act adds new provisions relating to the registration process, corporate governance, compliance examinations, conflicts of interest, and public disclosure of ratings and methodologies.

Second, the Dodd-Frank Act substantially increases the accountability of Nationally Recognized Statistical Rating Organizations ("NRSROs") by increasing their exposure not only to enforcement remedies such as monetary fines, but also to liability in private actions.

Finally, in Section 939A, the Dodd-Frank Act seeks to reduce reliance upon credit ratings by requiring the Commission and other federal agencies to review their regulations; to remove any references to, or reliance on, credit ratings in those regulations; and to substitute appropriate standards of credit-worthiness in place of credit ratings. The relevant section of the statute provides as follows:

> (a) AGENCY REVIEW.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—
>
> (1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and
>
> (2) any references to or requirements in such regulations regarding credit ratings.

> (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**. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

SUMMARY OF COMMENTS

The core challenge facing the Commission as it implements the Dodd-Frank Act mandate in Section 939A is to establish alternative "standards of credit-worthiness" that are appropriate substitutes for credit ratings. Eliminating regulatory reliance upon credit ratings without providing adequate alternatives will only undermine effective regulation of our capital markets and put investors at greater risk, not less.

To protect investors, the standards must be specific, strong, and uniform, and to prevent evasion by market participants they must also be clear, concrete, and mandatory.

The Proposed Rules are a commendable effort to ensure that the broker-dealer Net Capital Rules include appropriate standards of credit-worthiness that can replace references to credit ratings, so that a broker-dealer's assets are appropriately valued. However, the Proposed Rules must be strengthened in the following ways to achieve the statutory requirements of the Dodd-Frank Act:

- The credit-worthiness standards applicable to commercial paper, nonconvertible debt, and preferred stock must (1) incorporate a mandatory list of factors that broker-dealers must apply in their credit analysis; (2) eliminate all residual reliance on credit ratings; and (3) require broker-dealers to document not only their policies and procedures on credit risk assessment, but also each credit-worthiness determination they make under those policies and procedures.

- The Proposed Rules must provide credit-worthiness standards to replace references to credit ratings with respect to foreign currency options. Simply relying on the size of the foreign currency market to determine which foreign currency options deserve favorable treatment under the Net Capital Rule is insufficient. The new standard must either list the foreign currencies that, in the Commission's judgment, should be deemed "major market foreign currencies" for purposes of the Net Capital Rule, or require broker-dealers to apply a mandatory set of factors that bear on the credit-worthiness of foreign currencies.

- The Proposed Rules must establish an alternative set of credit-worthiness standards for use in measuring counterparty credit risk in derivatives transactions. Relying on the existing methodologies that broker-dealers currently use to evaluate such risk, while technically compliant with the Dodd-Frank Act, does not adequately promote uniformity and transparency. The Proposed Rules must adopt an overall standard of credit risk for those counterparties under the Net Capital Rule, and they must enumerate the specific factors that broker-dealers must apply in their credit analysis.

- The Proposed Rules relating to the anti-manipulation provisions in Regulation M must incorporate a credit-worthiness standard for nonconvertible and asset-backed securities, rather than simply relying on liquidity standards, unless the Commission can demonstrate that credit-worthiness has no bearing on the susceptibility of those securities to manipulation. Moreover, the Proposed Rules must spell out the "reasonable factors of evaluation" that must be applied under the liquidity standards. Finally, they must require that the entities which independently verify a broker-dealer's liquidity analysis be Commission registrants.

- The Proposed Rules must replace the reference to credit ratings in Rule 10b-10 customer confirmations relating to transactions in debt securities. To accomplish the originally intended investor protection objective, the Proposed Rules must require that confirmations alert customers to the importance of understanding the credit quality of a debt security and the impact of credit quality on the value, resale, and price of such securities.

- The Commission must follow a number of basic principles as it formulates appropriate credit-worthiness standards to replace credit ratings in the definitions of "mortgage related" and "small business related" securities. Those standards must be strong, detailed, mandatory, documented, and devoid of continued reliance on credit ratings. In particular, those standards must require a rigorous statistical analysis of the assets underlying those types of securities.

With these changes, the Proposed Rules will eliminate reliance on credit ratings under the Net Capital Rule while still ensuring the financial stability of broker-dealer firms and the protection of their customers that the law requires.

COMMENTS ON THE PROPOSED RULES

The Proposed Rules Must (1) Establish Mandatory Factors for the Credit Analysis of Commercial Paper, Nonconvertible Debt, and Preferred Stock; (2) Fully Eliminate Continued Reliance on Credit Ratings in that Analysis; and (3) Require Documentation of Each Credit-Worthiness Determination.

The Proposed Rules would remove references to credit ratings in Exchange Act Rule 15c3-1, known as the Net Capital Rule. The Net Capital Rule prescribes the minimum amount of regulatory capital that broker-dealers must maintain. It serves an important investor protection function by ensuring that, if broker-dealers experience financial difficulty, they will nevertheless be able to satisfy their obligations to customers. In addition, an effective Net Capital Rule greatly enhances protections against systemic risk because it is a market-based safeguard against the potential for cascading defaults in an inter-connected marketplace.

The Net Capital Rule requires broker-dealers to discount the value of the securities they hold when they compute the amount of net capital they have on hand. Currently, the Net Capital Rule allows the discount or "haircut" on commercial paper, nonconvertible debt, and preferred stock to be significantly lower than the presumptive level of 15 percent if those securities have been highly rated by NRSROs.[2]

The Proposed Rules would delete those references to credit ratings. In their place, the Proposed Rules would provide that, to apply the lower haircut percentages to commercial paper, nonconvertible debt, and preferred stock, the broker-dealer would have to determine that those securities had "only a minimal amount of credit risk," after applying "written policies and procedures the broker or dealer establishes, maintains, and enforces to assess credit-worthiness."[3]

The Release explains that when evaluating credit risk, a broker-dealer "could consider" a list of factors "to the extent appropriate."[4] The factors include eight considerations, ranging from credit spreads to the quality of the underlying assets in structured finance products. The Proposed Rules would also require broker-dealers to preserve their written policies and procedures for assessing credit risk for a period of at least three years.[5]

Consideration of the Factors Must Be Mandatory.

The Proposed Rules must be strengthened in several respects. First and foremost, the rules must be more prescriptive and *require* broker-dealers to consider the list of factors enumerated in the Release. Those factors must be set forth in the text of the rule itself.

This approach is crucial if the Proposed Rules are to achieve their purpose. If broker-dealers are left to devise their own policies and procedures for assessing credit risk, without strong, specific, clear, and mandatory guidelines to limit their discretion, they can be expected to develop formulae that will inevitably minimize credit risks associated with securities to minimize capital charges. The firms and their clients will consequently be subjected to greater financial risks, which clients typically discover only when it is too late and when another downturn or crisis has hit. A more prescriptive approach is essential to establish critical boundaries.

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2 Release at 26552
3 Proposed Rules § 240.15c3-1(c)(2)(vi)(E) and (F)(1) and (2).
4 Release at 26552.
5 Release at 26553.

One does not have to assume venal or malicious intent to foresee this entirely predictable result. History demonstrates repeatedly that risks are always understated when they are self-determined and when they have actual or perceived negative consequences, such as increased capital charges. History also shows that this is doubly harmful: first, it lulls everyone into a false sense of security because they believe the risks are properly evaluated and, second, everyone is caught by surprise and unprepared when the crisis hits and reveals the prior risk analysis to have little if any basis.

Establishing an explicit and detailed list of factors that broker-dealers must consider would also promote uniformity. The Dodd-Frank Act expressly directs agencies "to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency."[6] Regulatory uniformity enhances investor protection, fairness among market participants, and transparency in the marketplace.

Without detailed and uniform standards to guide them, broker-dealers will generate divergent discounts or haircuts for purposes of calculating net capital requirements. This will place some broker-dealers in a more precarious financial condition than other firms, exposing some investors to significantly greater risks. Divergent methodologies must not be permitted to cause such inconsistent results; investors cannot be expected to analyze the quality of these methodologies as a basis for differentiating among broker-dealers.

Inconsistent methodologies will also disadvantage and in effect punish any broker-dealers that are inclined to choose a more conservative approach to the assessment of credit risk. This will trigger a race-to-the-bottom as broker-dealers seek to avoid the competitive disadvantages that will arise from having appropriate or prudent risk evaluations.

By establishing concrete, mandatory standards, the Proposed Rules will help mitigate all of these problems, for the benefit of investors and the overall stability of the brokerage industry.

The Proposed Rules must also expand the list of factors that broker-dealers must consider when evaluating the credit risk associated with a security. The items listed in the Release are positive and, once incorporated into the Proposed Rules, will provide a useful and more objective framework for broker-dealers to apply. However, the list must be more comprehensive, and must cover all material considerations that bear on the credit-worthiness of the securities under review, including the nature of the issuer, the terms of the security, and the financial and regulatory context in which the issuer is operating. This enhancement to the Proposed Rules will help ensure that broker-dealer credit risk assessments are reliable and that broker-dealer net capital levels are adequate to protect investors.

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[6] Dodd-Frank Act § 939A

The List of Factors Must Exclude External Credit Ratings.

The list of factors in the Release must also be *narrowed* in one important respect. According to the Release, among the criteria that broker-dealers may consider when evaluating the credit risk associated with a security are "credit risk assessments" developed either internally *or by a credit rating agency.*[7] This factor would permit continued reliance on credit ratings, which conflicts with the letter and spirit of the Dodd-Frank Act.

The Dodd-Frank Act requires the Commission and other agencies to remove references to credit ratings from their regulations, and to substitute *alternative* standards of credit-worthiness as each agency deems appropriate. Allowing broker-dealers to continue using credit ratings when assessing credit risk would violate this statutory mandate.

The Proposed Rules must address this problem by deleting the reference to credit risk assessments made by credit rating agencies. At a minimum, the Proposed Rules must make clear that if a broker-dealer considers external credit ratings when conducting credit risk evaluations, its credit risk assessment for each security must be justifiable solely on the basis of other factors, without reference to the credit ratings.[8]

Broker-Dealers Must Be Required to Document Each Credit-Worthiness Determination.

Finally, the Proposed Rules must incorporate stronger documentation requirements. As currently drafted, the Proposed Rules would require each broker-dealer to preserve for at least three years the written policies and procedures that the broker-dealer establishes, maintains, and enforces for assessing credit risk for commercial paper, nonconvertible debt, and preferred stock.[9] This requirement is necessary, but it is not sufficient. As suggested in the Release, the Proposed Rules must also require each broker-dealer to create and maintain a record of each credit-worthiness determination that the broker-dealer makes.[10] That record must include all factors considered in evaluating the credit risk of the security, an explanation of how those factors support the determination made, and an identification of the personnel involved in making the determination.

This more detailed documentation requirement will serve two important purposes. First, requiring broker-dealers to create a record of their credit risk determinations will

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7 Release at 26553.

8 The same issue arose in connection with the Commission's effort to remove references to credit ratings from rules under the Investment Company Act. *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Release Nos. 33-9193; IC-29592 (Mar. 3, 2011), 76 Fed. Reg. 12896 (Mar. 9, 2011). Those proposed rules, and the accompanying release, indicated that investment companies could continue to rely heavily on credit ratings when selecting permissible money market fund investments. *Id.* at 12898, -899, -900, -902,-903. Better Markets expressed opposition to that approach, and we advance the same objections above. Better Markets, Inc. Comment Letter dated April 25, 2011.

9 Release at 26553.

10 Release at 26554.

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enable regulators to effectively monitor compliance with the Net Capital Rule and take appropriate remedial action when the new credit assessment standards have been misapplied and net capital levels drop below required levels. Second, these documentation standards will help promote actual compliance by broker-dealers. The process of documenting each credit risk determination will induce a more thorough and rigorous application of the broker-dealer's policies and procedures governing credit risk assessment.

The Proposed Rules Must Not Only Delete References to Credit Ratings With Respect to the Credit Analysis of Options on Major Market Foreign Currencies, But Must Also Establish an Alternative Standard of Credit-Worthiness.

Under Appendix A to Rule 15c3-1, options on any "major market foreign currency" receive more favorable net capital treatment than options on other types of currencies. The term "major market foreign currency" is defined to mean the currency of a sovereign nation (1) whose short-term debt is rated in one of the two highest categories by at least two NRSROs, and (2) for which there is a substantial inter-bank forward currency market.[11] The Proposed Rules would delete the first test for identifying a "major market foreign currency," because it includes references to credit ratings. However, rather than offering a substitute test, the Proposed Rules would simply leave the second prong intact as the sole definitional element.[12]

The Proposed Rules must be strengthened by providing an alternative standard of credit-worthiness to replace the reference to highly rated short-term sovereign debt. Merely deleting the first test, without providing an alternative measure of credit-worthiness, fundamentally alters and unacceptably weakens the definition.

The remaining portion of the definition, which is framed in terms of a "substantial inter-bank forward currency market," is not an adequate substitute for two reasons. First, it is too vague, since the term "substantial" is an extremely imprecise quantitative measure. Accordingly, it will not provide sufficient guidance for broker-dealers as they attempt to identify "major market foreign currency" options for purposes of the Net Capital Rule. In addition, this remaining element of the definition does not actually measure credit-worthiness, but instead focuses solely on the volume (and, in an imprecise way, the liquidity[13]) associated with a foreign currency.

The credit-worthiness of a nation's debt is an important test for identifying foreign currency options that deserve favorable treatment under the Net Capital Rule. The standing of a nation's debt can profoundly affect the relative value of the currency of that

[11] 17 C.F.R. § 240.15c3-1a(b)(1)(i)(C).

[12] Release at 26555.

[13] The size of a market does not measure liquidity, which is the appropriate standard for this purpose. For instance, the market could be composed of large and infrequent transactions among a limited number of participants. At a minimum, then, the Proposed Rules should address this issue by making it clear that "substantial" means a deep market with frequent transactions that provides reliable valuation through price discovery.

nation. Risk of default can lead to volatile and difficult-to-measure currency values, creating instability and putting the inter-bank forward currency market for that currency at risk. This, in turn, can adversely affect the value of foreign currency options for purposes of calculating net capital.

Therefore, another measure of credit-worthiness for sovereign debt must be incorporated into the Proposed Rules. Given the limited universe of foreign currencies, a simple and efficient solution would be for the Commission to create a list of foreign currencies, periodically updated, that are deemed to be "major market foreign currencies" for purposes of applying the Net Capital Rule. This approach would provide a simple, reliable, objective, and uniform standard that would promote consistent treatment of foreign currency options by broker-dealers under the Net Capital Rule, for the benefit of investors.

If the Commission chooses not to identify the "major market foreign currencies" for purposes of the Net Capital Rule, then, at a minimum, the Proposed Rules must adopt the approach discussed above in connection with commercial paper, nonconvertible debt, and preferred stock. Thus, the Proposed Rules would provide that the term "major market foreign currency" is limited to currency issued by a nation whose sovereign debt presents "*minimal credit risk*." The Commission would further incorporate a list of factors into the Proposed Rules that broker-dealers would have to apply in determining whether that standard was met. Those factors would need to be tailored to reflect the nature of sovereign debt and the distinctive characteristics that determine its credit-worthiness.

The Proposed Rules Must Establish a New, Uniform, and Transparent Standard to Replace Reliance on Credit Ratings in the Calculation of Counterparty Credit Risk.

Under Appendix E to Rule 15c3-1, broker-dealers authorized to use "alternative net capital" computations have multiple options for computing the deductions from net capital that must be made to account for derivatives-related counterparty credit risk. Currently, those broker-dealers may base their counterparty credit risk determinations either on NRSRO ratings or on the broker-dealer's own internal counterparty credit ratings. Those internal ratings must be performed according to methodologies approved by the Commission.[14] The Proposed Rules would eliminate the references to NRSRO ratings in Appendix E and would require authorized broker-dealers to use their own internal counterparty credit ratings as the sole basis for calculating necessary deductions from net capital associated with counterparty risk in derivatives transactions.

The Proposed Rules would not create a new credit-worthiness standard to replace reliance on NRSRO ratings, and the Commission justifies this approach by relying on the fact that Appendix E already includes an alternative test widely used by broker-dealers and the Proposed Rules would now mandate its use. It is true that the Proposed Rules will require broker-dealers to conduct their own internal credit analysis using methodologies that have been reviewed and approved by the Commission. In one sense, this is the type of

[14] 17 C.F.R. § 240.15c3-1e.

alternative standard of credit-worthiness that Congress intended agencies to substitute for credit ratings.

However, to satisfy the spirit, as well as the letter, of the Dodd-Frank Act, the Commission must adopt a new standard of credit-worthiness that is uniform and transparent. The Proposed Rules must adopt an overall credit standard, such as "minimal credit risk," and must require broker-dealers to apply an explicit set of factors that will appropriately gauge the credit risk associated with counterparties in derivatives transactions.[15]

The Proposed Rules Must Provide an Alternative to Reliance on Credit Ratings in the Exceptions for Investment Grade Nonconvertible and Asset-Backed Securities Under Regulation M, and Must Also Provide More Detailed Guidance for Applying the New Liquidity Standards.

Existing rules 101(c) and 102(d) of Regulation M set forth the types of securities that are exempt from the anti-manipulation provisions normally applicable in connection with securities distributions.[16] Those rules currently exempt nonconvertible and asset-backed securities that have been rated investment grade by at least one NRSRO. The Proposed Rules would remove those tests based on credit-ratings and replace them with alternative standards. However, as noted in the Release, those new standards are not intended as "proxies" for credit risk, but instead are designed to capture more precisely the trading characteristics of securities that make them "less prone" to the type of manipulation that Regulation M was intended to prevent.[17] Thus, in the Proposed Rules, the Commission has shifted its focus away from credit-worthiness to different attributes bearing more directly on susceptibility to manipulation.

Accordingly, the Proposed Rules replace the "investment grade" standard with a three-part test: nonconvertible and asset-backed securities are exempt from Regulation M if they (1) are liquid relative to the market for the asset class; (2) trade in relation to general market interest rates and yield spreads; and (3) are relatively fungible with securities of similar characteristics and interest rate yield spreads.[18]

As a threshold matter, and as conceded in the Release, the standards that the Proposed Rules adopt in place credit-ratings are not "standards of credit-worthiness" within the meaning of the Dodd-Frank Act.[19] Rather, they measure, in effect, the liquidity

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15 A similar analysis applies to Appendix F to Rule 15c3-1, which allows certain derivatives dealers to base counterparty credit risk calculations for net capital purposes either on NRSRO ratings or on the dealer's own internal credit ratings. 17 C.F.R. § 240.15C3-1F(D)(2) and (4). The Proposed Rules would eliminate the alternative of relying on NRSRO ratings, Proposed Rules § 240.15c3-1f(d)(3)(i), and for the same reasons discussed above in connection with Appendix E, the Commission must supply an appropriate alternative standard of credit-worthiness that derivatives dealers must apply.

16 17 C.F.R. § 240.101(c)(2) and 102(d)(2).

17 Release at 26559.

18 Proposed Rules § 242.101(c)(2) and 102(d)(2).

19 Release at 26559.

and fungibility of the securities involved in the distribution. While these traits do make securities more resistant to manipulation and therefore appropriate candidates for the exception, it is not clear that credit-worthiness should play *no* role in identifying the types of securities that should be exempt from the anti-manipulation rule.

The Release does not adequately explain the rationale for eliminating credit-worthiness altogether as an element of the exception. Unless credit-worthiness no longer has any relevance whatsoever to the anti-manipulation rule, there is no justification for ignoring the mandate of the Dodd-Frank Act and failing to provide an alternative standard to replace reliance on credit-ratings. Accordingly, the Proposed Rules must provide credit-worthiness standards, in accordance with the comments above: the Commission must establish an overall credit test that securities must meet to qualify for the exemption, and must identify the factors that will determine whether the overall credit standard is met.

With respect to the application of the new liquidity standards by market participants, the Proposed Rules must provide more guidance. As proposed, they require the person relying on the exception to determine that the three criteria in the exception have been met, "utilizing reasonable factors of evaluation."[20] They further require that the determination must be "verified by an independent third party."[21]

These provisions are useful, but they must be strengthened, or the very manipulation sought to be avoided under Regulation M will reappear via the exempted securities. The Proposed Rules must enumerate the types of factors that any person invoking the exception must apply to ensure that the three criteria are met. In addition, the Proposed Rules must set standards limiting the types of independent third parties that may serve as verifiers. For example, requiring verifiers to be Commission registrants would accomplish two important goals: ensuring that verifiers meet certain minimum fitness standards and ensuring that they are subject to the Commission's examination and enforcement authority.

As we have often argued, prescriptive requirements such as these are exceedingly important to deter evasion, promote uniformity in compliance, and facilitate regulatory oversight.

The Proposed Rules Must Require That Customer Confirmations Provide Investors with Useful Information About Credit Risk, in Place of References to Credit Ratings.

Rule 10b-10 under the Exchange Act requires broker-dealers effecting securities transactions for customers to provide those customers with written notification, at or before completion of the transaction, disclosing certain information about the terms of the transaction.[22] Currently, the confirmation relating to a debt security must inform the

[20] Proposed Rules § 242.101(c)(2) and 102(d)(2).
[21] *Id.*
[22] 17 C.F.R. § 240.10b-10.

customer if the debt security is unrated by an NRSRO.[23] The Proposed Rules would simply delete this requirement from Rule 10b-10.[24]

The Proposed Rules must require Rule 10b-10 confirmations to include information that will achieve the same basic investor protection goal that the disclosure requirement regarding debt securities was originally intended to accomplish. As noted in the Release, the purpose of the mandatory disclosure regarding whether debt securities were rated was not to provide investors with an actual assessment of credit-worthiness. Instead, it was intended to ensure that investors understood the potential need to learn more about the debt securities they had acquired from their broker-dealers.[25]

This purpose can be achieved without reference to credit ratings by informing investors that debt securities vary in terms of their credit-worthiness and that investors should understand the credit quality of the specific debt securities they have acquired through their broker-dealer. In addition, investors must be informed that credit quality can affect not only the value of the debt securities, but also their liquidity and price stability. These disclosures must be mandated so that the net effect of the Proposed Rules is not to provide investors with *less* information than they received prior to implementation of the Dodd-Frank Act.

The Definitions of "Mortgage Related Security" and "Small Business Related Security" Must Incorporate Clear Credit-Worthiness Standards in Place of References to Credit Ratings.

Section 939(e) of the Dodd-Frank Act deleted references to credit ratings in the statutory definitions of "mortgage related security" and "small business related security" under the Exchange Act. Section 939(e) replaced those references with "such standards of credit-worthiness as established by the Commission." These definitions were originally devised to help promote the securitization of both mortgage loans and small business loans, by alleviating some regulatory limitations with respect to securities that met the respective definitions. The Proposed Rules do not actually include suggested standards of credit-worthiness for use in the two definitions, but the Release seeks comment on potential standards that the Commission might develop to implement Section 939(e).[26]

The challenge facing the Commission here is an especially important one, since the alternative standards of credit-worthiness ultimately adopted will undoubtedly have an impact on a huge numbers of investors. In addition, mortgage backed securities proved to be fertile ground for a wide variety of abuses leading to the financial crisis, so extreme regulatory care must be applied in this area.

[23] 17 C.F.R. § 240.10b-10(a)(8).
[24] Proposed Rules § 240.10b-10.
[25] Release at 26564.
[26] Release at 26565.

A number of general principles must guide the Commission as it fashions its alternative standards of credit-worthiness for use in the definitions of "mortgage related" and "small business related" securities. Those standards must be—

- Strong;
- Detailed;
- Mandatory;
- Documented, when applied by market participants in their credit analysis; and
- Devoid of continued references to credit ratings by NRSROs.

As suggested in the Release,[27] and subject to these general principles, the approach followed by the Commission in the Proposed Rules with respect to the Net Capital Rule would be appropriate. The standard would be formulated in terms of "minimal amount of credit risk," provided that an appropriate set of factors were incorporated into the test. Those factors would have to be carefully tailored to address the nature of the securities at issue—the "asset-class specific" factors such as the quality of the underlying mortgages.

Analysis of the underlying assets must play a key role in assessing the credit-worthiness of these securities. In the past, the credit-worthiness of asset-backed securities has been based on a statistical analysis of historical data regarding assets that should perform similarly to the pooled assets. The results for the investors and the economy as a whole were catastrophic. To the extent that these types of securities will continue to be traded, there are several important factors which must be addressed:

- The assets that are used to provide the historical data for credit analysis must be highly correlated in terms of relevant criteria with the assets in the pool. The pooled assets must not be cherry-picked or subject to standards that distinguish them in any way from the historic data.

- The statistical analysis must be structured to yield a result which robustly predicts strong performance of the pooled assets.

- The tests of performance of the pooled assets must not be limited to historical circumstances. As a result of the mortgage securitization debacle, we know that testing based upon only historical assumptions is dangerous for investors and the economy. Credit analysis must consider the unprecedented conditions to which the performance of the pool of assets may be exposed. Thus, stress testing must account for historical, expected, possible, and extreme but plausible conditions.

Any standard of credit-worthiness used to replace credit rating references in the definitions for "mortgage-related" and "small business related" securities must incorporate these principles of credit analysis.

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[27] Release at 26566.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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