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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 242

[Release No. 34-94499; File No. S7-11-22]

RIN 3235-AL14

Removal of References to Credit Ratings From Regulation M

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is re-proposing amendments to remove the references to credit ratings included in certain Commission rules. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), among other things, requires the Commission to remove any references to credit ratings from its regulations. In one rule governing the activity of distribution participants, the Commission is proposing to remove the reference to credit ratings, substitute alternative measures of credit-worthiness, and impose related recordkeeping obligations in certain instances. In another rule governing the activity of issuers and selling security holders during a distribution, the Commission is proposing to eliminate the exception for investment-grade nonconvertible debt, nonconvertible preferred securities, and asset-backed securities.

DATES: Comments should be received on or before May 23, 2022.

ADDRESSES: Comments may be submitted by any of the following methods:

<u>Electronic Comments</u>

- Use the Commission's Internet comment form (http://www.sec.gov/rules/submitcomments.htm); or

- Send an email to rule-comments@sec.gov. Please include File Number S7-11-22 on the subject line; or

Paper Comments

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-11-22. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Operating conditions may limit access to the Commission's Public Reference Room. All comments received will be posted without change; we do not edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: John Guidroz, Branch Chief, Laura Gold, Special Counsel, Jessica Kloss, Attorney-Adviser, or Josephine Tao, Assistant Director, in the Office of Trading Practices, at (202) 551-5777, Division of Trading and Markets, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing to amend the existing exceptions found in 17 CFR 242.101 ("Rule 101") and 17 CFR 242.102 ("Rule 102") for investment-grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities. Specifically, the Commission is proposing to remove the requirement to qualify for the exception in each of these rules that these securities be rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO"). In its place, in Rule 101, the Commission proposes to except (1) nonconvertible debt securities and nonconvertible preferred securities (collectively, "Nonconvertible Securities") that meet a specified probability of default threshold, and (2) asset-backed securities that are offered pursuant to an effective shelf registration statement filed on the Commission's Form SF-3. In addition, the Commission is proposing to eliminate the existing exception in Rule 102 for investment-grade Nonconvertible Securities, and asset-backed securities. The Commission is also proposing amendments to 17 CFR 240.17a-4(b) ("Rule 17a-4(b)") under the Securities Exchange Act of 1934 ("Exchange Act") to require broker-dealers to maintain the written probability of default determination.

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I. Background

Title IX, Subtitle C, of the Dodd-Frank Act includes provisions regarding statutory and regulatory references to credit ratings in the Exchange Act and the rules promulgated thereunder.[1] One such provision, Section 939A, requires the Commission to "review any regulation issued by [the Commission] that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings."[2] Upon completion of this review, the Commission must "remove any reference to or requirement of reliance on credit ratings" and "substitute in such regulations such standard of credit-worthiness" as the Commission determines to be appropriate for such regulations. In making such a determination, the Commission shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by the Commission, taking into account the entities it regulates and the purposes for which such entities would rely on such standards of credit-worthiness.[3] The statute also requires the Commission to

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1 *See* Pub. L. 111-203 secs. 931–939H, 124 Stat. 1376, 1872-90 (2010). These provisions are designed "[t]o reduce the reliance on ratings." Joint Explanatory Statement of the Committee of Conference, Conference Committee Report No. 111-517, to accompany H.R. 4173, 864–79, 870 (June 29, 2010).

2 Pub. L. 111-203 sec. 939A(a); s*ee infra* note 4.

3 *See id*. at sec. 939A(b).

transmit a report to Congress upon the conclusion of the review required in Section 939A(a).[4]

In reference to the requirements in Section 939A, the Commission is proposing amendments to Rule 101 and Rule 102 to remove the existing exceptions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are rated by at least one NRSRO, as that term is used in Rule 15c3-1 under the Exchange Act,[5] in one of its generic rating categories that signifies investment grade.[6] Throughout this release, this exception referencing an investment grade rating is referred to as the "Investment Grade Exception," or the "Investment Grade Exceptions" when referencing the exception provided in Rule 101 and Rule 102 or the rules collectively, as applicable. In place of the Investment Grade Exception in Rule 101, the Commission proposes to substitute alternative standards of credit-worthiness with respect to the type of security that is the subject of a distribution. First, for distributions of Nonconvertible Securities, the Commission is proposing a standard that is based on the probability of default of the issuer.[7] Second, for distributions of asset-backed securities, the

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4 *Id.* at sec. 939A(c); *see* U.S. SECURITIES AND EXCHANGE COMMISSION STAFF, REPORT ON REVIEW OF RELIANCE ON CREDIT RATINGS: AS REQUIRED BY SECTION 939A(C) OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2011), *available at* https://www.sec.gov/news/studies/2011/939astudy.pdf. Staff reports, Investor Bulletins, and other staff documents (including those cited herein) represent the views of Commission staff and are not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of these documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations for any person.

5 17 CFR 240.15c3-1. In 1975, the Commission adopted the term NRSRO as part of its amendments to Exchange Act Rule 15c3-1. In 2013, pursuant to Section 939A of the Dodd-Frank Act, the Commission adopted amendments to Rule 15c3-1 to remove the reference to NRSROs. *See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Release No. 34-71194 (Dec. 27, 2013) [79 FR 1522, 1527–28 (Jan. 8, 2014)].

6 *See* 17 CFR 242.101(c)(2), 17 CFR 242.102(d)(2).

7 To assist the Commission in conducting effective examinations and oversight of distribution participants and their affiliated purchasers, the Commission is also requiring the maintenance and preservation of the written probability of default determination. *See infra* Part V.

Commission is proposing to except asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3. Finally, the Commission is proposing to eliminate the Investment Grade Exception in Rule 102 and not replace it with an alternative standard.

As a set of prophylactic anti-manipulation rules, Regulation M is designed to preserve the integrity of the securities trading markets as independent pricing mechanisms by prohibiting activities that could artificially influence the market for an offered security. Subject to exceptions, Rules 101 and 102 prohibit issuers, selling security holders, distribution participants,[8] and any of their affiliated purchasers[9] from, directly or indirectly, bidding for, purchasing, or attempting to induce another person to bid for or purchase a covered security[10] during a specified period referred to as the "restricted period."[11]

The Investment Grade Exceptions are two of several exceptions to the general

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8 *See* 17 CFR 242.100 ("Rule 100") (defining "distribution participant" as any "underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution").

9 Specifically, Rule 101 governs the activities of "distribution participants," while Rule 102 governs the activities of the issuer and selling security holders. Rules 101 and 102 also apply to the affiliated purchasers of underwriters and issuers or selling security holders, respectively.

10 *See* 17 CFR 242.100 (defining "covered security" as any security that is the subject of a distribution or any reference security, and "reference security" as a security into which a security that is the subject of a distribution may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security).

11 The restricted period for any particular distribution commences one or five business days before the day of the pricing of the offered security and continues until the distribution is complete. The restricted period that applies to a particular offering is determined based on the trading volume value of the offered security and the public float value of the issuer. *See* Rule 100. A person determines when it completes its participation in the distribution based on its role. *See* Rule 100; *Anti-Manipulation Rules Concerning Securities Offerings*, Release No. 34-38067 (Dec. 20, 1996) [62 FR 520, 522 (Jan. 3 1997)] ("Regulation M Adopting Release"). In addition, securities acquired in the distribution for investment purposes by any person participating in a distribution, or any affiliated purchaser of such person, are deemed to be distributed. Rule 100; Regulation M Adopting Release, 62 FR 523.

prohibitions of Rules 101 and 102. The Commission expressed its belief that certain securities and activities should be excepted from the prohibitions in order to allow for activities necessary for the distribution to occur; to limit adverse effects to the trading market that could result from these prohibitions absent such exceptions; and to allow conduct that is not likely to have a manipulative impact.[12] The Commission did not except other securities and activities, however, expressing a belief that the application of Regulation M is appropriate "where the incentive to manipulate can escalate."[13] The securities and activities exceptions provided in Regulation M take into account the different types of interests that distribution participants, issuers, and selling security holders have regarding the outcome of a distribution by providing different and limited exceptions in Rule 102 to issuers and selling security holders.[14] Rule 102 contains fewer exceptions than Rule 101 because issuers and selling security holders have the greatest interest in an offering's outcome and generally do not have the same market access needs as underwriters.[15]

II. Prior Proposals to Remove References to Credit Ratings in Regulation M

The Commission has previously proposed two alternatives with respect to the Investment Grade Exceptions, once in 2008 ("2008 Proposal")[16] and once in 2011 ("2011 Proposal").[17] The

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[12] *See Trading Practices Rules Concerning Securities Offerings,* Release No. 33-7282 (Apr. 11, 1996) [61 FR 17108, 17111, 17120 (Apr. 18, 1996)] ("Regulation M Proposing Release").

[13] Regulation M Adopting Release, 62 FR 528. The Commission also stated more generally that Regulation M applies where there is a "readily identifiable incentive to manipulate the price of an offered security." *Id.* at 540.

[14] *See* Regulation M Adopting Release, 62 FR 530.

[15] *Id.*

[16] *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Release No. 34-58070 (July 1, 2008) [73 FR 40088, 40095-97 (July 11, 2008)] ("2008 Proposing Release").

[17] *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Release No. 34-64352 (Apr. 27, 2011) [76 FR 26550 (May 6, 2011)] ("2011 Proposing Release").

Commission did not adopt any rules based on the 2008 Proposal or the 2011 Proposal.[18]

A. 2008 Proposal

In 2008, prior to the enactment of the Dodd-Frank Act, the Commission proposed to substitute the Investment Grade Exceptions with a standard for Nonconvertible Securities based primarily on the well-known seasoned issuers ("WKSI") concept from Rule 405 of the Securities Act of 1933 ("Securities Act"), as well as a standard for asset-backed securities that were registered on Form S-3.[19] Commenters expressed uniform opposition to the 2008 Proposal.[20] Many of these commenters stated their view that changes to the Regulation M exceptions, such as those in the 2008 Proposal, were not necessary as the Regulation M exceptions did not raise the same concerns about investors' undue reliance on credit ratings as other rules could.[21] Commenters also stated that a result of the 2008 Proposal would be new burdens on issuers and underwriters from imposing the restrictions of Regulation M on currently excepted investment

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18 *See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Release No. 34-71194 (Dec. 27, 2013) [79 FR 1522 (Jan. 8, 2014)].

19 2008 Proposing Release, 73 FR 40095–97. More specifically, the 2008 Proposal—consistent with the definition of WKSI in Securities Act Rule 405—would have excepted Nonconvertible Securities of issuers who have issued at least $1 billion aggregate principal amount of nonconvertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act. *See* 17 CFR 230.405, paragraph (1)(i)(B)(1) of the definition of WKSI; *see also* 2008 Proposing Release, 73 FR 40096.

20 *See* 2011 Proposing Release at 26559 (discussing commenter views about the 2008 Proposal). Comments received in response to the 2008 Proposal are contained in File No. S7-17-08, *available at* https://www.sec.gov/comments/s7-17-08/s71708.shtml. Comments that were received in response to the 2008 Proposal that are relevant to the substance or scope of the amendments being proposed in this release and are discussed below in Part IV. Comments that were received in response to the 2008 Proposal that are relevant to the economic effects of the amendments being proposed in this release and are discussed below in Part VIII.

21 *See*, *e.g.*, Letter from Deborah A. Cunningham and Boyce I. Greer, Co-chairs, Securities Industry and Financial Markets Association ("SIFMA") Credit Rating Agency Task Force, to Florence E. Harmon, Acting Secretary (Sep. 4, 2008) ("SIFMA Letter 1") at 14 ("Regulation M is primarily directed at the actions of the issuers of securities and the investment banks who underwrite them; in contrast, the investors that the Commission is concerned with are not users of Regulation M.").

grade securities.[22] Additionally, commenters expressed the view that certain issuers of high yield securities that are currently subject to Regulation M, but are arguably more vulnerable to manipulation than securities currently excepted from Regulation M, would have been excepted from Rules 101 and 102.[23] These commenters generally did not suggest specific alternatives to the proposed rule changes.[24]

In 2009, in light of the uniform opposition by commenters and continuing concern regarding the undue influence of credit ratings, the Commission reopened the comment period for the 2008 Proposal and invited comments suggesting alternative proposals to achieve the Commission's goals.[25] The Commission received three additional comment letters. Of these, two reiterated earlier objections,[26] and the third stated that the 2008 Proposal would have resulted in adverse effects on foreign sovereign issuers of debt securities.[27] Although the Commission invited commenters to suggest alternative proposals, no new alternatives were suggested.[28] As noted above, the Commission did not adopt any rules based on the 2008 Proposal.

B. 2011 Proposal

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22 Letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association ("ABA"), to Florence E. Harmon, Acting Secretary (Oct. 10, 2008) ("ABA Letter") and SIFMA Letter 1 at 13.

23 ABA Letter at 16 and SIFMA Letter 1 at 13.

24 The ABA did, however, suggest that should the Commission insist on using the WKSI standard for investment grade Nonconvertible Securities, it do so only as an alternative to the current exceptions in Rules 101(c)(2) and 102(d)(2). ABA Letter at 17. However, the ABA expressed its "strong[] belie[f] that the Commission should retain the current exceptions." *Id.* at 16.

25 *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Release No. 34-60790 (Oct. 5, 2009) [74 FR 52374, 52375 (Oct. 9, 2009)].

26 Letter from Mary Keogh, Managing Director, Regulatory Affairs and Daniel Curry, President, DBRS, Inc., to Elizabeth M. Murphy, Secretary (Nov. 13, 2009); Letter from Sean C. Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Elizabeth M. Murphy, Secretary (Dec. 8, 2009).

27 Letter from Steven G. Tepper, Arnold & Porter LLP, to the Honorable Mary L. Schapiro, Chairman (Dec. 8, 2009) ("Arnold & Porter Letter").

28 *See* 2011 Proposing Release, 76 FR 26559.

In 2011, after the Dodd-Frank Act was signed into law, the Commission issued a different proposal, which would have replaced the Investment Grade Exceptions with a standard based on the trading characteristics that the Commission believed made the exceptions apply to securities that were less prone to the type of manipulation that Regulation M seeks to prevent. The 2011 Proposal would have replaced the Investment Grade Exceptions with an exception for Nonconvertible Securities and asset-backed securities that (1) were liquid relative to the market for that asset class, (2) traded in relation to general market interest rates and yield spreads, and (3) were relatively fungible with securities of similar characteristics and interest rate yield spreads.[29] The 2011 Proposal would have required the person seeking to rely on the exception to make the determination that the security in question met these standards utilizing reasonable factors of evaluation. Further, this determination would have been required to be subsequently verified by an independent third party.[30]

Almost all commenters expressed concerns about aspects of the 2011 Proposal.[31] For example, commenters generally had concerns regarding the practicality of the 2011 Proposal. More specifically, there were concerns that, because of the forward-looking and subjective nature of the proposed standards in this release, it would be impractical to make consistent

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[29] 2011 Proposing Release, 76 FR 26559.

[30] *Id.* at 26560.

[31] Comments received in response to the 2011 Proposal are contained in File No. S7-15-11, *available at* https://www.sec.gov/comments/s7-15-11/s71511.shtml. Comments that were received in response to the 2011 Proposal that are relevant to the substance or scope of the amendments being proposed in this release are discussed below, in Part IV. Comments that were received in response to the 2011 Proposal that are relevant to the economic effects of the amendments being proposed in this release are discussed below, in Part VIII. One commenter expressed complete support for the 2011 Proposal. *See* Letter from Kurt N. Schacht, Managing Director, Standards and Financial Markets Integrity, and Linda L. Rittenhouse, Director, Capital Markets Policy, CFA Institute to Elizabeth M. Murphy, Secretary (Dec. 20, 2011) ("CFA Letter").

determinations among market participants, even in the same distributions.[32] Many commenters contrasted these issues with the fact that using credit ratings under the existing standard establishes a bright-line for market participants.[33] Many commenters also stated that the 2011 Proposal would have added costs and delays to the offering process.[34]

One commenter suggested that the risk of manipulation is low for the securities at issue.[35] Another said that the 2011 Proposal was contrary to the approach in Regulation M in general and the exceptions specifically, which was to focus the restrictions of the regulation on those circumstances where the chance for manipulation was heightened,[36] though others disagreed.[37] One commenter suggested that all fixed income securities be excepted from Rules 101 and

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[32] Letter from Sullivan & Cromwell LLP to Elizabeth M. Murphy, Secretary (July 5, 2011) ("Sullivan & Cromwell Letter") at 3; *see also* Letter from Suzanne Rothwell, Managing Member, Rothwell Consulting LLC to Elizabeth M. Murphy, Secretary (July 5, 2011) ("Rothwell Letter") at 6–7 and Letter from Kenneth E. Bensten, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA to Elizabeth M. Murphy, Secretary (July 5, 2011) ("SIFMA Letter 3") at 3–10. SIFMA Letter 3 stated that this could lead to market participants being overly conservative in their analysis in fear of other distribution participants taking more negative views of the security or being overly optimistic regarding the security in order to gain a competitive advantage, leaving the application of the exceptions to something other than whether the security is less susceptible to manipulation. *See* SIFMA Letter 3 at 7.

[33] Letter from Davis Polk & Wardwell LLP to Elizabeth M. Murphy, Secretary (July 5, 2011) ("Davis Polk Letter") at 2; Rothwell Letter at 7; Sullivan & Cromwell Letter at 3; SIFMA Letter 3 at 3; *see also* Letter from Dennis M. Kelleher, President & CEO, and Stephen W. Hall, Securities Specialist, Better Markets, Inc., to Elizabeth M. Murphy, Secretary (July 5, 2011) ("Better Markets Letter") at 5 (arguing for bright-line standards to ensure that manipulation does not occur). Some commenters also pointed to the success of the references to credit ratings in the current exceptions at creating workable exceptions to Regulation M. *See* Rothwell Letter at 2; Sullivan & Cromwell Letter at 3.

[34] Davis Polk Letter at 3; Rothwell Letter at 7; Sullivan & Cromwell Letter at 4; SIFMA Letter 3 at 7.

[35] Davis Polk Letter at 1.

[36] Davis Polk Letter at 1; SIFMA Letter 3.

[37] Sullivan & Cromwell Letter at 2 (stating that "[a]s a purely conceptual matter, we think the new standard is logical and consistent with the principles underlying Regulation M, as they have been developed over time"); CFA Letter at 6–7 (stating that "the exemptions . . . appear to be reasonably focused at preventing the types of manipulation that the regulation seeks to deter").

102.[38] One commenter believed that the 2011 Proposal would have excluded some investment grade securities, changing the scope of the exception.[39]

Commenters also suggested that unintended consequences could have resulted from the 2011 Proposal. Some suggested that, in light of the fact that transactions in Rule 144A securities are generally excepted from Rules 101 and 102,[40] the lack of a bright-line could have reduced the attractiveness of registered offerings because of the complications in using the exceptions from Regulation M as changed by the 2011 Proposal.[41] However, one of these commenters agreed with the Commission's assessment that the "impact of the change should not be substantial."[42]

Some commenters questioned whether Section 939A of the Dodd-Frank Act requires that the Commission change Regulation M at all,[43] whereas others suggested that the proposal did not go far enough to comply with that section.[44] One commenter suggested that the Commission

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[38] This commenter said that the rationale for the exceptions for investment grade fixed income securities applies equally to non-investment grade fixed income securities. SIFMA Letter 3 at 14.

[39] Davis Polk Letter at 4.

[40] *See*, *e.g.*, 17 CFR 242.101(b)(10).

[41] Sullivan & Cromwell Letter at 4–5; SIFMA Letter 3 at 4.

[42] Sullivan & Cromwell Letter at 2. However, this commenter also stated that it did not "perceive any real purpose being served by this proposed change" and while the change would not be substantial, "that is not a good reason to make it." *Id.* It also described the potential impact of the proposal on distributions that are not completed immediately after pricing. *Id.* at 3–5.

[43] For example, commenters who questioned the need for the changes pointed out that the underlying concern with Section 939A, that market participants had become overly reliant on credit ratings as a substitute for their own credit analysis, was not present in the Regulation M exceptions at issue because Regulation M regulates trading practices. *See* Rothwell Letter at 4; Sullivan & Cromwell Letter at 3. One of these commenters also stated that, because the credit rating process has been improved by regulatory changes in recent years, including the Credit Rating Agency Reform Act of 2006, the Commission did not need the 2011 Proposal. *See* Rothwell Letter at 4.

[44] *See* SIFMA Letter 3 at 4 (suggesting adopting a modified version of the 2008 Proposal "now that the Dodd-Frank Act *requires removal* of references to credit ratings") (emphasis added); *see also* Letter from Chris Barnard to Elizabeth M. Murphy, Secretary (June 6, 2011); Better Markets Letter at 13 (questioning whether the 2011 Proposal offered a sufficient "standard of credit-worthiness" as required in Section 939A).

adopt amendments similar to those included in the 2008 Proposal in response to the 2011 Proposal in light of the apparent mandate of 939A to not retain the status-quo.[45] This commenter noted that it preferred a proposal that utilized an objective, bright-line standard.[46] As noted above, the Commission did not adopt any rules based on the 2011 Proposal.

III. Application of Regulation M to Distributions of Nonconvertible Securities and Asset-Backed Securities

The application of Regulation M's prohibitions to distributions of Nonconvertible Securities and asset-backed securities generally is limited because distribution participants and affiliated purchasers are restricted only from bidding for or purchasing securities that are identical in all of their terms to the security being distributed.[47] In other words, the restrictions do not apply for a security if there is a single basis point difference in coupon rates or a single day's difference in maturity dates from the security in distribution.[48]

The Investment Grade Exceptions trace back to a 1975 no-action position taken by Commission staff regarding former Exchange Act Rule 10b-6, the predecessor to Rules 101 and 102.[49] This no-action letter was premised on the principle that investment grade Nonconvertible

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45 SIFMA Letter 3 at 7–8.

46 SIFMA Letter 3 at 9; Letter from Sean C. Davy, Managing Director, Corporate Credit Markets Division, SIFMA, to Elizabeth M. Murphy, Secretary (Jan. 24, 2014) at 3.

47 Regulation M Adopting Release, 62 FR 524.

48 To illustrate with a simple example, absent an exception, a broker-dealer who is participating in a distribution of XYZ Corp.'s 3% bonds maturing 12/31/2029 would be prohibited from making a market in bonds with those terms prior to completing the distribution. The broker-dealer would not, however, be prohibited from making a market in XYZ Corp.'s 3% bonds maturing 12/31/2030 because the date of maturity, a term of the bond, is different from the security in distribution.

49 For a discussion of why the Commission considered replacing former Exchange Act Rule 10b-6 (and other predecessor trading practices rules) with Regulation M, see *Review of Antimanipulation Regulation of Securities Offerings,* Release No. 34-33924 (Apr. 19, 1994) [59 FR 21681 (Apr. 26, 1994)].

Securities and asset-backed securities are less likely to be subject to manipulation because they are traded on the basis of their yields and credit ratings rather than the identity of the particular issuer.[50] This reasoning served as the basis for the Commission's adoption of the Investment Grade Exceptions in Regulation M[51] and continues to serve in part as the basis for the proposed amendments to Rule 101.

While the Commission carried over its reasoning from former Exchange Act Rule 10b-6 to serve as the premise of the Investment Grade Exceptions, it did not adopt the former rule's broad application. In contrast to Regulation M's limited applicability only to distributions of securities that have identical terms, former Exchange Act Rule 10b-6 applied to distributions of "any security of the same class and series."[52] The phrase "same class and series" was construed broadly to encompass securities that were sufficiently similar in their terms to the security in a distribution to raise the possibility that bids for or purchases of the outstanding security might facilitate the distribution, even in the absence of an inherent mathematical relationship between the prices of the two securities.[53]

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50 Letter from Robert C. Lewis, Associate Director, Division of Market Regulation, to Donald M. Feuerstein, General Partner and Counsel, Salomon Brothers (Mar. 4, 1975). The request letter to the staff states that debt securities "are merely a right to receive a fixed amount of money no later than a specified future date, and the issuer's prospects are relevant only insofar as they reflect on its ability to meet its obligations to the debtholders. Thus, nonconvertible debt securities with similar economic terms and similar degrees of assurance of payment are substantially fungible even though their issuers may be different. The economic terms of particular debt issues are susceptible to precise comparison, particularly when mathematically translated into yield to maturity, average life or call. Although the degree of assurance of payment cannot be precisely quantified, debt investors are not influenced by many developments in the issuer's affairs that are material to equity investors. . . . Thus the identity of the issuers of corporate bonds with similar risk factors is not important in the analysis of fixed income securities."

51 *See* Regulation M Adopting Release, 62 FR 527.

52 Former Exchange Act Rule 10b-6(a)(3).

53 *See Review of Antimanipulation Regulation of Securities Offerings*, Release No. 34-33924 (Apr. 19, 1994) [59 FR 21681, 21688 (Apr. 26, 1994)]; *see also* Gamble Skogmo, Inc., SEC No-Action Letter, (Jan. 11, 1974), in

Accordingly, some commenters responding to the 2008 Proposal and the 2011 Proposal stated that reliance on the Investment Grade Exceptions largely is limited to two situations. The first situation is a so-called "reopening," which is an offering of an additional principal amount of fixed-income securities that are identical to, and fungible with, the securities that are already outstanding.[54] One commenter stated that an issuer may want to make a series of offerings of its fixed-income securities via a reopening to match its funding needs or the desires of its target investor class.[55] Further, some foreign sovereign issuers may conduct a reopening for public finance purposes.[56] The second situation identified by commenters is a so-called "sticky offering," which is an offering where a lack of demand results in an underwriter being unable to sell all of the securities in a distribution.[57] One commenter stated that an investor failing to honor a previously given indication of interest is an example of a situation that can cause a sticky offering.[58] Another example provided by a commenter is a "best-efforts" offering.[59]

One commenter noted that, absent the Investment Grade Exceptions, underwriters would

which the staff took a no-action position to permit bids for or purchases of the issuer's outstanding debt securities that varied by at least 1% in coupon interest rate and by at least ten years in maturity from those of the debt securities being distributed.

54 *See* SIFMA Letter 3 at 6.

55 *Id.*

56 *See* Arnold & Porter Letter at 2–3.

57 Sullivan & Cromwell Letter at 4. The Commission also indicated that a sticky offering could be a circumstance in which Regulation M would impact debt securities, stating its belief that "as a practical matter, Rule 101 and Rule 102 will have very limited impact on debt securities, except for the rare situations where selling efforts continue over a period of time." Regulation M Adopting Release, 62 FR 528.

58 Sullivan & Cromwell Letter at 4.

59 Rothwell Letter at 9. In a best-efforts offering, the underwriters are not required to sell any specific number or dollar amount of securities but will use their best efforts to sell the securities offered. *See Plain English Disclosure*, Release No. 34-38164, (Jan. 14, 1997) [62 FR 3152 (Jan. 21, 1997)].

be prohibited from making a market in the distribution securities while the distribution continued.[60] The implication of this is that underwriters would have to "weigh (a) the risk of . . . a continuing distribution occurring, against (b) the possible disruptive effect of having no underwriters making a market in the immediate post-pricing period."[61] Another commenter identified that the absence of an Investment Grade Exception from Rule 102 would disrupt the ability of foreign sovereign issuers and their affiliates to purchase any of the issuer's securities in connection with the sovereign issuer's own general trading and investment activities, or for other public purposes, during the applicable restricted period.[62]

IV. Proposed Amendments to Rules 101 and 102 to Remove References to Credit Ratings

As discussed below, the Commission is proposing to eliminate the Investment Grade Exceptions from both Rules 101 and 102. The Commission is proposing to replace the Investment Grade Exception in Rule 101 with two separate exceptions based on different standards: (1) with respect to Nonconvertible Securities, an exception that is based on a probability of default standard as an indicator of credit-worthiness, and (2) an exception for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3.

A. Rule 101

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[60] Sullivan and Cromwell Letter at 4.

[61] *Id.* (discussing the alternative to following the steps required for an underwriter to determine the availability of the exception from Regulation M under the 2011 Proposal).

[62] Arnold & Porter Letter at 3.

1. Excepted Securities: Nonconvertible Securities

With respect to Nonconvertible Securities, the Commission is proposing to replace the NRSRO reference currently included in Rule 101(c)(2) with a standard utilizing a specified probability of default threshold based on certain structural credit risk models ("Structural Credit Risk Models").[63]

a) Existing Exception for Investment Grade Nonconvertible Securities

As discussed above, Rule 101(c)(2) currently provides an exception for Nonconvertible Securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. The Commission excepted investment grade Nonconvertible Securities from Rule 101 "based on the premise that these securities traded on the basis of their yield and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation."[64]

b) Overview of Structural Credit Risk Models

In 1974, Robert C. Merton published a paper that provided a method, based on the Black-Scholes option pricing model,[65] of analyzing a company's credit risk by modeling a company's equity as a call option on the company's assets ("Merton (1974) Model"), which is generally

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63 As discussed below, the term "structural credit risk model" for purposes of the proposed exception in Rule 101(c)(2)(i) shall mean any commercially or publicly available model that calculates the probability that the value of the issuer may fall below a threshold based on an issuer's balance sheet.

64 Regulation M Adopting Release, 62 FR 527.

65 Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 637–54 (1973). The Black-Scholes option pricing model is used to determine the fair price or theoretical value for a call or put option based on a number of variables, including the volatility and price of the underlying stock, the type of option, time, the option's strike price, and the risk-free rate.

regarded as the first Structural Credit Risk Model.[66] Since 1974, Structural Credit Risk Models, such as the Merton (1974) Model and the Successor Models, have become widely relied upon to determine the probability of an issuer defaulting on its loan obligations.[67] Many commercial data providers, as part of software suites that allow users to analyze securities, employ Structural Credit Risk Models as a way to measure the credit-worthiness of companies.[68] Generally, these models assume that owners of a company's equity will continue to pay the company's liabilities if the company's value exceeds its liabilities. Equivalently, if the equity owners were considered to own a call option on the value of the company with a strike price equivalent to the liabilities owed, the equity owners would exercise the call on the value of the company. If, however, the company's liabilities exceed the company's value, the models assume that the equity owners will choose to default on the company's liabilities, or equivalently, the equity owners would not exercise the call on the value of the company. Accordingly, Structural Credit Risk Models, such as the Merton (1974) Model and the Successor Models, provide a method to estimate the probability that a company might default on its liabilities based on the Black-Scholes option pricing model.

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66 Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 J. FIN. 449, 449-70 (1974). The Merton (1974) Model has been expanded upon and used to develop new Structural Credit Risk Models that rely on its principles ("Successor Models"), such as the Black-Cox (1976) model and the Leland (1994) model. *See, e.g.*, Suresh Sundaresan, *A Review of Merton's Model of the Firm's Capital Structure with its Wide Applications*, 5 ANN. REV. FIN. ECON. 21, 21–41 (2013); Fischer Black & John C. Cox, *Valuing Corporate Securities: Some Effects of Bond Indenture Provisions*, 31 J. FIN. 351, 351–67 (1976); *see also* Hayne E. Leland, *Corporate Debt Value, Bond Covenants, and Optimal Capital Structure*, 49 J. FIN. 1213, 1213-52 (1994).

67 *See infra* Part VIII.B. For example, the Merton (1974) Model and the Successor Models are included in the curriculum for such credentials as the Chartered Financial Analyst. *See, e.g.*, *Credit Analysis Models*, CFA INST. (2022), *available at* https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/credit-analysis-models.

68 *See infra* note 84.

Structural Credit Risk Models typically use measures from firm accounting statements and firm-specific and aggregate market prices. Generally, Structural Credit Risk Models require input variables to calculate an estimated probability of default for a specified horizon, including market value and volatility of the assets, as well as assumptions regarding the threshold for firm asset values, below which the equity owner would default on its obligations ("Default Point").[69] Structural Credit Risk Models provide a probability that a firm's assets will fall below the Default Point at or by the expiration of a defined period of time. Generally, the following variables are needed to calculate the probability of default: (1) the value of the firm, which can be based on observed market prices of a firm's equity security or estimated based on a firm's balance sheet; (2) the volatility of the firm's equity or assets, which can also be based on market observations or estimated based on a firm's balance sheet; (3) the risk-free rate; (4) a time horizon; and (5) the Default Point. Application of Structural Credit Risk Models may be limited in the absence of a market for a firm's equity securities if the market price of the firm's assets, which is required to calculate the probability of default, is difficult to determine.[70]

c) Proposed Probability of Default Exception

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[69] The Default Point is frequently calculated as all short-term liabilities plus half of the long-term liabilities. *See* Mario Bondioli, Martin Goldberg, Nan Hu, Chengrui Li, Olfa Maalaoui, and Harvey J, Stein, *The Bloomberg Corporate Default Risk Model (DRSK) for Public Firms* (2021), *available at* https://ssrn.com/abstract=3911300.

[70] Structural Credit Risk Models calculate the probability of default based on inputs from an issuer's balance sheet. Transactions in equity securities are frequently used as a proxy to determine the value of the firm and the overall volatility of the issuer's assets in Structural Credit Risk Models. Even though a market for an issuer's equities may not exist, this alone does not preclude the ability for a distribution participant to use a Structural Credit Risk Model. Specifically, the issuer's balance sheet will include the liabilities, assets, and equity, which, with further analysis, can be used to determine the inputs for the models. Distribution participants, based on their activities as an underwriter, broker-dealer, or other person who has agreed to participate in a distribution, would have access to an issuer's balance sheet to calculate the probability of default.

As discussed above, Section 939A of the Dodd-Frank Act requires the Commission to remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness as the Commission determines is appropriate for that regulation.[71] The Commission believes that credit-worthiness, which was the basis of the Investment Grade Exception for Nonconvertible Securities in Rule 101, is still appropriate to use as an exception to Rule 101.[72] Specifically, securities of issuers of a certain credit quality trade based on yield and credit-worthiness[73] and are less susceptible to manipulation because other similar Nonconvertible Securities are available to investors as an alternative to the security in distribution. If pricing of a Nonconvertible Security offering is inconsistent with pricing in the overall secondary market for similar Nonconvertible Securities, an investor may purchase

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71 Although two commenters to the 2011 Proposal believed that Section 939A of the Dodd-Frank Act did not mandate the removal of credit rating references from Regulation M, the Commission believes that Section 939A of the Dodd-Frank Act requires the Commission to remove such references from Regulation M, without flexibility to retain the references, contrary to the suggestion made by these commenters. *See supra* note 43. Specifically, Section 939A of the Dodd-Frank Act requires the Commission to review "any references to or requirements in such regulations regarding credit ratings" and issue a report upon conclusion of the review. *See* Pub. L. 111-203 sec. 939A(a) and (c); *see supra* note 4. It then requires the Commission to "remove *any reference to* or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness" as the Commission determines to be appropriate for such regulations. *See* Pub. L. 111-203 sec. 939A(b) (emphasis added). Accordingly, the Commission believes that it does not have discretion to retain the Investment Grade Exceptions provided in Rules 101 and 102.

72 *See supra* note 50 and accompanying text. Sticky offerings of Nonconvertible Securities issued by credit-worthy issuers might indicate that a security is not trading based upon its yield or credit quality, due to some reason, despite the perceived credit-worthy nature of the issuer (based on a probability of default calculation or otherwise). As discussed below, a distribution participant should be able to find someone willing to purchase the Nonconvertible Securities of credit-worthy issuers because the securities would be trading based on their yield and price in relation to securities of similar credit-worthiness. The inability to sell securities of credit-worthy issuers could reflect, for example, a lag between the trading in the market for such Nonconvertible Securities and the credit rating, or more recent concerns related to the issuer of the securities reflected in the market but not yet absorbed in credit-worthiness assessments or inputs for such assessments. The Commission solicits comments below regarding this particular issue.

73 Bonds trade among investors and dealers in secondary markets at prices that depend on economy-wide interest rates, as well as on market perceptions regarding the likelihood that the issuing company will make the promised payments. Hendrik Bessembinder & William Maxwell, *Markets: Transparency and the Corporate Bond Market*, 22 J. ECON. PERSP. 217, 220 (2008).

alternative Nonconvertible Securities that have a better yield, yet are of comparable credit-worthiness, than the security being distributed. Accordingly, the ability to substitute similar Nonconvertible Securities in the market for the security in distribution limits the potential impact that a distribution participant might attempt to exert on the market and distribution of such security. Additionally, when debt has a very low probability of default, the cashflows are close to risk free. Thus, the price of the debt is mainly subject to fluctuations based on aggregate interest rates rather than firm-specific or security-specific news. Thus, Nonconvertible Securities of credit-worthy issuers are less susceptible to the type of manipulation that Rule 101 seeks to prevent.[74] Furthermore, as distribution participants have relied on the Investment Grade Exception, which is based on credit-worthiness, to facilitate orderly distributions of Nonconvertible Securities, the proposed exception has limited potential to disrupt the trading market for securities that have been the subject of a reopening.[75]

As discussed below in Part VIII.B, Structural Credit Risk Models calculate a probability of default that provides a measure of the credit-worthiness of an issuer of a Nonconvertible Security. The Commission preliminarily believes that the probability of default as calculated by Structural Credit Risk Models is an appropriate substitute as a standard of credit-worthiness in

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74 Some commenters to the 2008 Proposal, which would have replaced a credit-worthiness standard with a WKSI standard, believed that the 2008 Proposal would place burdens related to complying with Regulation M on issuers and underwriters who are currently able to rely on the Investment Grade Exceptions. The proposed exception using Structural Credit Risk Models, in contrast to the 2008 Proposal, continues to rely on the premise underlying the Investment Grade Exception—that certain Nonconvertible Securities trade based on their yield and credit-worthiness. Accordingly, similar to how the prohibitions related to Regulation M do not exist for securities that currently meet the Investment Grade Exception, the prohibitions associated with Rule 101 would not exist under the proposed exception for Nonconvertible Securities that trade based on their yield and credit-worthiness.

75 *See* Regulation M Proposing Release, 61 FR 17117 (stating reasons for the exceptions from Regulation M).

Rule 101(c)(2). In particular, the probability of default[76] as estimated by Structural Credit Risk Models is widely used by market and distribution participants to measure credit-worthiness of issuers.[77] As such, the Commission preliminarily believes that the use of Structural Credit Risk Models to determine credit-worthiness could be used as an alternative for Nonconvertible Securities with an investment grade rating for purposes of proposed Rule 101(c)(2)(i).[78]

The probability of default can be independently determined by Structural Credit Risk Models based on observable market events and information available on a firm's balance sheet without reliance on an investment grade credit rating by an NRSRO. Probability of default can be used to identify securities that trade based on their yield and high credit-worthiness, similar to the Nonconvertible Securities that are excepted based on the existing Investment Grade Exception, and thus would be less susceptible to the manipulation that Rule 101 is designed to prevent.

Commenters to the 2011 Proposal raised concerns regarding the 2011 Proposal that the Commission preliminarily believes are not present regarding Structural Credit Risk Models. For example, commenters were concerned that it would be impractical under the 2011 Proposal to make consistent determinations among market participants even in the same distributions and

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76 The term "probability of default" as used in this release to describe the proposed requirement means the actual (or physical) probability, rather than the risk-neutral probability.

77 *See supra* notes 65–68 and accompanying text; *see also infra* note 158. The Commission considered including reduced-form models in addition to Structural Credit Risk Models as part of the exception in Rule 101(c)(2)(i). Reduced-form models rely on statistical analysis rather than the balance sheet to determine a firm's creditworthiness. However, unlike Structural Credit Risk Models, they lack in rigorous theoretical justification as well as economic interpretation of the resulted relationships between the model inputs.

78 Securities with low probability of default (by credit-worthy issuers) do not need to price default risk (because it is very low) and therefore trade based on other, observable characteristics, such as yields or maturity. This implies less price uncertainty, which leaves less room for manipulation of prices.

that the standard proposed in the 2011 Proposal is impractical, forward-looking, and subjective.[79] The Commission preliminarily believes the Structural Credit Risk Models can result in consistent determinations and can be replicated by distribution participants, particularly if distribution participants utilize the same model. Furthermore, the use of a bright-line test, such as a probability of default of 0.055% as discussed below, should address the concern of some commenters that the exception will impose new costs and delays in the offering process and reduce the attractiveness of registered offerings.[80] Whereas the 2011 Proposal depended on a distribution participant's subjective expectations about the future regarding how a security would trade in the market, the proposed standard specifically includes a 0.055% probability of default threshold. The Commission acknowledges that the complex nature of the models, assumptions, and estimated inputs used to estimate the probability of default may not be comparable across different issuers or if the estimates are done using different Structural Credit Risk Models, the results may not be comparable. The Commission, however, believes that the assumptions and estimates that are used to determine the probability of default using Structural Credit Risk Models are appropriately practical, as well as objective, and accordingly the proposed standard is not impractical or overly subjective. In particular, as noted throughout the release, market participants currently rely on Structural Credit Risk Models to assess the credit-worthiness of issuers.

Under the proposed amendment to Rule 101, the exception would be available to the Nonconvertible Securities of issuers for which the probability of default, estimated as of the day

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79 *See supra* note 32.

80 *See supra* note 41.

of the determination of the offering pricing and over the horizon of 12 calendar months[81] from such day, is less than 0.055%,[82] as determined and documented in writing[83] by the distribution participant using a Structural Credit Risk Model.[84] As discussed in Part VIII.B, based on an analysis of the probability of default and investment grade ratings of a sample of Nonconvertible Securities available on the market as of October 22, 2021, the Commission preliminary believes that a probability of default, estimated as of the day of the determination of the offering pricing and over the horizon of 12 calendar months from such day, that is less than 0.055%, as determined by a Structural Credit Risk Model, provides an appropriate substitute for investment grade ratings. Limiting the exception to issuers of Nonconvertible Securities that have a probability of default of less than 0.055% should limit the exception to Nonconvertible Securities that are less susceptible to the type of manipulation that Regulation M is designed to prevent.

Exceptions for investment grade rated Nonconvertible Securities existed in former Exchange Act Rule 10b-6, which preceded the adoption of Regulation M. As discussed above,

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81 The proposed exception would specify 12 calendar months to provide a uniform time horizon to use in the Structural Credit Risk Models to calculate the probability of default. The Commission preliminarily believes that 12 calendar months would provide a minimum period of time for an estimation of probability of default that could address investor concerns that a Nonconvertible Security would default during or shortly after the distribution of the securities. Furthermore, the Commission preliminarily believes that 12 calendar months is the appropriate horizon to include in the Rule to calculate probability of default because it is the horizon that corresponds with vendor models that use Structural Credit Risk Models to calculate probability of default and map to investment grade ratings. Specifying the time horizon in the rule is intended to limit the ability of a distribution participant to modify the time horizon to generate a more favorable probability of default if such distribution participant chooses to calculate the probability of default on its own.

82 *See infra* Part VIII.B.

83 *See infra* Part V.

84 Vendors offer a number of commercial applications based on Structural Credit Risk Models. The Commission preliminarily believes that these models are relied upon by market participants to analyze the credit quality of Nonconvertible Securities or the issuers of such securities. Furthermore, the probability of default calculated by Structural Credit Risk Models, such as the Merton (1974) Model and the Successor Models, can be calculated by distribution participants without the use of a vendor.

Regulation M excepts securities based on their credit-worthiness as determined by an investment grade rating from a NRSRO. As noted by commenters to the 2008 Proposal and 2011 Proposal, the Investment Grade Exception has provided a bright-line test to identify securities that are less prone to the type of manipulation that Regulation M is designed to prevent.[85] The Commission preliminarily believes a standard utilizing a threshold derived from Structural Credit Risk Models provides the advantage of serving as a bright-line test to identify securities that, similar to Nonconvertible Securities currently excepted from Rule 101 based on the Investment Grade Exception, trade based on their yield and credit-worthiness. In particular, based on the Commission's analysis comparing probabilities of default with NRSRO credit ratings, the Commission preliminarily believes that the 0.055% threshold would effectively identify securities that trade based on yield and credit-worthiness, because this threshold appropriately captures most of those securities that meet the credit-worthiness standard under the existing Investment Grade Exception.[86] Accordingly, the Commission preliminary believes that the 0.055% threshold appropriately calibrates the probability of default to determine the credit-worthiness of an issuer whose Nonconvertible Securities would trade based on yield and credit-worthiness, similar to the current Investment Grade Exception.[87]

The Commission acknowledges that a probability of default less than 0.055% could be both under- and over- inclusive in capturing the securities that are excepted under the existing

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[85] *See* ABA Letter at 15–17; *see also* Rothwell at 2.

[86] *See infra* Part VIII.B. Although the proposed standard would include certain securities that are not investment grade as determined by an NRSRO, the model-implied probabilities of default generally use current estimates of equity valuation and volatility, and hence incorporate the most recent news affecting the valuation and perceived volatility of the firm. *See infra* Part VIII.B. As such, an estimate derived from Structural Credit Risk Models is more likely to reflect the most up-to-date indicator of an issuer's credit-worthiness without being hampered by the lag that may exist with NRSRO-determined credit ratings.

[87] *See infra* note 159.

Investment Grade Exception in Rule 101. As a result, the restrictions of Rule 101 would apply to certain Nonconvertible Securities that are currently excepted securities under Rule 101(c)(2). Furthermore, some securities that are not currently excepted securities under Rule 101 could become excepted securities under the proposed probability of default metric. The Commission preliminarily believes that it is appropriate to use a 0.055% threshold because even if it does not capture exactly the same set of securities covered under the existing investment grade standard, this 0.055% threshold would identify Nonconvertible Securities that are less susceptible to the manipulation that Regulation M is designed to prevent because they trade based on their yield and credit-worthiness as determined by the current financial condition of the issuer.

Rule 101(c)(2)(i) would define the term Structural Credit Risk Model to mean any commercially or publicly available model that calculates the probability that the value of the issuer may fall below the Default Point based on an issuer's balance sheet. These models, which estimate the probability of default related to the financial condition of the issuer based on the issuer's liabilities, provide a measure of credit-worthiness specific to that issuer. Additionally, the definition would include only commercially or publicly available models. The Commission understands that distribution participants, such as underwriters and broker-dealers, currently use commercially available models from various vendors to measure and manage credit risk. These commercially available vendor models estimate a probability of default based on the issuer's balance sheet information to set thresholds and market estimates of firm value and volatility. Furthermore, distribution participants can use commonly available spreadsheet software to calculate the probability of default based on publicly available models, which may be found in academic and professional journals.[88] Limiting the definition of Structural Credit Risk Models

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[88] *See supra* note 66.

to commercially or publicly available models is intended to capture these commercially and publicly available models that we understand distribution participants already use and have access to. At the same time, we intend to prevent parties with an interest in the price of the security that is the subject of a distribution and outcome of such distribution from developing their own models to achieve favorable results.

d) Request for Comment

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support their views. Commenters are requested to provide empirical data, economic studies, and other factual support for their views to the extent possible.

1. Do commenters agree that the credit-worthiness of an issuer of Nonconvertible Securities reduces the risk of manipulation that Rule 101 is designed to prevent? Please explain. Is an exception based on probability of default appropriate to preserve Rule 101's anti-manipulation goals? Why or why not?
2. Should the probability of default threshold be higher than 0.055%? For example, should the probability of default threshold be 0.06%, 0.07%, or some other threshold? If so, what should the probability of the default threshold be and why?
3. Should the probability of default threshold be lower than 0.055%? For example, should the probability of default threshold be 0.05%, 0.04%, or some other threshold? If so, what should the probability of the default threshold be and why?
4. Is the 12 calendar months used to calculate the probability of default an appropriate time horizon? Or should some other time horizon be used? Please explain. For example, should it be for the term of the Nonconvertible Security? If so, what should the time horizon be to calculate the probability of default for purposes of Rule 101?

Please explain.

5. Are there other models or model types besides Structural Credit Risk Models that the Rule should use to calculate the probability of default for purposes of Rule 101? If so, please provide the name of the model and provide support regarding why it would be an appropriate substitute for the Investment Grade Exception. Are there model types other than Structural Credit Risk Models that calculate a probability of default? For example, would a reduced-form model provide a probability of default calculation that would indicate a Nonconvertible Security is of such credit-worthiness that such security should be excepted from Rule 101? Please explain.
6. What challenges, if any, would there be to relying on an exception to Rule 101 based on the probability of default as calculated using Structural Credit Risk Models, as defined in Rule 101(c)(2)(i)? Is the definition of Structural Credit Risk Model clear? Should the exception list which models would be considered Structural Credit Risk Models? Is the requirement for the models to be commercially or publicly available clear, or is further guidance needed? Should the exception provide a test regarding what makes a model a Structural Credit Risk Model? For example, should the test for a Structural Credit Risk Model be limited to models published in academic or trade journals that refine the Merton (1974) Model? Please explain.
7. Is there a standard other than Structural Credit Risk Models that Rule 101 should use as a replacement for the Investment Grade Exception? If so, what other standard should proposed Rule 101(c)(2)(i) use and why?
8. Should the calculation of the probability of default in proposed Rule 101(c)(2)(i) be limited to distribution participants? Should the Rule permit distribution participants

to rely on the probability of default calculated by persons that are not distribution participants? If so, who should the Rule include and why should such a person be specifically included in proposed Rule 101(c)(2)(i)? Are there any reasons why the Rule should not permit a distribution participant to perform its own calculation (subject to recordkeeping requirements as proposed)? Please explain. Should distribution participants be required to post or make the probability of default public on their website to rely on the exception? Please explain.

9. Do commenters disagree with the Commission's preliminary belief that market participants are currently relying on vendors' widely available commercial applications based on Structural Credit Risk Models to analyze the credit quality of Nonconvertible Securities or the issuers of such security? Do distribution participants currently have access to vendor probability of default determinations? Please explain why or why not.

10. How often do distribution participants rely on the Investment Grade Exception for Nonconvertible Securities where no other exception from Rule 101 is available?

11. As discussed in Part III, the Commission understands that the Investment Grade Exception is used in limited circumstances, *i.e.,* re-openings, sticky offerings, best efforts offerings, and foreign sovereign issuances. Are there other circumstances where distribution participants rely on the Investment Grade Exception? Please explain. Furthermore, as discussed above in this section, a sticky offering might indicate that an offering is not trading based upon its yield or credit quality. Specifically, the distribution participant is unable to sell its allotment. If the underlying premise of the exception were true, a distribution participant should be

able to find someone willing to purchase the Nonconvertible Securities because the security would be trading based on its yield and price in relation to securities of similar credit-worthiness. Do sticky offerings of credit-worthy issuers disprove the underlying premise for excepting certain Nonconvertible Securities (*i.e.* that securities offerings that become sticky do not trade based on their yield and credit-worthiness, or are there other characteristics of sticky offerings that impact how these securities trade)? For example, do sticky offerings indicate that the credit-worthiness of an issuer is not a sound basis on which to except Nonconvertible Securities, or that there may be other characteristics that may make the securities more at risk of manipulation? If so, what tools are available to distribution participants that could serve as an indicator of such characteristics that could be incorporated into the exception? Since whether a nonconvertible security will become sticky is unknown at the start of the Regulation M restricted period, should the Commission remove the exception from Rule 101 for investment grade Nonconvertible Securities completely? Why or why not?

12. Would the Nonconvertible Securities proposed to be excepted be more vulnerable to manipulation than the securities that meet the existing investment grade standard? Why or why not?

13. Please discuss whether and to what extent investors take into account reliance on the Investment Grade Exception for Nonconvertible Securities when making a decision to invest in such securities. Please also discuss whether, given that Rule 101 is directed at distribution participants and their affiliated purchasers, current Rule 101 poses any danger of undue reliance on NRSRO ratings.

14. Are there factors other than those identified in the proposed exception that influence the trading of Nonconvertible Securities? Are there additional requirements that the Commission should consider with respect to the proposed exception? Are there any requirements that the Commission should remove from the proposal?
15. Would persons needing to use the proposed exception have access to adequate information to determine whether a particular security meets the exception in proposed Rule 101(c)(2)(i)? Why or why not? Should the exception require the issuer's balance sheet to be audited?
16. If the exception as proposed is adopted should the Commission include a period of time for distribution participants to implement the exception based on probability of default? For example, should the exception, if adopted, include a three month, nine month or twelve month implementation period? Please explain. Should the exception, if adopted, go into effect within a short period of time after publication, such as 30-calendar days from being published in the Federal Register? Please explain.

2. Excepted Securities: Asset-Backed Securities Offered Pursuant to an Effective Shelf Registration Statement Filed on Form SF-3

To implement Section 939A(b) of the Dodd-Frank Act, the Commission is, among other things, proposing to replace the existing exception provided in Rule 101(c)(2) for investment grade asset-backed securities[89] with an exception for asset-backed securities that are offered pursuant to an effective shelf registration[90] statement filed on Form SF-3,[91] as discussed below.

a) Background: Form SF-3

In 2014, the Commission adopted shelf eligibility criteria for asset-backed securities offerings registered on new Form SF-3 in part to implement Section 939A(b) of the Dodd-Frank Act.[92] Form SF-3 includes the following transaction requirements among other shelf eligibility criteria:

- Delinquent assets do not constitute 20% or more, as measured by dollar volume, of the asset pool as of the measurement date;
- With respect to securities backed by certain leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases does not constitute 20% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date;
- A certification by the chief executive officer of the depositor is made at the time of each takedown;

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89 *See* 17 CFR 242.101(c)(2) (providing an exception for asset-backed securities "that are rated by at least one nationally recognized statistical rating organization, as that term is used in [Rule 15c3-1 under the Exchange Act], in one of its generic rating categories that signifies investment grade").

90 Shelf registration is a procedure that allows companies to file a single registration statement covering more than one issuance of the same security, subject to certain requirements. *See generally* 17 CFR 230.415 (providing requirements for securities to be registered for an offering to be made on a continuous or delayed basis in the future).

91 *See* Proposed Rule 101(c)(2)(ii). Currently, the exception for asset-backed securities is provided in the same paragraph as the exception for Nonconvertible Securities, in Rule 101(c)(2). *See* 17 CFR 242.101(c)(2). The Commission is proposing to separate the existing exception into separate exceptions for Nonconvertible Securities and asset-backed securities in Proposed Rules 101(c)(2)(i) and 101(c)(2)(ii), respectively.

92 *See Asset-Backed Securities Disclosure and Registration*, Release No. 34-72982 (Sept. 4, 2014) [79 FR 57184 (Sept. 24, 2014)] ("Regulation AB II Adopting Release"). Form SF-3 also carried over shelf-eligibility requirements for asset-backed securities that previously were located in Form S-3, such as transaction requirements regarding the percentage of delinquent assets and, for certain lease-backed securitizations, the portion of the pool attributable to residual value. *See* Regulation AB II Adopting Release, 79 FR 57265, n.936.

- An asset review provision in the underlying transaction agreements requires review of the pool assets, upon the occurrence of certain trigger events, for compliance with the representations and warranties made with regard to those assets;
- A dispute resolution provision for repurchase requests is contained in the underlying transaction documents; and
- A disclosure provision, as required in an underlying transaction agreement, of investors' requests to communicate with other investors related to an investor's rights under the terms of the asset-backed security was received during the reporting period by the party responsible for making Form 10-D filings.[93]

The Commission designed the shelf eligibility requirements to help ensure a certain "quality and character" in light of the requirement to reduce regulatory reliance on credit ratings.[94] In particular, the shelf eligibility requirements were designed to help ensure that expected cash flows are sufficient to service payments or distributions in accordance with their terms;[95] that obligated parties more carefully consider the characteristics and quality of the assets that are included in the pool;[96] that asset-backed securities shelf offerings have transactional safeguards and features that make those certain securities appropriate to be issued without prior Commission staff review;[97] and that issuers design and prepare asset-backed securities offerings with greater oversight and care.[98] As discussed below, the Commission believes that the asset-backed

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93 *See* Registration Statement Under the Securities Act of 1933 (Form SF-3), *available at* https://www.sec.gov/files/2017-03/formsf-3.pdf; Regulation AB II Adopting Release, 79 FR 57189.

94 *See* Regulation AB II Adopting Release, 79 FR 57189.

95 *See* Regulation AB II Adopting Release, 79 FR 57265.

96 *See* Regulation AB II Adopting Release, 79 FR 57278.

97 *See* Regulation AB II Adopting Release, 79 FR 57283.

98 Regulation AB II Adopting Release, 79 FR 57265, 57285.

securities offered pursuant to an effective shelf registration statement filed on Form SF-3 trade primarily on the basis of yield and credit-worthiness. This proposed rule change would not limit a market participant's ability to substitute a security that is similar, and that is of comparable credit-worthiness, to the security that is the subject of a distribution if the pricing of the security were inconsistent with pricing in the overall secondary market for similar asset-backed securities, thereby limiting the potential for manipulation. The Commission continues to believe that its original basis for excepting securities of a certain quality and character is appropriate and that such securities are less at risk of the manipulation that Regulation M addresses.[99]

b) Existing Exception for Investment Grade Asset-Backed Securities

As discussed above, Rule 101(c)(2) currently provides an exception for asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. The Commission excepted investment grade asset-backed securities from Rule 101 because such securities trade primarily on the basis of yield and credit rating.[100] In providing this rationale, the Commission stated that the principal focus of investors in the asset-backed securities market is on the structure of a class of securities and the nature of the assets pooled to serve as collateral for those securities rather than on the identity of a particular issuer.[101] The Commission also stated that Rule 101 excepts investment grade securities that are

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[99] *See* Regulation M Adopting Release, 62 FR 527; *see also Prohibitions Against Trading by Persons Interested in a Distribution*, Release No. 34-19565 (Mar. 4, 1983) [48 FR 10628, 10631 (Mar. 14, 1983)] (stating the Commission's belief that the "fungibility" of certain types of securities makes manipulation of their price very difficult); *supra* note 50 and accompanying text.

[100] *See* Regulation M Adopting Release, 62 FR 527.

[101] *See* Regulation M Adopting Release, 62 FR 527.

"primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders."[102]

c) Proposed Amendments to Rule 101

As discussed above, in accordance with Section 939A of the Dodd-Frank Act, the Commission proposes to remove Rule 101's current exception for investment grade asset-backed securities based on NRSRO ratings. In place of that exception, the Commission is proposing a new exception in Rule 101(c)(2)(ii) for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3. This proposed rule change, which would carry over the standard of credit-worthiness included in the Commission's Form SF-3, also helps to implement the mandate that, to the extent feasible, uniform standards of credit-worthiness be used.[103]

The proposed rule is not based on a probability of default threshold derived from Structural Credit Risk Models with respect to asset-backed securities. An exception for asset-backed securities that is based on a probability of default threshold may be unfeasible due to the potential widespread inability of distribution participants and their affiliated purchasers to collect all of the information required to calculate the probability of default, such as the value and volatility of the assets underlying asset-backed securities. Therefore, the Commission is

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102 *See* Regulation M Adopting Release, 62 FR 527 (citations omitted). The Commission stated that such rationale also applies to the existing identical exception provided in Rule 102(d)(2) of Regulation M. Regulation M Adopting Release, 62 FR 531.

103 Pub. L. 111-203 sec. 939A(b) (requiring agencies to "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").

proposing an exception for certain asset-backed securities based on a separate standard that is more consistent with the existing Investment Grade Exception for asset-backed securities, as discussed below. The proposed rule does not contain a standard of credit-worthiness that relies on Form SF-3 with respect to Nonconvertible Securities because the transaction requirements included in Form SF-3 are relevant only to asset-backed securities. As discussed below, because the transaction requirements included in Form SF-3 serve as an indicator of credit-worthiness, the proposed exception that relies on Form SF-3 would not apply to securities that are not subject to those transaction requirements.

The proposed exception continues to be derived from the premise that certain asset-backed securities are traded based on factors such as their yield and credit-worthiness.[104] The Commission is proposing to except only the asset-backed securities offered pursuant to an effective shelf registration statement filed on Form SF-3 to further Regulation M's anti-manipulation goals. This proposed requirement regarding an effective Form SF-3 would except from Rule 101 the types of asset-backed securities that would trade based on their yield and credit-worthiness due to their qualities and characteristics and that are therefore less prone to the type of manipulation that Regulation M seeks to prevent.[105]

The Commission believes that the transaction requirements included in Form SF-3 allow for shelf offerings of only those asset-backed securities that share the qualities and characteristics of the investment grade asset-backed securities currently excepted from the provisions of Rule

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104 *See* Regulation M Adopting Release, 62 FR 527.

105 *See supra* note 50 and accompanying text. The ability of a market participant to substitute a security that is similar, and that is of comparable credit-worthiness, to the security that is the subject of a distribution limits the ability of a distribution participant or its affiliated purchaser from bidding up the price of the subject security.

101: with respect to both sets of securities, the principal focus of investors is the structure of a class of securities and the nature of the assets pooled to serve as collateral for those securities, rather than on the identity of a particular issuer.[106] First, eligibility for offering securities pursuant to a Form SF-3 is limited, in part, by the percentage of delinquent assets and, for certain lease-backed securitizations, by the portion of the pool attributable to the residual value.[107] For an asset-backed securities offering with an effective Form SF-3, delinquent assets cannot constitute 20% or more of the asset pool. Delinquent assets may not convert into cash within a finite period of time, as required by the definition of "asset-backed security," because they are not performing in accordance with their terms and management or that other action may be needed to convert the assets into cash. However, as expressed at the adoption of Form SF-3, in principle, asset-backed securities should be primarily dependent on the pool of assets self-liquidating instead of on the ability of the entity performing collection services.[108] The application of the limitation on delinquent assets included in Form SF-3 was designed to ensure that attention is focused on the ability of collateral of the underlying asset pool to generate cash

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[106] *See supra* note 102.

[107] *See* 17 CFR 239.45(b)(v), (vi); Form SF-3, I.B.1(e).

[108] *Asset-Backed Securities*, Release No. 33-8518 (Dec. 22, 2004) [70 FR 1506, 1517 (Jan. 7, 2005)] ("Regulation AB Release"). In adopting the 20% delinquency concentration level, the Commission codified a staff position that an asset-backed security will not fail to meet the definition of "asset-backed security" solely because such a security is supported by assets having total delinquencies of up to 20% at the time of the proposed offering. *See* Regulation AB Release, 70 FR 1517 (citing Bond Mkt. Ass'n, SEC Staff No-Action Letter, 1997 WL 634124 (Oct. 8, 1997)). This threshold was the same threshold that was applied to certain other matters affecting registration and disclosure requirements for asset-backed securities (e.g., non-recourse commercial mortgage securitizations, pooling of corporate debt securities, and securitizations involving third-party credit enhancement). *See* Bond Mkt. Ass'n, SEC Staff No-Action Letter, 1997 WL 634124, at * 3. The staff position was based on the premise that such a threshold for total delinquency concentration would, by itself, not present a materially greater risk of asset non-performance or default at the security level. *See Id.*, 1997 WL 634124, at * 4.

flow rather than on the identity of the issuer and its ability to convert those assets into cash,[109] consistent with the Commission's original basis for excepting investment grade asset-backed securities from Rule 101.[110]

Second, Form SF-3 includes certain transaction requirements with respect to the structure of the asset-backed security being offered. Such structural requirements include (1) a certification by the depositor's chief executive officer that, among other things, the securitization structure provides a reasonable basis to conclude that the expected cash flows are sufficient to service payments or distributions in accordance with their terms; (2) a review of the asset-backed security's pool of assets upon the occurrence of certain triggering events, including delinquencies, by a person that is unaffiliated with certain transaction parties, such as the sponsor, depositor, servicer, trustee, or any of their affiliates; and (3) a dispute resolution provision, contained in the underlying transaction documents, for any repurchase request. When adopting the requirements included in Form SF-3, the Commission stated that sponsors may have an increased incentive to carefully consider the characteristics of the assets underlying the securitization and accurately disclose these characteristics at the time of offering. The Commission also believed that investors should benefit from the reduced losses associated with nonperforming assets because, as a result of this new shelf requirement, sponsors will have less of an incentive to include nonperforming assets in the pool.[111] Because the transactional safeguards included in Form SF-3 provide incentives for obligated parties to, among other

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109 *See* Regulation AB Release, 70 FR 1517.

110 *See* Regulation M Adopting Release, 62 FR 527.

111 *See* Regulation AB II Adopting Release, 79 FR 57283.

things,[112] more carefully consider the quality and character of the assets that are included in the pool,[113] asset-backed securities that are offered pursuant to an effective Form SF-3 should trade based on their yield and credit-worthiness rather than on the identity of a particular issuer.[114] The application of the transaction requirements included in the Commission's Form SF-3, therefore, should result in the offering of asset-backed securities that have similar qualities and characteristics to the investment grade asset-backed securities currently excepted under the existing provision in Rule 101(c)(2).

The Commission believes that the requirement regarding an effective shelf registration statement filed on Form SF-3 is an appropriate substitute for the Investment Grade Exception currently provided in Rule 101(c)(2) because the proposed standard intends to limit eligibility for that exception to only those asset-backed securities that trade based on their yield and credit-worthiness due to their particular qualities and characteristics. Because the ability of distribution participants and their affiliated purchasers to bid up the price of an asset-backed security offered pursuant to an effective Form SF-3, during a distribution, is limited by a market participant's ability to substitute the security with other securities that are similar and of comparable credit-worthiness,[115] the Commission believes that such a security is less susceptible to the types of manipulation that Regulation M seeks to prevent.

d) Request for Comment

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support their views. Commenters are requested to provide

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112 *See supra* notes 94–98 and accompanying text.

113 *See* Regulation AB II Adopting Release, 79 FR 57278.

114 *See, e.g.*, Regulation AB II Adopting Release, 79 FR 57277–78.

115 *See* Regulation M Adopting Release, 62 FR 527; *see also supra* note 50 and accompanying text.

empirical data, economic studies, and other factual support for their views to the extent possible.

17. How often and in which context is the Investment Grade Exception for asset-backed securities utilized where no other exception from Rule 101 is available?

18. As discussed above, the existing Investment Grade Exception for asset-backed securities and the proposed exception provided in paragraph (c)(2)(ii) of Rule 101 are premised on the ability of a market participant to substitute a security (in distribution) with other securities that are similar and of comparable credit-worthiness if there is a pricing aberration in the secondary market for similar securities. What is the universe of securities that is likely to be substituted in such instance? Please explain.

19. If the Investment Grade Exception for asset-backed securities is rarely, infrequently, or never used, or if the proposed standard for asset-backed securities has limitations in practice or otherwise, should the Commission remove the exception for asset-backed securities completely? Why or why not?

20. What specific trading activities that currently occur pursuant to the Investment Grade 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 asset-backed securities or an exception for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3? What benefits or challenges would this approach create?

21. Should the proposed exception be expanded to apply to all asset-backed securities, such as asset-backed securities registered on Form SF-1? What activities would then

be allowed that were previously prohibited under Rule 101? To what extent would these additional activities be at risk of manipulation? Why or why not?

22. Are there any types of asset-backed securities that should not be covered by the proposed exception? Please explain.
23. Would the asset-backed securities excepted in the proposal be more vulnerable to manipulation than the securities that meet the existing investment grade standard? Why or why not?
24. Is the proposal to except only asset-backed securities that are offered pursuant to an effective shelf registration statement filed on the Commission's Form SF-3 an appropriate substitute for credit ratings in this context? What effect(s), if any, would the proposed modifications to the current exception have on the market for asset-backed securities? Please explain.
25. How difficult and costly in practice would the requirements of the proposed exception be to apply? If the requirements are more difficult or costly to apply, how might this impact the scope of securities subject to the prohibitions of Regulation M? For example, to what extent, if any, might a narrower range of securities meet the exception as a result of the proposal, if adopted? If fewer securities are excepted from the prohibitions of Regulation M, in what ways and to what extent, if any, would this impact the market for those securities that would no longer qualify for an exception?
26. Will fewer asset-backed securities issuances meet the requirement for this exception? If so, what impact would this proposed exception have on the market for new issuances of these securities?

27. Please discuss whether and to what extent investors take into account reliance on the current Rule 101(c)(2) exception for investment grade asset-backed securities when making a decision to invest in such securities.
28. Are there factors other than those identified in the proposed exception that influence the trading of such securities? Are there additional requirements that the Commission should adopt with respect to the proposed exception? Are there any that the Commission should remove from the proposal?
29. Would a probability of default standard be appropriate for the exception for asset-backed securities? Are there models used to calculate a probability of default threshold (e.g., reduced-form models or structural models of credit risk) for asset-backed securities that would be relevant to consider based on the type of security involved? If so, what threshold should be included in the exception to Rule 101 for asset-backed securities? What benefits would this approach provide? What other concerns could this approach raise? How would this approach address potential conflicts of interest involving the distribution participant or affiliated purchaser? Please explain.
30. Are there any concerns with regard to distribution participants and affiliated purchasers' ability to collect any of the information required for the probability of default calculation for asset-backed securities? If so, please explain.

B. Rule 102

1. Existing Investment Grade Exception

Rule 102 contains fewer exceptions than Rule 101 does because issuers and selling security holders have the greatest interest in an offering's outcome (and thereby should be subject to Regulation M's prohibitions) but generally do not have the same market access needs as underwriters do (and as such are expected to have less of a desire to seek an exception).[116] Despite these differences in the situation of issuers and selling security holders as compared to distribution participants, the exception for certain investment grade securities provided in former Exchange Act Rule 10b-6 was carried over to Regulation M as paragraph (d)(2) at the adoption of Rule 102.[117]

2. Proposed Removal of Investment Grade Exception

The Commission is proposing to amend Rule 102 to remove the Investment Grade Exception. As noted above, there are limited situations in which issuers, selling security holders, or their affiliated purchasers rely on the Investment Grade Exception provided in Rule 102.[118] Given this apparent limited reliance, coupled with the incentive for issuers, selling shareholders, and their affiliated purchasers to manipulate the market for the distributed security exists

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[116] Regulation M Adopting Release, 62 FR 530. Further, the Commission has also stated that "[a]n issuer or selling shareholder may have a substantial incentive to raise improperly the price of offered securities." Regulation M Proposing Release, 61 FR 17120.

[117] The Commission initially proposed not to include the Investment Grade Exception in Rule 102. Regulation M Proposing Release, 61 FR 17120 ("[T]he Commission preliminarily believes that it may not be appropriate to extend the . . . the exception for investment grade debt and investment grade preferred securities provided in Rule 101, to issuers, selling security holders, or their affiliated purchasers.") The Commission, however, adopted the Investment Grade Exception in Rule 102 "based on commenters' views and the rationales indicated . . . for an identical exception to Rule 101." Regulation M Adopting Release, 62 FR 531.

[118] No commenter responding to the 2011 Proposal mentioned issuers, selling security holders, or their affiliated purchasers relying on the Investment Grade Exception. However, one commenter to the 2008 Proposal commented that the substitution of the Investment Grade Exception with a WKSI standard would prevent foreign sovereign issuers or affiliated purchasers from purchasing the foreign sovereign's bonds for its own general trading and investment activities, or for other public purposes, during the applicable restricted period. *See* Arnold & Porter Letter at 3. Given that the prohibitions of Regulation M apply only to bonds with the exact same terms of the bond in distribution, as discussed above in Part III, the Commission believes that the concerns raised by this commenter would rarely occur. Furthermore, the bond in distribution could be structured by the foreign sovereign in a manner so that Rule 102's restrictions would not impede a foreign sovereign issuer or its affiliated purchasers from engaging in its own general trading and investment activities, or for other public purposes.

regardless of the credit quality of the security,[119] the Commission believes that the existing exception should be eliminated without replacement.[120] Further, the Commission believes that, while substituting an alternative standard of credit-worthiness may except securities that have little manipulative potential, retention of such an exception is not likely necessary to facilitate orderly distributions of securities or to limit potential disruptions in the trading market in light of issuers' limited market access needs.[121] Accordingly, the proposed amendment to Rule 102 should protect investors and further Regulation M's anti-manipulation goals in the rare event of

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[119] *See supra* Part IV.B.1.

[120] Other than "exempted securities," as defined in Section 3(a)(12) of the Exchange Act, the Investment Grade Exception provided in Rule 102 is the only security-based exception that permits an issuer, selling shareholder, or its affiliates to purchase the securities in distribution absent a need for the issuer to facilitate an orderly distribution or to limit potential disruptions in the trading market. For example, the security-based exception for open-ended investment companies is designed to ensure that open-ended investment companies can redeem shares during a continuous distribution without (by itself engaging in that exact activity) violating Regulation M. *See* 17 CFR 242.102(d)(4). Rule 102 does not provide an actively-traded securities exception like Rule 101 does. Instead, the relevant exception provided in Rule 102 is based on actively-traded *reference* securities, which is designed to allow issuers or selling security holders to purchase an actively-traded reference security issued by an unaffiliated entity in a hedging transaction. *See* Rule 101(c)(1) and Rule 102(d)(1). As the Commission stated in the adopting release regarding the actively-traded *reference* securities exception, the Commission believes that persons subject to Rule 102 should not be able to trade in their securities. *See* Regulation M Adopting Release at 531. As stated in the Regulation M Adopting Release, the Commission's view is based on the issuers' and selling security holders' stake in the proceeds of the offering, and their generally lesser need to engage in securities transactions. *Id.*

[121] *See* Regulation M Proposing Release, 61 FR 17117 (stating reasons for exceptions from Regulation M). Disruption to the trading market may be limited because distribution participants would still be able to rely on the exception from Rule 101 if they meet the requirements of the proposed rules. While the one commenter that addressed sovereign issuers and Rule 102 pointed to certain exemptive orders issued in the early 2000s to support a contention that sovereign issuers should continue to be excepted from Regulation M because the securities trade primarily on the basis of a spread to a United States Treasury security, all but one of the exemptive orders cited by the commenter only exempted the recipient from Rule 101. *See* Arnold & Porter Letter at 3. For orders cited by this commenter that only provided an exemption from Rule 101, *see Federative Republic of Brazil* (Jan. 21, 2000; Apr. 29, 2003; July 3, 2003; Sept. 9, 2003; Oct. 15, 2003). *See also Regulation M - Sovereign Bond Exemption* (Jan. 12, 2003) (order exempting certain distributions of certain sovereign bonds from Rule 101, not Rule 102). For the one order cited by this commenter that provided an exception from Rule 102, *see United Mexican States* (Feb. 17, 1999). Because the proposed amendments would place distribution participants in a similar position to distribution participants trading the securities issued by the sovereign issuers pursuant to existing Rule 101 exemptive orders, and given that the exception under Rule 102 appears seldom used, we believe it is appropriate to eliminate the exception in Rule 102 as proposed.

an issuer or its affiliate desiring to purchase or bid for Nonconvertible Securities or asset-backed securities that are in distribution.

Under the proposed amendment to Rule 102, an issuer of investment grade Nonconvertible Securities and asset-backed securities that is participating in a distribution of its own securities would not have an exception and would need to ensure that the applicable restricted period is complete before purchasing, bidding for, or attempting to induce others to purchase or bid for, the covered security. Market participants can structure their offerings to ensure compliance with Rule 102 by, for example, completing the distribution prior to purchasing any covered security and thus completing the applicable Rule 102 restricted period, or distributing bonds with different terms from outstanding bonds. The Commission preliminarily believes that eliminating the exception is appropriate because it would decrease the risk of conduct raising improperly the price of an offered security without impeding the facilitation of orderly distributions of securities.[122] For the same reason, while the Commission adopted the Investment Grade Exception in Rule 102 in response to commenters responding on the original Regulation M Proposing Release[123] and received one comment discussing this exception in response to the 2008 Proposal,[124] the Commission is concerned that issuers and selling security holders have the greatest interest in an offering's outcome thereby heightening the risk of manipulation.

3. Request for Comment

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[122] Regulation M Proposing Release, 61 FR 17120. *See also Review of Antimanipulation Regulation of Securities Offerings,* Release No. 34-33924 (Apr. 19, 1994) [59 FR 21681, 21686 (Apr. 26, 1994)] (stating "issuers and selling shareholders have a clear incentive to manipulate the price of the securities to be distributed. A very small change in the market price of a security, which in some circumstances may be accomplished at relatively little expense, can result in a substantial increase in offering proceeds.").

[123] *See* Regulation M Adopting Release at 531.

[124] *See* Arnold & Porter Letter.

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support alternative recommendations. Please provide empirical data, when possible, and cite to economic studies, if any, to support alternative approaches.

31. Do issuers, selling security holders, and their affiliated purchasers have an incentive to manipulate securities that currently qualify for the Investment Grade Exception from Rule 102? If yes, would substituting the probability of default approach for the current exception address this incentive to manipulate?
32. If commenters are aware of situations where issuers, selling security holders, or their affiliated purchasers are currently relying on the Investment Grade Exception in Rule 102, do these activities raise improperly the price of the offered securities? Why or why not?
33. If the Investment Grade Exception in Rule 102 proposed to be removed is adopted, would it result in potential disruptions to trading and if so, please explain. Can market participants structure their distributions to comply with Regulation M? In light of the proposed removal of the exception, would any alternative structures be detrimental to the capital raising process?
34. Would the proposed removal of the Investment Grade Exception in Rule 102 impede the facilitation of orderly distributions of securities or result in potential disruptions to trading markets? Why or why not?
35. Should the Commission adopt an exception based on either the probability of default standard for Nonconvertible Securities or asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3 for Rule 102

instead of removing the Investment Grade Exception without substituting an alternative? Why or why not? Should the Commission adopt an exception for Rule 102 if a distribution participant determines that a security is an excepted security pursuant to Rule 101(c)(2)?

36. As discussed above, one commenter to the 2008 Proposal believed that the removal of the Investment Grade Exception for foreign sovereign bonds would impede a foreign sovereign or its affiliated purchasers from engaging in its own general trading and investment activities, or other public purposes. Should the Commission adopt an exception from Rule 102 for bonds issued by a foreign government or political subdivision thereof? For example, should the Commission except from Rule 102 any bond issued by a foreign sovereign or political subdivision thereof filed with a registration statement pursuant to Schedule B of the Securities Act? Do all bonds issued by foreign sovereigns or political subdivisions thereof trade based on a spread to U.S. Treasury securities? Please explain.

V. Recordkeeping Requirement: Rule 17a-4(b)(17)

A. Proposed Recordkeeping Requirement

The Commission is proposing a new recordkeeping requirement that broker-dealers who are distribution participants or affiliated purchasers must keep certain records pursuant to Rule 17a-4 under the Exchange Act, the Commission's broker-dealer record retention rule. Proposed paragraph (b)(17) of Rule 17a-4 would require broker-dealers relying on the exception for Nonconvertible Securities to preserve the written probability of default determination made pursuant to proposed paragraph (c)(2)(i) of Rule 101. Accordingly, broker-dealers relying on the exception in proposed paragraph (c)(2)(i) of Rule 101 would be required to preserve for a period of not less than three years, the first two years in an easily accessible place, the written probability of default determination made pursuant to proposed paragraph (c)(2)(i) of Rule 101.

Under proposed paragraph (c)(2)(i) of Rule 101, broker-dealers relying on the exception would need to determine and document in writing that the probability of default of the issuer of Nonconvertible Securities is, estimated as of the day of the determination of the offering pricing and over the horizon of 12 calendar months from such day, less than 0.055% using a Structural Credit Risk Model. Broker-dealers relying on the exception in proposed Rule 101(c)(2)(i) would be required to preserve the written probability of default determination pursuant to Rule 17a-4. The proposed amendment to Rule 17a-4 would modify the existing practices of broker-dealers who are distribution participants or affiliated purchasers to impose new recordkeeping burdens when relying on the exception in proposed Rule 101(c)(2)(i). A broker-dealer that uses a vendor to determine the probability of default threshold could satisfy this recordkeeping requirement by maintaining documentation of the assumptions used in the vendor model, as well as the output provided by the vendor supporting the probability of default determination. A broker-dealer calculating the probability of default on its own could satisfy the recordkeeping requirement by maintaining documentation of the value of each variable used to calculate the probability of default, along with a record identifying the specific source(s) of such information for each variable.

The proposed requirement to preserve the written probability of default determination pursuant to Rule 17a-4 is consistent with other retention obligations of records that Exchange

Act rules impose on broker-dealers.[125] Exchange members and broker-dealers are currently required to comply with the three-year preservation period in Rule 17a-4 for other records and should have procedures to satisfy such preservation requirements in place.[126]

The proposed recordkeeping requirement is intended to aid the Commission in its oversight of broker-dealers who are distribution participants or affiliated purchasers and rely on the exception in proposed paragraph (c)(2)(i) of Rule 101 by requiring such broker-dealers to retain the written probability of default determination supporting their reliance on the exception. The written records documenting the probability of default determination would be subject to review in regulatory examinations by Commission staff and self-regulatory organizations.

B. Request for Comment

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support their views.

37. Is the retention of information by distribution participants or affiliated purchasers for a period of three years, the first two years in an easily accessible place, in proposed paragraph (b)(17) of Rule 17a-4 appropriate? If not, what would be a more appropriate period of time, and why? Would investors, the Commission, or the public benefit from a retention period that is longer than three years? What would the costs be for broker-dealers who are distribution participants or affiliated purchasers for a retention period that is longer than three years?
38. Is the retention requirement in proposed paragraph (b)(17) of Rule 17a-4 burdensome or costly? Please explain. If so, in what ways could modifications to the Rule as

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[125] *See id.*

[126] 17 CFR 240.17a-4(b).

proposed reduce these burdens and costs? What would the costs be for broker-dealers who are distribution participants or affiliated purchasers to preserve the written probability of default determination?

39. Should broker-dealers who are distribution participants or affiliated purchasers relying on the exception in proposed paragraph (c)(2)(i) of Rule 101 be required to document information in addition to the proposed required documentation (*i.e.*, the written probability of default determination)? For example, should a broker-dealer be required to retain the documentation governing the probability of default estimation if the broker-dealer uses a vendor model?

VI. General Request for Comment

The Commission solicits comment on all aspects of the proposed amendments to Rule 101, Rule 102, and Rule 17a-4, as well as any other matter that may impact any of the proposals discussed above. Please provide empirical data, when possible, and cite to economic studies, if any, to support alternative approaches. In particular, the Commission asks commenters to consider the following questions:

40. In proposing the criteria above, the Commission has focused on indicators of credit-worthiness. Is credit-worthiness alone an appropriate signifier of whether a security is susceptible to manipulation under the conditions in which Rule 101 is concerned? Why or why not?

41. Please comment in particular on any relevant changes to the Nonconvertible Securities or asset-backed securities markets since Regulation M was adopted in 1996 and how these developments should affect the Commission's evaluation of the proposed amendments. How do these changes fit within the relevant changes to the

debt markets (more generally) since Regulation M's adoption?

VII. Paperwork Reduction Act Analysis

A. Background

Certain provisions of proposed amendments impose "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[127] Specifically, the Commission estimates that respondents would incur PRA burden when determining whether a distribution of a nonconvertible security qualifies for the proposed exception from Regulation M. The Commission also believes that there would be PRA burdens associated with documenting this determination. These PRA burdens would be distinct from the existing OMB-approved collection of information burden estimates under Rule 101 and Rule 17a-4 because the Commission has not estimated that respondents incur PRA burdens when determining whether a security qualifies for the current Investment Grade Exception.[128] The Commission is submitting the proposed amendments to the Office of Management and Budget ("OMB") for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a current valid control number.

The titles and control numbers for these collections of information are as follows:

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[127] *See* 44 U.S.C. 3501 *et seq.* The burden associated with the information collection requirements are referred to as "PRA burdens."

[128] The Commission preliminarily believes that the proposed amendment to Rule 102 would not change the PRA burden estimates under the current OMB-approved collections of information for that rule because those estimates do not include any collections of information or burden related to the determination of whether a security qualifies for the Investment Grade Exception. The proposed amendment would eliminate the exception under Rule 102, so respondents would continue to incur no burden making a determination because they would not be making one. *See Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Rule 102 of Regulation M* (OMB Control No. 3235-0467) (Feb. 5, 2020), *available at* https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201911-3235-012 (discussing the burden estimates under Rule 102).

Rule	Title	OMB Control Number
Rule 101	Rule 101, 17 CFR 242.101 (Activities by Distribution Participants)	3235-0464
Rule 17a-4	Records to be Preserved by Certain Brokers and Dealers	3235-0279

As discussed above, Regulation M is designed to preserve the integrity of the securities trading market as an independent pricing mechanism by prohibiting activities that could artificially influence the market for an offered security. Subject to exceptions, Rule 101 prohibits distribution participants and their affiliated purchasers from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase a covered security during a restricted period. Rule 17a-4 requires a broker-dealer to preserve certain records if it makes or receives them.

In reference to the requirement in Section 939A, the Commission is proposing amendments to Rules 101 and 102 to remove the existing exceptions for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that are rated by at least one NRSRO in one of its generic rating categories that signifies investment grade. With respect to Nonconvertible Securities in Rule 101, the Commission proposes to substitute a standard that would except securities for which the probability of default, estimated as of the day of the determination of the offering pricing and over the horizon of 12 calendar months from such day, is less than 0.055%, as determined by a Structural Credit Risk Model. Broker-dealers who are distribution participants and their affiliated purchasers that would be relying on the proposed exception from Rule 101 would be required to preserve for a period of not less than three years, the first two years in an easily accessible place, the written probability of default determination. The Commission is also proposing to except asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3.

The discussion of estimates that follows is limited to a discussion of the new information collection requirements that result from the proposed amendments. The Commission is not estimating that the proposed amendments would increase or decrease the existing approved information collections under Rule 101 and Rule 17a-4 because those information collections are not related to making a determination about whether a security qualifies for the Investment Grade Exceptions. The information collections in the proposed amendments are distinct, so they are the only information collections discussed herein.

B. Proposed Use of Information

The information collected under the proposal would be used to ensure that the nonconvertible debt securities most resistant to manipulation are excepted from Rule 101. Further, the Commission preliminarily believes that the information contained in the records required to be retained and kept pursuant to the proposed amendment to Rule 17a-4 would be used to assist the Commission in conducting effective examinations and oversight of distribution participants and their affiliated purchasers.

C. Information Collections

The proposed amendments that impose information collection burdens would apply to distribution participants and affiliated purchasers that choose to rely on the exception for a distribution of Nonconvertible Securities. As noted in Part VIII.A.1, there were 237 underwriters of Nonconvertible Securities in 2020. The Commission preliminarily believes that this number will remain roughly consistent because of the capital, expertise, and relationships needed to underwrite a Nonconvertible Security. The Commission, therefore, is estimating that 237 respondents would be subject to PRA burdens under the proposed amendments.

As discussed below, the Commission preliminarily believes that respondents would incur PRA burdens under the proposed amendments because distribution participants and their affiliated purchasers would be required to analyze each distribution of Nonconvertible Securities to determine whether the distribution qualifies for the exception. Respondents would also incur PRA burdens under Rule 17a-4 because distribution participants would be required to keep certain records documenting this determination that support their reliance on the exception.

1. Rule 101

Under the proposed amendment to Rule 101, respondents wishing to rely on the exception for a distribution of Nonconvertible Securities would be required to gather the data serving as the inputs and then perform the analysis necessary to calculate the probability of default of the issuer whose securities are the subject of the distribution.[129] This requirement would result in respondents incurring recordkeeping burden. The Commission preliminarily believes that this process would likely be highly automated, and that respondents would initially comply with this requirement by reprograming systems to create a means to calculate electronically the probability of default based on manually gathered and entered inputs for financial modeling. The Commission preliminarily believes that all respondents would be broker-dealers who have experience using their own proprietary version of a publicly available

[129] The Commission recognizes that some respondents may choose to utilize the probability of default estimates calculated and made available by a third-party vendor rather than perform the calculations themselves. The Commission's burden estimate for the proposed amendment to Rule 101 is based upon respondents gathering the required data and calculating the probability of default internally without the use of third-party vendors, because the Commission lacks granular information from which to base an estimate of the proportion of respondents that would use vendors. The Commission welcomes comments on this approach, including regarding the likelihood and cost of using third-party vendors, including any time burden associated with using such services.

Structural Credit Risk Model so the initial configuration of systems will be handled internally and take 3 hours per respondent. The Commission also preliminarily believes that broker-dealers already have the software and systems in place that would be required to make the calculations.[130] Accordingly, the Commission estimates that the total industry-wide initial burden for the proposed amendment to Rule 101 would be 711 hours.[131]

An issuer's probability of default is forward-looking and changes over time, so the Commission preliminarily believes that respondents would manually gather the inputs required to calculate probability of default each time it participates in a distribution of debt securities. There were 19,076 offerings of Nonconvertible Securities in 2020.[132] Because financial modeling generally, and the probability of default calculation more specifically, is well-known by industry participants, the Commission preliminarily believes that respondents would have employees that are familiar with how to gather the required inputs. The Commission, therefore, estimates that would take respondents roughly 1 hour per distribution of Nonconvertible Securities on this requirement. Accordingly, the Commission estimates that the amendment to Rule 101 will result in an aggregate annual ongoing industry-wide burden of 19,076 hours. The Commission, therefore, estimates that the total PRA burden resulting from the proposed

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[130] Further, the Commission preliminarily believes that respondents that choose to utilize the probability of default estimates calculated and made available by a third-party vendor would already have access to the vendor's software and systems containing these estimates, typically as part of an existing subscription, so they would not need to procure further services or subscriptions from these vendors. The Commission welcomes comments on this preliminary belief and on any related costs and burdens.

[131] 237 respondents x 3 hours = 711 hours.

[132] This number was obtained from Mergent, a financial data provider. Data for 2021 is not yet available in Mergent.

amendment to Rule 101 would be 19,787 hours in the first year[133] and 19,076 hours thereafter.

The Commission preliminarily believes that the proposed amendments would not result in respondents incurring PRA burden when participating in distributions of asset-backed securities because whether an asset-backed security has an effective registration statement on Form SF-3 is an objective, observable fact.[134] Further, under the proposed amendments, there is no requirement for distribution participants or their affiliated purchasers to keep records documenting its reliance on the exception for distributions of asset-backed securities.

2. Rule 17a-4

The proposed amendment to Rule 17a-4 would require broker-dealers relying on the exception in proposed paragraph (c)(2)(i) to preserve for a period of not less than three years, the first two years in an easily accessible place, the written probability of default determination. Because the burden to make these records is accounted for in the PRA estimates for the amendment to Rule 101, the burden imposed by these proposed new requirements under Rule 17a-4 is limited to the maintenance and preservation of the written records.[135] The Commission estimates that this recordkeeping requirement would impose an initial burden of 25 hours per respondent for updating the applicable policies and systems required to account for capturing the records made pursuant to proposed paragraph (c)(2)(i). Accordingly, the Commission estimates

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[133] 711 hours (initial burden) + 19,076 hours (ongoing annual burden) = 19,787 hours.

[134] *See* 17 CFR 239.45.

[135] As noted above, for the purposes of these estimates, the Commission assumes that no registrants are using vendors to rely on the proposed exceptions, however, the Commission also preliminarily believes that the burden associated with the proposed amendment to Rule 17a-4 would not differ between respondents that rely on a third-party vendor and those that do not.

that the total industry-wide initial burden for this requirement would be 5,925 hours.[136] The Commission also estimates that respondents would incur an ongoing annual burden of 10 hours per firm for maintaining such records as well as to make additional updates to the applicable recordkeeping policies and systems to account for the proposed rules, leading to a total ongoing industry-wide burden of 2,370 hours.[137] The Commission, therefore, estimates that the total PRA burden resulting from the proposed amendment to Rule 17a-4 would be 8,295 hours in the first year[138] and 2,370 hours thereafter.

PRA Summary Table

	Initial Burden Hours	Ongoing Annual Burden Hours per year (After First Year)	Total PRA Burden Hours in First Year
Industry-Wide Burden due to Proposed Amendment to Rule 101	711	19,076	19,787
Industry-Wide Burden due to Proposed Amendment to Rule 17a-4	5,925	2,370	8,295

D. Collection of Information is Mandatory

Each collection of information discussed above would be a mandatory collection of information.

E. Confidentiality

The Commission would not typically receive confidential information as a result of this collection of information. To the extent that the Commission receives—through its examination

[136] 237 respondents x 25 hours = 5,925 hours.

[137] 237 respondents x 10 hours = 2,370 hours.

[138] 5,925 hours (initial burden) + 2,370 hours (ongoing annual burden) = 8,295 hours.

and oversight program, through an investigation, or by some other means—records or disclosures from a distribution participant regarding the probability of default determination, such information would be kept confidential, subject to the provisions of applicable law.

F. Retention Period of Recordkeeping Requirement

Pursuant to proposed Rule 17a-4(b)(17) a broker-dealer who is a distribution participant or affiliated purchaser would be required to retain information for a period of not less than three years, the first two years in an easily accessible place.

G. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information and assumptions used therein; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed amendments would have any effects on any other collection of information not previously identified in this section. The Commission also requests that commenters provide data to support their discussion of the burden estimates.

While the Commission welcomes any public input on this topic, the Commission asks commenters to consider the following questions:

42. Is the Commission adequately capturing the respondents that would be subject to burdens under the proposed amendments? Specifically, would more or fewer than the

237 respondents determine the probability of default?

43. Is the Commission accurately estimating the amount of time it would take to program systems and gather the data required to perform the probability of default calculations?
44. Would any aspects of the proposed amendments that are not discussed in this PRA Analysis affect the burden associated with the collection of information?
45. Do commenters agree with the Commission's preliminary belief that the proposed amendment to Rule 102 would not change PRA burdens?
46. Do commenters agree with the Commission's preliminary belief that the proposed amendments would not result in respondents incurring PRA burden when participating in distributions of asset-backed securities?

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing the burdens. Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, MBX.OMB.OIRA.SEC_desk_officer@omb.eop.gov, and send a copy to Vanessa Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, D.C. 20549-1090, with reference to File No. S7-11-22. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-11-22, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, D.C. 20549-2736.

VIII. Economic Analysis

The Commission is sensitive to the economic consequences and effects, including costs and benefits, of its rules. Some of these costs and benefits stem from statutory mandates, while others are affected by the discretion exercised in implementing the mandates. Section 3(f) of the Exchange Act provides that whenever the Commission is engaged in rulemaking pursuant to the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[139] Additionally, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition. Section 23(a)(2) also provides that the Commission shall not adopt any rule which would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The analysis below addresses the likely economic effects of the proposed amendments, including the anticipated benefits and costs of the amendments, and their likely effects on efficiency, competition, and capital formation. The Commission also discusses the potential economic effects of certain alternatives to the approach taken by these amendments. Some of the benefits and costs discussed below are difficult to quantify. For example, sticky offerings are generally not identified in the available data and may be difficult to trace in the appropriate records of the distribution participants. Therefore, much of the discussion of economic effects is

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139 *See* 15 U.S.C. 78c(f).

qualitative.

A. Baseline

1. The Investment Grade Fixed Income Market

To assess the economic effects of the proposed amendments, the Commission is using as the baseline the nonconvertible debt, nonconvertible preferred, and asset-backed securities markets as they exist at the time of this release, including applicable rules that the Commission has already adopted.

The affected parties include Nonconvertible Security and asset-backed security (collectively "fixed-income securities")[140] distribution and market participants, such as issuers, selling security holders, underwriters, banks, broker-dealers, and their affiliated purchasers; fixed-income security investors, such as retail investors, mutual funds, exchange traded funds, and separate investment accounts; vendors of the relevant market data; and NRSROs. Currently a majority of the distribution participants in the relevant markets are subscribed to a major vendor of the market data necessary to evaluate various aspects of the distribution. Further, a rating by an NRSRO is necessary in order for distribution participants to rely on the Investment Grade Exception. Today there are nine credit rating agencies registered with the Commission as NRSROs.[141] Three large NRSROs (S&P Global Ratings, Moody's Investors Services, Inc., and Fitch Ratings, Inc.) have historically accounted for most of the market share in this market. As of December 31, 2020, these three market participants accounted for 94.7% of all of the NRSRO

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[140] The term "fixed-income" in the Economic Analysis section refers to nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities.

[141] U.S. SEC. AND EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 2 (2022), *available at* https://www.sec.gov/files/2022-ocr-staff-report.pdf.

credit ratings outstanding.[142]

The affected securities are nonconvertible debt, nonconvertible preferred, and asset-backed securities. In 2020, there were 19,076 issues of nonconvertible debt, with 694 issuers and 237 participating underwriters involved.[143] Additionally, in 2020, there were 152,069 issues of mortgage-backed securities with 195 underwriters involved and 7,255 issues of other asset-backed securities with 155 underwriters.[144]

2. The Investment Grade Exception to Regulation M

Regulation M is designed to prevent manipulative activities that could artificially influence the demand and pricing of covered securities.[145] In particular, Rules 101 and 102 of Regulation M prohibit distribution and market participants from bidding for or purchasing a covered security, unless an exception, such as the Investment Grade Exception, applies.[146] At the time the exception was included, the investment grade securities, that is securities characterized by sound credit-worthiness, were considered to be traded primarily on yield and maturity, rather than the factors that determine credit-worthiness of the issuer and add uncertainty to the pricing of the issue.[147] Thus sound credit-worthiness was considered to be a good proxy for manipulation risk. Such issues were presumed to have low probability of default and were thus considered to have low pricing uncertainty and low manipulation risk, which

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142 *Id.* at 24.

143 The statistics are based on the data from Mergent.

144 The data for the asset-backed securities (including mortgage-backed securities) comes from Bloomberg.

145 *See supra* Part 0.

146 *See* 17 CFR 242.101(a), 102(a); *see, e.g.*, 17 CFR 242.101(c)(2), 102(d)(2).

147 *See* Regulation M Adopting Release, 62 FR 527.

formed the basis for the exception. The Commission continues to believe that sound credit-worthiness is a good proxy for manipulation risk since securities issued by firms with sound credit-worthiness trade primarily on yield and maturity and not on issuer-specific characteristics that may increase pricing uncertainty.

The Commission believes that the application of the Investment Grade Exception to Rules 101 and 102 is primarily limited to two cases:[148] reopenings (an offering of an additional principal amount of securities that are identical to the securities already outstanding) and sticky offerings (an offering where a lack of demand results in an underwriter being unable to sell all of the securities in a distribution). Reopenings are used infrequently and constitute about 3% of the relevant securities' markets' issuance volume.[149] Sticky offerings are not identified in the relevant databases, making it difficult to assess their relative magnitude.

Reopenings are used in situations when such financing method offers the benefit of cost-effectiveness. For example, it may be cheaper for an issuer to offer a series of small offerings as opposed to one large offering, as the latter could result in a lower offering price due to the supply pressure. Further, since a reopening issue is fungible with securities already in circulation and can be traded interchangeably with these securities in the secondary market, it provides additional liquidity benefits to the investors.[150]

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148 Some commenters note that best efforts offerings (*see supra* note 59) and foreign sovereign offerings (*see supra* note 62) could also be affected by the exceptions in Rules 101 and 102.

149 The estimate is obtained using Mergent data for the relevant fixed income securities during the past five years as of Oct. 2021.

150 *See* SIFMA Letter 3 at 6; John Berkery & Remmelt Reigersman, *Re-openings: Issuing Additional Debt Securities of an Outstanding Series*, MAYER BROWN 1-2 (2020), *available at* https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/05/reopenings_-issuing-additional-debt-securities-of-an-outstanding-series.pdf. *See also* Arnold & Porter Letter at 3.

Sticky offerings typically result when a large investor fails to fulfill its expressed purchase interest in the issue,[151] which could be due to a negative factor that transpired in regard to the issue or issuer. In such cases it may become challenging to trade the issue based solely on the yield and maturity (otherwise it would have become possible to find another purchaser in a timely manner). This may give rise to a heightened risk of manipulation even if the security is rated as investment grade.

The Commission preliminarily believes that the exception based on investment grade rating is rarely used in practice in Rule 102. Rule 102 prohibits trading of the securities fungible with the securities being issued by issuers, selling security holders, and their affiliated purchasers.[152] However, issuers and selling security holders generally do not have the same market access needs as underwriters and are not expected to buy the securities they are issuing.[153]

The Investment Grade Exception was included in the regulation as it was considered a good proxy for the likelihood of manipulation risk.[154] However, the reference to NRSRO ratings in the Commission's rules may encourage investors to place undue reliance on the NRSRO ratings. Additionally, even though credit-worthiness has been historically considered a good proxy for manipulation risk, it is still not a precise measure of such risk and therefore there are costs associated with using such a proxy that currently exist in the relevant markets. Specifically, in some instances distribution participants may choose to engage in manipulative activities of the securities of issuers with sound credit-worthiness. As a result, under the existing

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[151] Sullivan & Cromwell Letter at 4.

[152] *See supra* Part IV.A.1.c. for a relevant discussion.

[153] *See supra* Part IV.B.

[154] *See supra* Part III (discussing the history of the Investment Grade Exceptions).

rules, situations may arise in which securities with high manipulation risk are excepted from Regulation M.

B. Benefits of the Proposed Amendment

As mentioned above, Section 939A of the Dodd-Frank Act requires the Commission to "remove any reference to or requirement of reliance on credit ratings, and to substitute in such regulations such standard of credit-worthiness as the Commission determines to be appropriate."[155] In this proposed rule, the Commission proposes to rely upon the Structural Credit Risk Models to measure credit-worthiness.[156] These models have become widely used to estimate the probability of default of an issuer.[157]

Structural Credit Risk Models typically take the issuer balance sheet measures of debt obligations as given and estimate a probability of default based on the market value and volatility of the firm's equity. The value of equity is viewed in these models as the value of a call option on firm assets where the strike price is the total notional value of debt. Since the market value of

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155 Pub. L. 111-203 sec. 939A(a). The Commission has issued several releases concerning the removal of references to credit ratings: *Security Ratings*, Release No. 34-64975 (July 27, 2011) [76 FR 46603 (Aug. 3, 2011)]; *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Release No. 34-71194 (Dec. 27, 2013) [79 FR 1522 (Jan. 8, 2014)]; *Removal of Certain References to Credit Ratings under the Investment Company Act*, Release No. IC-30847 (Dec. 27, 2013) [79 FR 1316 (Jan. 8, 2014)]; *Asset-Backed Securities Disclosure and Registration*, Release No. 34-72982 (Sept. 4, 2014) [79 FR 57184 (Sept. 24, 2014)]; *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*, Release No. IC-31828 (Sept. 16, 2015) [80 FR 58124 (Sept. 25, 2015)].

156 See for example the seminal model by Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 JOURNAL OF FINANCE 449, 449-70 (1974), along with related successive refinement models such as Fischer Black & John C. Cox, *Valuing Corporate Securities: Some Effects of Bond Indenture Provisions*, 31 J. FIN. 351, 351-67 (1976); Robert Geske, *The Valuation of Corporate Liabilities as Compound Options*, 12 J. FIN. & QUANTITATIVE ANALYSIS 541, 541-52 (1977); and Oldrich A. Vasicek, *Credit Valuation*, KMV (Mar. 22, 1984), among others.

157 *See supra* note 67.

equity, the volatility of equity, and the notional value of debt can be calculated from the market and balance sheet data, under the Structural Credit Risk Models the volatility of the value of the assets and the market value of assets, which are not observable, can be estimated. The probability of default can be calculated as the probability that the call option will expire out-of-the-money, which occurs when the value of the company falls below the book value of the debt.

As discussed above, Structural Credit Risk Models are based on the structure of the balance sheet.[158] The key assumption of a Structural Credit Risk Model is that default occurs when the value of the company falls below the book value of the debt. Since the future value of the firm is unknown, a Structural Credit Risk Model must make assumptions about the probability distribution of possible firm values in different scenarios, some of which may trigger default. These assumptions include the current firm value and the volatility of firm value, for which the observed market value of equity and the volatility of equity is often an input. Some models include assumptions over the firm's dividend policy.

The Commission preliminarily believes that the probability of default based on the Structural Credit Risk Models is an appropriate proxy for credit-worthiness. As discussed previously, the Commission continues to believe that credit-worthiness is an appropriate standard to reflect manipulation risk since securities issued by firms with sound credit-worthiness trade primarily on yield and maturity and have low pricing uncertainty. Thus, the probability of default based on Structural Credit Risk Models is a reasonable proxy for manipulation risk.

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158 An alternative set of models used to derive probability of default are 'reduced-form models'. The reduced-form models rely on statistical analysis rather than the balance sheet to determine a firm's creditworthiness. However, compared to Structural Credit Risk Models, they lack in rigorous theoretical justification as well as economic interpretation of the resulted relationships between the model inputs. *See, e.g.*, Edward Altman, Andrea Resti, & Andrea Sironi, *Default Recovery Rates in Credit Risk Modeling: A Review of the Literature and Empirical Evidence*, 33 ECON. NOTES 183 (2004) (discussing the competing models), *available at* https://onlinelibrary.wiley.com/doi/10.1111/j.0391-5026.2004.00129.x.

The Commission calibrated the 0.055% threshold in the sample of nonconvertible fixed income securities so as to capture approximately 90% of the investment grade securities in our sample of nonconvertible fixed income securities (2436 distinct investment grade issues with probability of default below 0.055% out of 2710 total investment grade rated issues in the sample). This threshold also captures 125 distinct non-investment grade issues with probability of default below 0.055%. Overall, 2561 issues meet the proposed exception as compared with the 2710 issues under the current exception.[159] The securities with probability of defaults within the first 12 months, as estimated based on a widely accepted Structural Credit Risk Model, below the 0.055% threshold are proposed to be excepted from Rule 101.

An advantage of using probabilities of default implied by Structural Credit Risk Models instead of NRSRO credit ratings is that these model-implied probabilities of default generally use current estimates of equity valuation and volatility, and hence incorporate most recent news affecting the valuation and perceived volatility of the firm. In contrast, credit rating agencies are generally slower than the market in updating credit ratings and outlooks and thus may reflect less

159 The most recent available investment grade status (as of the last available Mergent update through Dec. 2020) for nonconvertible securities issued between 2016 and 2020 was obtained from Mergent while the probability of default estimates were obtained for a cross-section of securities available in Bloomberg as of Oct. 22, 2021, which represents an average trading day with respect to the relevant market metrics. Since the cross-section of the relevant securities does not change considerably from day to day and the relevant metrics are typically calculated based on the data over a several months period or longer, it is unlikely that the results of the analysis are considerably affected by the specific day selected for the analysis. Please refer to Mario Bondioli, Martin Goldberg, Nan Hu, Chngrui Li, Olfa Maalaoui, & Harvey J. Stein, *The Bloomberg Corporate Default Risk Model (DRSK) for Private Firms* (working paper Aug. 27, 2021), *available at* https://ssrn.com/abstract=3911330 (retrieved from SSRN Elsevier database), for methodology description of Bloomberg probability of default measure.

up-to-date information.[160][161]

Distribution participants should be able to calculate the probability of default internally using Structural Credit Risk Models. One of the benefits of the proposed amendment is that the distribution participants will have the flexibility of selecting the model they find most convenient to assess the credit-worthiness of issuers for the purposes of using the exception. This means the distribution participants will no longer have to rely on an NRSRO rating for the issue for purposes of the Regulation M exception and will no longer have to rely on an NRSRO's choice of the model for such purposes. Furthermore, the Commission preliminarily believes that multiple vendors currently provide estimates of the probability of default based upon Structural Credit Risk Models as a part of default packages that include various market data and metrics.[162]

Removing the reference to credit ratings from Rules 101 and 102 of Regulation M may also have a benefit of expanded options available to distribution participants compared to the Regulation M Investment Grade Exception requirement, as the proposed requirement will no longer rely on a limited number of vendors providing credit ratings, which may reduce possible negative consequences from limited competition. Structural Credit Risk Models as a measure for

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[160] This is consistent with the following SEC staff statement in COVID-19 Market Monitoring Group, *Credit Ratings, Procyclicality and Related Financial Stability Issues: Select Observations*, SEC (July 15, 2020) ("Cost of debt capital is driven by a wide range of financial and non-financial factors and forces; ratings downgrades are generally lagging indicators of cost of debt capital."), *available at* https://www.sec.gov/news/public-statement/covid-19-monitoring-group-2020-07-15.

[161] Some academic studies find evidence that Structural Credit Risk Models may be able to respond to aggregate and firm specific news faster than credit ratings. Also, such models are able pick up on differences in default risk *within* a credit rating bucket. However, credit ratings do not necessarily imply probabilities of default and thus may not be directly comparable to probability of default estimated using a Structural Credit Risk Model. *See* Jing-zhi Huang & Hao Zhou, *Specification Analysis of Structural Credit Risk Models* (Fed. Res. Bd., Fin. & Econ. Discussion Series,2008-552008), *available at*https://www.federalreserve.gov/pubs/feds/2008/200855/200855pap.pdf; Moody's Analytics, *EDF Overview* (2011) (outlining the approach by Moody's KMV), *available* at https://www.moodysanalytics.com/-/media/products/EDF-Expected-Default-Frequency-Overview.pdf; Giuseppe Montesi & Giovanni Papiro, *Risk Analysis Probability of Default: A Stochastic Simulation Model*, 10 J. CREDIT RISK 29 (2014).

[162] See a relevant discussion in *supra* Part IV.A.1.c).

credit-worthiness could therefore serve as a better proxy for manipulation risk than credit ratings because, by prescribing a methodology rather than a metric generated by only a certain category of regulated vendors (that is, NRSROs), distribution participants may have more options for either using a vendor supplied Structural Credit Risk Model or using their own proprietary version of a publicly available Structural Credit Risk Model.

Under the proposed amendments, the Structural Credit Risk Models cannot, as a practical matter, apply to asset-backed securities due to the complexity of the structure of such instruments. In the case of asset-backed securities, the Commission preliminarily believes that securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3 should also be excepted from Rule 101. Form SF-3 requirements provide objective criteria that also ensure that the securities with the least amount of manipulation risk are allowed to rely on the Regulation M exception. Specifically, Form SF-3 requirements limit the number of nonperforming assets in the asset-backed security pool, require review of the pool assets, and require certification by the chief executive officer, among other things. The Commission continues to believe, as noted when it adopted these requirements, that use of Form SF-3 incentivizes sponsors to carefully review and disclose the underlying assets' characteristics, reducing the overall uncertainty about the asset-backed security and therefore the risk of manipulation. Accordingly, asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3 have similar qualities and characteristics to the investment-grade asset-backed securities currently excepted from Rule 101(c)(2). Further, an analysis of a merged sample of Form SF-3 filers and Bloomberg credit ratings for year 2021 asset-backed securities issuances demonstrates that 78% of Form SF-3 filers' issuances have investment grade status (362 out of 464 rated issuances), while the remaining 22% of issuances have non-investment grade status (102 issuances).[163] To the extent that asset-backed securities for which a Form SF-3 is filed includes securities that have low manipulation risk but lack an investment grade rating, the additional benefit of the proposed amendments is allowing such low manipulation risk issues to rely on the exception and encouraging participation in the relevant market.

The Commission is proposing to eliminate the exception entirely from Rule 102, as discussed above, given the heightened risk of manipulation that exists for issuers and selling security holders and absence of a need to facilitate an orderly distribution or to limit potential disruptions in the trading market, coupled with our understanding that the Investment Grade Exception is generally not relied upon in practice, as issuers and selling security holders who are subject to Rule 102, unlike broker-dealers, typically do not trade outstanding issues of their own securities that are identical to the issue being distributed in the secondary market.[164] The economic benefit of the proposed amendment is that it may contribute to the Dodd-Frank Act goals of reducing perceived government endorsement of NRSROs and over-reliance on credit ratings by market participants in Regulation M by removing the relevant reference to credit ratings.

C. Costs of the Proposed Amendment

The Commission recognizes that some of the affected distribution participants may bear

[163] We note that 770 investment grade asset-backed security issuances (by 191 issuers) from the 2021 Bloomberg sample did not merge with the sample of Form SF-3 filers in part due to necessarily present imperfections in issuer name matching and in part due to a much smaller number of Form SF-3 filers (62 issuers). This may imply a possibility that a fairly large number of issuances that are able to rely on the exception currently will be excluded under the proposed standard. The asset-backed securities eligible for Rule 144A were excluded from the analysis as they are able to rely on a different exception.

[164] See also a relevant discussion in *supra* note 120. Eliminating the Investment Grade Exception, however, could affect the ability of foreign sovereign issuers to purchase any of such issuer's securities. *See* discussion in *infra* Part VIII.C.5 and Arnold & Porter Letter at 3.

costs from the proposed amendments. The proposed amendments may alter the universe of securities that can rely on the exception and additionally may prevent issuers from using the exception in some cases potentially leading to fewer issues of the affected securities. If some distribution participants decide not to participate in certain issues as a result of the proposed amendments, the costs of the affected issues may increase. For example, when fewer banks or broker-dealers are available, these distribution participants may be able to charge higher fees. Additionally, as the result of the proposed amendments fewer issues may take place, potentially limiting issuers' ability to raise capital and affecting investors in the relevant securities as the available security selection and liquidity may be reduced.

There are several types of costs that could arise: (1) costs associated with calculations or obtaining the probability of default estimate; (2) costs associated with maintaining records related to the probability of default estimation; (3) costs due to the probability of default being an imperfect proxy for credit-worthiness, (4) asset-backed securities' costs associated with the proposed amendments, (5) costs related to Rule 102 amendments (6) indirect and other costs of the amendments. We discuss these costs in detail below.

1. Costs Associated with Obtaining the Estimate of the Probability of Default

Distribution participants may incur costs related to determining the probability of default. Consistent with the PRA section,[165] the Commission estimates that it would take a distribution participant 3 hours to establish a system to gather the data serving as the inputs and then perform

[165] *See supra* Part VII.C.1.

the analysis necessary to calculate the probability of default of the issuer whose securities are the subject of the distribution, for an aggregate cost of $240,318.[166] Consistent with the PRA section,[167] the Commission also estimates that it would take a distribution participant one hour to gather the inputs required to calculate probability of default each time it participates in a distribution of Nonconvertible Securities. There were 19,076 offerings of Nonconvertible Securities in 2020. Therefore, it is estimated that annually distribution participants would spend $6,447,688[168] in the aggregate complying with this requirement.

Any costs associated with using a vendor to obtain probability of default estimate should be minimal, as the Commission preliminarily believes that distribution participants engaged in the offering of Nonconvertible Securities would typically already have subscriptions to vendors that provide calculations regarding the probability of default based on Structural Credit Risk Models.[169] Furthermore, we believe that distribution participants, in particular those that choose to determine the probability of default estimate internally, would already have the computational resources necessary to conduct such analysis internally.[170]

2. Costs Associated with Maintaining Records Related to the Probability

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[166] The Commission estimates the wage rate based on salary information for the securities industry compiled by SIFMA. *See Management & Professional Earnings in the Securities Industry—2013*, SIFMA (Oct. 7, 2013), *available at* https://www.sifma.org/resources/research/management-and-professional-earnings-in-the-securities-industry-2013/. These estimates are modified by the Commission staff to account for an 1800 hour work-year and multiplied by 5.35 (professionals) or 2.93 (office) to account for bonuses, firm size, employee benefits and overhead. These figures have been adjusted for inflation through the end of 2021 using data published by the Bureau of Labor Statistics. 237 distribution participants x 3 hours x $338 hour for a compliance manager = $240,318.00.

[167] *See supra* Part V.C.1.

[168] 19,076 offerings x 1 hour x $338 hour for a compliance manager = $6,447,688.

[169] *See supra* note 84.

[170] *See supra* Part IV.A.1.c).

of Default Estimation

Distribution participants would also incur costs related to capturing and maintaining records regarding the probability of default determination. Consistent with the PRA section,[171] the Commission estimates that it would take a distribution participant 25 hours to update the applicable policies and systems required to account for capturing the records made pursuant to proposed Rule 101(c)(2)(i), for an aggregate cost of $2,002,650.[172] Consistent with the PRA section,[173] the Commission also estimates that it would take a distribution participant 10 hours to maintain such records as well as to make additional updates to the applicable recordkeeping policies and systems to account for the proposed rules. Therefore, it is estimated that annually broker-dealers would spend $801,060[174] in the aggregate complying with this requirement.

3. Costs Associated with Structural Credit Risk Model Based Probability of Default Being an Imperfect Proxy for Credit-worthiness

As discussed previously, the proposed Structural Credit Risk Models are designed to measure credit-worthiness, and credit-worthiness itself is considered to be a good measure of manipulation risk. There are costs that are currently present in the relevant markets associated with credit-worthiness being an imperfect proxy for manipulation risk. However, in the absence of a better proxy for manipulation risk, credit-worthiness has continued to successfully serve the

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171 *See supra* Part VII.C.2.

172 237 distribution participants x 25 hours x $338 hour for a compliance manager = $2,002,650.

173 *See supra* Part V.C.1.

174 237 distribution participants x 10 hours x $338 for a compliance manager = $801,060.

purpose of measuring such risk for many years. This is also supported by the comments stating that investment grade standard has been successfully used in Rules 101 and 102 exception.[175] The proposed amendments are not expected to alter those costs and the discussion that follows focuses instead on the costs associated with the proposed Structural Credit Risk Models as a proxy for credit-worthiness.

The use of any model to estimate credit-worthiness necessarily provides an imperfect measure. Structural credit risk models are no exception. We note, however, that NRSROs similarly may rely on imperfect models of estimating issuer credit-worthiness. Moreover, models such as Structural Credit Risk Models often are a part of the analysis involved in obtaining a credit rating.[176]

Some ways to implement Structural Credit Risk Models make use of historical trading data to produce a reliable estimate of the model input parameters. These data may not be available for certain infrequently traded securities. In some circumstances the market for a security has not yet been established and sufficient trading data are unavailable, making it difficult to apply the exception.

Additionally, Structural Credit Risk Models rely on a number of parameter estimates such as firm market value and volatility, which could be difficult to assess as these values change with market conditions and business fluctuations. A changing term structure of interest rates and noise trading in the market can further distort the probability of default estimates. Incorrect parameter estimates may result in the incorrect estimates of default probability and allow distribution participants to rely on the exception for risky issues or prevent distribution

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175 *See*, for example, Rothwell at 2 and ABA at 15 -17.

176 *See, e.g.*, John Y. Campbell, Jens Hilscher, & Jan Szilagyi, *In Search of Distress Risk*, 63 J. FIN. 2899 (2008), *available at* https://scholar.harvard.edu/files/campbell/files/campbellhilscherszilagyi_jf2008.pdf.

participants from relying on the exception for safe issues. Implied probabilities of default are sensitive to market prices and estimates of market volatility and consequently tend to be counter cyclical, increasing during market downturns, which are often also periods of increased uncertainty. A constant threshold which is not time-varying would potentially result in fewer firms qualifying for the exception during market downturns, which may result in more issuances during this period not qualifying or firms choosing not to issue, hence increasing their cost of capital or limiting their access to capital. While credit rating downgrades are also counter cyclical, they tend to be slow in incorporating updates[177] and relatively fewer firms will have an investment grade credit rating during downturns, the impact of the counter cyclicality of default probabilities implied by Structural Credit Risk Models would be stronger relative to using credit ratings: during periods of distress, using these probabilities of default will likely result in fewer firms with an investment grade credit rating falling below the threshold, and thus fewer firms qualifying for the exception relative to using credit ratings. Distribution participants would, however, be able to adjust the required estimated model parameters and inputs frequently as market conditions change, mitigating the costs discussed above.

Due to the number of variations among Structural Credit Risk Models and their estimated inputs, the probability of default estimates may be subjective to some extent and not comparable across different issuers or for the same issuer across different issues if estimates are based on different models, or done by different researchers or vendors. The latter may affect market participants' ability to effectively rely on the estimates to make comparative assessments across multiple securities. However, this is also true of the credit ratings that often rely on similar

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[177] *See* COVID-19 Market Monitoring Group, *supra* note 160 ("Cost of debt capital is driven by a wide range of financial and non-financial factors and forces; ratings downgrades are generally lagging indicators of cost of debt capital.").

models, which mitigates these costs of the proposed amendments relative to the market baseline.

In addition, as discussed previously in reference to the selected threshold, the amendment may expand slightly the universe of firms that qualify for the exception and include firms that did not receive an investment grade credit rating, but have a structural credit model implied probability of default that falls below the threshold. The debt prices of these firms may be prone to manipulation if the price of their debt is relatively less sensitive to aggregate interest rate changes.

Additionally, this amendment may create potential opportunities for new products offered by the vendors designed specifically for a given issue or issuer. A custom designed estimate paid for by the issuer may lead to potential conflicts of interest since the vendor is incentivized in this case to produce an estimate which would allow the issuer to rely on the exception. However, the existing major vendors supplying probability of default estimates have numerous clients currently using this information for business purposes other than the Rule 101 exception. Therefore, given the reputational concerns it is unlikely that these vendors would produce a slightly different product to cater specifically to the use of these estimates for purposes of relying on the Rule 101 exception. Additionally, the model input estimates or assumptions may be tweaked by the distribution participants in such a way as to produce the desired estimation result if the model is estimated internally and may result in market participants' adjusting the models so as to be able to rely on the exception.[178] This may result in an additional cost of adding some manipulation risk to the relevant markets if manipulation prone issues are allowed to rely on the exception as a result.

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[178] The definition of Structural Credit Risk Models for purposes of Rule 101(c)(2)(i) is limited to commercially or publicly available models, which would limit a distribution participant's ability to develop its own models to achieve favorable results.

Finally, the proposed threshold of 0.055% for the exception is based on model assumptions and historical data. Future market evolution may result in this threshold becoming either too large or too small, allowing risky issues to rely on the exception or preventing safe issues from using it. This may vary by industry, with the threshold being more restrictive in some industries relative to the original NRSRO investment grade designation. Moreover, probabilities of default as implied by Structural Credit Risk Models tend to be counter-cyclical and can spike in periods of crisis due to decreases in market valuation and increases in equity volatility. Consequently, fewer investment grade firms would fall below the threshold. Credit rating by NRSROs are also countercyclical but tend to be slow moving, since credit rating changes often lag updates to firm conditions that would impact cost of capital.[179]

4. Costs Associated with Asset-backed Securities' Amendments

The proposed amendments may render some asset-backed securities ineligible to rely on the exception from the Regulation M. This may increase issuance costs for the distribution participants. For instance, broker-dealers may reduce an offering's size or increase fees if required to comply with Regulation M. Additionally, distribution participants may need to establish new business relationships due to Regulation M restrictions. Furthermore, some issuers may decide not to issue the affected securities if required to comply with Regulation M restrictions. As a result, some asset-backed securities' issues may not take place, which could affect issuers' ability to raise capital and could affect investors in the relevant markets by potentially reducing the selection of the available asset-backed securities.

5. Costs Associated with Amendments to Rule 102

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179 COVID-19 Market Monitoring Group, *supra* note 160 ("Cost of debt capital is driven by a wide range of financial and non-financial factors and forces; ratings downgrades are generally lagging indicators of cost of debt capital.").

As discussed previously, the effect of eliminating the exception from Rule 102 is expected to be minimal since the exception is likely not useful from a practical standpoint, because the issuers and selling security holders who are subject to Rule 102 typically do not trade their own securities that are being issued. However, as was identified previously in a comment letter, an Investment Grade Exception from Rule 102 could affect the ability of foreign sovereign issuers or their affiliates to purchase any of such issuer's securities.[180] In the past the Commission has issued exemptive relief for some foreign sovereign issuers because they trade, as represented in incoming letters, based on a yield spread to US treasuries.[181] This might mean that bonds of foreign sovereign issuers are less susceptible to manipulation risk since there is less uncertainty in regards to their valuation. Eliminating the exception from Rule 102 may increase issuance costs or deter market participants from issuing such securities with low manipulation risk.

6. Indirect and Other Costs of the Amendments

Besides the direct effects on the distribution participants and affected securities discussed above the proposed amendment may also generate indirect effects on investors in these securities and NRSROs. For instance, if issuer participation in the relevant security issues becomes limited, some issues may not take place that otherwise would. Investors may face a more limited choice of investment instruments as a result, for example in the case of reopenings. This may further affect liquidity of their portfolios since reopenings can offer additional liquidity benefits as the securities offered in reopenings are interchangeable with the existing issues. However, as already discussed, these costs are expected to be minimal as reopenings are used infrequently.

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[180] Arnold & Porter Letter at 3.

[181] *See supra* note 121.

The proposed amendment does not rely on an NRSRO rating in order to determine if an issue can rely on the exception. This may diminish NRSROs' clientele to the extent NRSROs choose not to provide Structural Credit Risk Model-based estimates of the probability of default for their existing clients opting to rely on the exception. However, the amendment may increase the clientele of the vendors that supply relevant data and metrics to the distribution participants if such vendors already supply probability of default estimates or choose to offer this estimate as a part of their services. In addition, if firms do not solicit credit rating services from NRSROs beyond the estimate of a probability of default implied by a Structural Credit Risk Model, investors will not be able to benefit from the information provided by a credit rating report and ongoing coverage of the firm that otherwise would be provided through the distribution participant.

D. Efficiency, Competition, and Capital Formation

As discussed previously, distribution participants will have flexibility to select the best Structural Credit Risk Model to access credit-worthiness as a measure of manipulation risk for their business. This may encourage market participation in affected security issues and, as a result, could improve competition between issuers for the investors as well as between other distribution participants. Further, widely available estimates of the probability of default as well as an option of internal model estimation could lead to a more competitive environment as the requirement to rely on proprietary credit risk models of a small number of NRSROs is removed. The improved competition, market participation and efficiency ultimately should lead to more efficient capital formation as the access to and functioning of the relevant fixed income markets improves. We note however that these effects are not expected to be significant because the exceptions in Rules 101 and 102 affect only a small portion of the relevant market as discussed previously.

However, while unlikely, it is possible that a new business model could emerge in the relevant markets that leads to conflicts of interest and neutralizes the effects discussed above. For instance, distribution participants could contract with a vendor or a credit rating agency directly to create a custom estimate of the probability of default. This could result in a business model where an issuer pays for the supplied estimate and where vendors may be incentivized to produce an estimate designed to fit the desired estimation result. Thus issues that otherwise would not be able to rely on the exception could end up being excepted potentially increasing the manipulation risk in the relevant markets, which in turn could negatively affect competition and capital formation.

Further, the positive effects discussed above could be offset by the fact that some issuers may face higher costs or no longer be able to use the exception, for example, due to imperfect model estimates as a result of market fluctuations or changing market. High costs of issuance or inability to rely on the exception may deter participants from issuing the affected securities, which could impact the competition and capital formation in the relevant markets. Further, potential negative effects of non-uniform estimates and subjectivity additionally reduce these benefits. Finally, potentially increased issuance costs due to some asset-backed securities being ineligible for the exception may also negatively affect market participation and competition of the relevant markets.

E. Reasonable Alternatives

Alternative 1 discussed below deals with the proposed threshold, 2-4 propose alternative approaches to using Structural Credit Risk Models as a standard of credit-worthiness to measure manipulation risk. Alternative 5 discusses elimination of the exception, alternative 6 deals with asset-backed securities, while alternative 7 discusses Rule 102 options.

1. Alternative Threshold for Probability of Default

The proposed threshold of 0.055% was chosen so as to capture most of the investment grade securities while at the same time capturing the fewest of the non-investment grade securities. However, a different threshold could be used in the proposed exception, which would capture different proportions of investment and non-investment grade securities. For example, a higher threshold of 0.5% is estimated to capture about 98.6% of investment grade securities (2673 out of 2710 investment grade issues), overall resulting in 2883 issues that can rely on the exception under the proposed standard[182]. A lower threshold of 0.01% is estimated to capture about 65% of investment grade securities (1760 out of 2710 investment grade issues) and overall results in 1811 issues that can rely on the exception under the proposed standard.[183] The advantage of a higher threshold is that it captures a larger set of investment grade securities, but at the expense of also capturing a small set of non-investment grade securities, which could be more prone to manipulation risk. As alternatives, the Commission could increase the threshold, which would allow more investment grade securities to rely on the exception at expense of potentially a higher manipulation risk; or decrease the threshold, which would limit the ability of some of the investment grade securities to use the exception, but would potentially also limit the number of non-investment grade securities allowed to rely on the exception and, as a result, also limit manipulation risk.

As an alternative to providing a specific number as a threshold, the Commission could

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[182] 2883 issues captured by the new proposed standard (with probability of default below 0.5%) consist of 2673 investment grade issues and 210 non-investment grade rated issues.

[183] 1811 issues captured by the new proposed standard (with probability of default below 0.01%) consist of 1760 investment grade issues and 51 non-investment grade rated issues.

specify a method for distribution participants to use in calculating such a threshold. For example, such method could involve calculating probability of default for a sample of nonconvertible securities similar to the distribution participant's securities issued over a specified time interval and comparing it to investment grade status or another specified standard of credit-worthiness. A longer time interval would capture more issues and improve statistical accuracy at expense of having market conditions potentially changing and generating incorrect estimates. A shorter time interval ensures the market conditions have not changed but includes fewer issues resulting in a smaller sample and lower statistical accuracy.

The main advantage of specifying a method as opposed to a number for the threshold is its flexibility with respect to changing market conditions. The main disadvantage of this alternative is subjectivity of the analysis involved, which may lead to non-uniform application of the Regulation M exception across issues or issuers; or lead to market participants adjusting the estimation to be able to rely on the exception.

2. Exception Based on Security Characteristics

As an alternative replacement for the reference to investment grade securities, the Commission has considered analysis that could be based on security characteristics, such as (1) total amount of issue outstanding (public float); (2) yield to maturity of the security during a past trading period; or (3) empirical duration.[184] Other relevant security characteristics that could be used are outlined in the 2011 Proposal.[185] Such analysis could be performed internally or externally and could be additionally verified by a third party. Below we discuss public float, yield to maturity and empirical duration criteria in more detail.

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[184] Empirical duration is bond duration calculated based on historical data rather than a formula. Typically, it is estimated using a regression analysis of the relationship between market bond prices and Treasury yields.

[185] 2011 Proposing Release, 76 FR 26557-64.

- **Exception Based on the Total Amount of Issue Outstanding (Public Float).**

  To the extent that it is more difficult to manipulate price of a larger issue, public float could be used as an alternative criterion to reflect manipulation risk. This criterion has the advantage of being straightforward and easy to evaluate. Due to its simplicity it lacks the estimation issues associated with other measures such as the probability of default. However, determination of a threshold for public float to select securities for the exception is complicated due to its considerable variation across issuers or industries. A specific threshold selection could potentially disadvantage smaller issuers—especially during periods of market downturns when valuations are low.[186]

- **Exception Based on Yield to Maturity.**

  Securities that are traded primarily on yield and maturity have low manipulation risk, as discussed before, since their pricing does not reflect issuer specific risks. Yield to maturity, therefore, can be used as an alternative criterion to evaluate manipulation risk. However, using yield to maturity as a criterion for securities eligible for the exception is also problematic. Even though this criterion is similarly easy to obtain and lacks any major estimation issues, selecting a threshold is not straightforward. For instance, yield to maturity differs considerably by industry. Selecting a fixed threshold may result in some industries being under-represented and others over-represented in the pool of eligible issues. Moreover, yield to maturity often moves with risk-free rates; thus fewer firms would be excepted during periods of high interest rates.

- **Exception Based on Empirical Duration.**

[186] See also a related discussion in *supra* note 70.

Empirical duration is another alternative proxy that can be used to evaluate Nonconvertible Securities for an exception from Regulation M. Negative empirical duration might be an indication that a Nonconvertible Security or its issuer is of low credit-worthiness. A Nonconvertible Security with negative empirical duration is less impacted by changes in interest rates than Nonconvertible Securities of credit-worthy issuers and trades similar to equity securities. Although negative empirical duration may demonstrate that a particular issuer or security is not credit-worthy, it has some limitations that impact the viability of negative empirical duration as a substitute for the Investment Grade Exception. In particular, this measure relies heavily on statistical analysis, requires the Nonconvertible Security to be traded, and may lack intuitive interpretation, which renders empirical duration a poor proxy for the type of manipulation that Regulation M is designed to prevent.

3. Exception Based on Issuer Characteristics

The Commission has also considered an exception based on issuer characteristics, for example, the interest coverage ratio, the WKSI standard, as suggested in the 2008 Proposal,[187] or a criterion based on a reduced-form credit risk model, as an alternative to the Structural Credit Risk Models. We discuss these alternatives below.

- **Exception Based on the WKSI Standard.**

  The Commission could adopt the WKSI standard as a criterion to determine eligibility for the exception. The issuers that fall under the WKSI definition are large and established firms that typically have sound credit-worthiness. The advantage of this characteristic is its simplicity and straightforward calculations. However, the

[187] 2008 Proposing Release, 73 FR 40095-97.

WKSI standard as discussed in the 2008 Proposal was heavily criticized, for instance for allowing risky high-yield issues to be eligible for the exception and preventing issues by smaller but otherwise credit-worthy issuers from relying on the exception.[188]

- **Exception Based on the Interest Coverage Ratio.**

  Another possible issuer-based criterion for exception eligibility is the interest coverage ratio. A high interest coverage ratio typically indicates the issuer's ability to repay debt and can be used as a criterion to reflect credit-worthiness. It has the advantage of being a simple and easy to calculate value. However, the interest coverage ratio is an accounting measure that can result in inconsistent outcomes as it is based on the reported earnings rather than cash flows. Reported earnings may differ based on accounting practices of the firm. The proposed Structural Credit Risk Models have an advantage over interest coverage ratio since they are not dependent on reported earnings, which are heavily influenced by accounting practices.

- **Exception Based on Reduced-Form Credit Risk Model.**

  An alternative to using Structural Credit Risk Models is reduced-form credit risk models.[189] The latter models could be a good measure of credit-worthiness and of manipulation risk to the extent that credit-worthiness is a good proxy for manipulation risk. Unlike structural models, reduced-form models do not assume

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188 ABA Letter at 15-17 and SIFMA Letter 1 at 13.

189 The reduced-form credit risk models are discussed, for example, in Robert Litterman & Thomas Iben, *Corporate Bond Valuation and the Term Structure of Credit Spreads*, 17 (3) FIN. ANALYSTS J. 52, 52-64 (1991); Robert A. Jarrow & Stuart M. Turnbull, *Pricing Derivatives on Financial Securities Subject to Default Risk*, 50 J. FIN. 53, 53-86 (1995); Robert A. Jarrow, David Lando, & Stuart M. Turnbull, *A Markov Model for the Term Structure of Credit Risk Spreads*, 10 REV. FIN. STUD. 481, 481-523 (1997); Darrell Duffie & Kenneth J. Singleton, *Modeling the Term Structures of Defaultable Bonds*, 12 REV. FIN. STUD. 687, 687-720 (1999).

default occurs when firm value falls below a threshold. The default is instead assumed to follow an unobserved process and the default model can be fitted to the market data. The advantage of these models is they do away with some of the unrealistic requirements of Structural Credit Risk Models, for example when the firm value, its volatility or other required parameters are unobserved. Even though such models can be considered more flexible and may provide better fit for the observed default events, their ability to predict future defaults may not necessarily exceed that of the structural models. In addition, unlike structural models, they suffer from a lack of theoretical background of the assumed relationships, or the intuitive interpretation of the model dependencies and why the defaults occur. Unrestricted use of these models might also provide more opportunity to choose a reduced-form model specification which enables use of the exception.

4. Exception Based on Issuer and Issue Characteristics

The Commission considered, as another alternative, an analysis based on both security and issuer characteristics; for example, characteristics outlined in Exchange Act Rule 15c3-1. Rule 15c3-1 specifies a set of factors to determine a minimum amount of credit risk broker-dealers can use to determine if a security can qualify for lower haircuts: (1) credit spreads; (2) securities-related research; (3) internal or external credit assessments; (4) default statistics; (5) inclusion in an index; (6) enhancements and priorities; (7) price, yield and/or volume; or (8) asset-class specific factors.[190] Some of these factors, such as default statistics or credit assessments, measure issuer credit-worthiness, while others, such as price, yield, or volume,

[190] *See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, Release No. 34-71194 (Dec. 27, 2013) [79 FR 1522, 1527-28 (Jan. 8, 2014)].

measure the manipulation risk present in each specific issue, providing a good overall assessment of manipulation risk.

The advantage of this alternative is that it would align the exception with already existing standards that broker-dealers might apply to determine whether a security has a minimal amount of credit risk. The standard in Rule 15c3-1 was adopted in 2013 as a replacement for a reference to investment grade securities pursuant to Section 939A of the Dodd-Frank Act. Such test could have minimum additional costs for broker-dealers who already have all the necessary procedures in place for its application.

However, the scope and objectives of the 15c3-1 standard and the exception in Rules 101 and 102 of Regulation M are different: the 15c3-1 standard applies only to broker-dealers, which already have the necessary arrangements in place to apply 15c3-1 standard, whereas the Regulation M exceptions affect a broader range of market participants. For example, banks involved in the relevant security issues will also be affected. Depending on these other participants' systems and regulatory obligations, it may be costly for them to replace the investment grade standard with the minimal credit risk standard. This could result in a situation where different distribution participants are facing different costs,[191] possibly deterring some market participants.

5. Elimination of the Exception

The Commission also considered eliminating the exception for fixed-income securities. The advantage of this alternative is a more uniform application of Regulation M, which eliminates the situations when manipulation-prone securities fall under the exception due to

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[191] This is unlike the Structural Credit Risk Model based probability of default that would imply the same costs for all the participants who obtain the estimated values.

limitations of proxies used to select the securities to be excepted. For instance, as discussed above, there are various limitations of the Structural Credit Risk Models' applications, which may limit the ability of certain issuers to rely on the exception or allow issuers with a higher risk of having their securities manipulated to avoid Regulation M. If the exception is eliminated, any limitations of such a proxy for manipulation risk are eliminated as well.

In addition, this approach could ultimately relieve broker-dealers from the need to spend time or costs to implement, understand, and calibrate any proposed standard such as a Structural Credit Risk Model. The Commission preliminarily believes that most broker-dealers already have the capability to undertake those calculations themselves or procure them from a data vendor and would benefit from the continued availability of an exception despite the costs.

However, this approach raises a number of concerns. Specifically, eliminating the exception could make some offerings in the excepted securities considerably more costly. For example, with respect to reopenings, broker-dealers who might otherwise elect to reopen a bond offering may determine not to do so to avoid restrictions of Regulation M that could arise during such a reopening if it becomes a sticky offering. This could increase the cost of the issue that has to rely on the next-best alternative structure. Further, an alternative transaction structure, if selected, may decrease the liquidity of the securities being issued because they would not be fungible with the previously issued securities. This may also result in some distribution participants, such as broker-dealers, deciding not to participate. This could limit the number of available participants, potentially increasing fees faced by the issuers. Further, if certain issues do not take place under the proposed amendments, it could reduce the selection of available securities for the investors in the relevant markets and may limit issuers' ability to raise capital.

However, these costs might be mitigated because a party subject to the prohibitions of

Rules 101 or 102 could structure its buying activity before or after the applicable restricted period so as not to incur any costs associated with relying on the exceptions.

The above arguments apply to all currently excepted investment grade securities because any such issue can become a sticky offering and the distribution participants have to account and adjust for this possibility ex-ante. In a scenario where an underwriter is unable to sell its allotted securities to the public on or promptly after the pricing date, there is no exception on which to rely, the underwriter/broker-dealer would likely ex-ante adjust the cost of issuance to reflect this added risk. Broker-dealers could be more cautious in structuring potentially sticky offerings if they know they will be required to comply with Regulation M (and have no exceptions available), by reducing an offering's size or increasing fees as a risk premium. This could potentially raise the cost of investment grade offerings. However, this could also decrease the probability of an offering to become sticky, potentially reducing manipulation risk in the relevant markets.

The removal of the exception could also affect the liquidity of the fixed-income issues if reopenings of issues already in circulation are more costly, potentially reducing issuers' reliance on this financing structure, which negatively impacts the investors in the relevant markets.

This alternative could also disrupt some established business relationships. In certain circumstances new relationships may need to be established. For example, if an offering becomes sticky, the issuer may need to seek a different broker-dealer to comply with the Regulation M requirements. This would increase costs of the affected security offerings, including the new broker dealer fees or the search costs, especially when the market has a limited number of available broker-dealers.

6. Alternative for Asset-Backed Securities

As an alternative for asset-backed securities the Commission could use a standard based on the value at risk. Value at risk measures the percentage loss of the security in the worst case scenarios over a specified time period. It can be estimated by performing a simulation over the underlying securities' pool and determining the cash flows available to the asset-backed security in each scenario. A number of commercially available options can be used to perform this analysis. Value at risk can be a good indicator of manipulation risk since low value at risk indicates that the majority of the cash flows are sufficiently assured. The price of the asset-backed security in this case is more certain and is less subject to manipulation risk.

However, value at risk is by construction estimated for a specified time period and thus only accounts for the potential losses during such period, while losses may also occur after this time period. In this case the price of the asset-backed security may depend on issue-specific factors and be prone to manipulation despite the estimated value at risk over the specified time period being low. This may allow securities with high manipulation risk to rely on the exception.

7. Alternatives for Rule 102 Exception

The Commission considered exempting all bonds issued by a foreign government or political subdivision thereof from Rule 102 of Regulation M. This would allow such issuers to avoid compliance costs associated with Regulation M requirements as discussed above. However, this alternative implies excepting non-investment grade foreign sovereign securities along with investment grade foreign sovereign securities. This may introduce considerable risk that some foreign sovereign issuers with low credit-worthiness and which are subject to a considerable geopolitical risk are allowed to rely on Regulation M exception. This could potentially result in a high pricing uncertainty and a high manipulation risk introduced into the relevant markets.

The Commission also considered excepting asset-backed securities from Rule 102 that are offered pursuant to an effective shelf registration statement filed on Form SF-3. However, this alternative might introduce risk regarding issuers, selling shareholders, or their affiliated purchasers engaging in activity to favorably affect the distribution based on their interest in an offering's outcome, without any benefit to facilitating orderly distributions or to limiting potential disruptions in the trading market.[192] These market participants, unlike distribution participants, may have an interest in the specific pricing of the issue and could benefit from engaging in activity that impacts the market. Thus, excepting such asset-backed securities from requirements of Regulation M could introduce manipulation risk in the relevant markets.

F. Request for Comment

We solicit comments on all aspects of this proposal. We ask that commenters provide specific reasons and information to support alternative recommendations. Please provide empirical data, when possible, and cite to economic studies, if any, to support alternative approaches.

47. Are commenters aware of any additional examples of situations when Structural Credit Risk Models cannot be applied or are difficult to apply? Please explain why these situations occur.
48. Are there any assumptions or inputs of Structural Credit Risk Models that may be relevant to the estimation of the probability of default and may require additional clarification?
49. Do commenters agree with the Commission's assessment of the availability and

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[192] *See supra* note 120.

associated costs of the estimates for probability of default based on Structural Credit Risk Models? Similarly, do commenters agree with the Commission's assessment of availability and associated costs of the necessary software or other resources necessary to obtain the estimates internally? Are there any factors that the Commission failed to consider?

50. Do commenters agree with the Commission's assessment of the proposed method of threshold measurements? Would a different method of threshold have greater benefits or fewer costs than the proposed method of threshold measurements? It is difficult to select a threshold that would capture all of the investment grade securities and none of the non-investment grade securities due to the imperfect correlation of credit ratings and probability of default. Should the current method used to calculating the threshold aim at capturing a larger set of investments grade securities, such as a set above 90%, or aimed at capturing a smaller set of non-investment grade securities, such as fewer than 125 issues? Should a different date other than October 22, 2021, for the analysis be selected? Should the Commission propose a method for calculating the threshold instead of proposing a number? Should the Commission provide guidance on the sample of securities, time interval, standard of credit-worthiness as a basis for comparison, or other specifications that should be used in this method?

51. Are commenters aware of any available data that may help identify how many issuances of asset-backed securities with investment grade rating might be excluded under the proposed standard?

52. Are commenters aware of cases when incorrect estimates of Structural Credit Risk

Models' parameters result in inaccurate probability of default estimates? For example, cases when the estimated probability of default is high for an issuer with sound credit-worthiness and vice versa. Please provide the supporting data and calculations if available.

53. Are there cases where probability of default is not a reasonable proxy for credit-worthiness and therefore manipulation risk? If so, why is it a poor proxy in those cases?

54. What concerns, if any, do commenters have regarding the counter cyclicality of probabilities of default implied by Structural Credit Risk Models?

IX. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act of 1980[193] ("RFA") requires the Commission to undertake an initial regulatory flexibility analysis of the proposed rule on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.[194] Pursuant to Section 605(b) of the RFA, the Commission hereby certifies that the proposed amendments to the rule, would not, if adopted, have a significant economic impact on a substantial number of small entities. For purposes of Commission rulemaking in connection with the RFA, small entities include broker-dealers with total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act,[195] or, if not required to file such statements, a broker or

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[193] 5 U.S.C. 603(a).

[194] 5 U.S.C. 605(b).

[195] *See* 17 CFR 240.17a-5(d).

dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[196]

With respect to the amendments to Rules 101 and 102, it is unlikely that any broker-dealer who is defined as a "small business" or "small organization" as defined in Rule 0-10[197] could be an underwriter or other distribution participant as it would not have sufficient capital to participate in underwriting activities. Small business or small organization for purposes of "issuers" or "person" other than an investment company is defined as a person who, on the last day of its most recent fiscal year, had total assets of $5 million or less.[198] We believe that none of the various persons that would be affected by this proposal would qualify as a small entity under this definition as it is unlikely that any issuer of that size had investment grade securities that could rely on the existing exception. Therefore, we believe that these amendments would not impose a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to Rules 101 and 102, and Rule 17a-4 could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

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[196] *See* 17 CFR 240.0-10(c).

[197] 17 CFR 240.0-10.

[198] 17 CFR 240.0-10(a).

X. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[199] the Commission is also requesting information regarding the potential impact of the proposed amendments on the economy on an annual basis. In particular, comments should address whether the proposed changes, if adopted, would have a $100,000,000 annual effect on the economy, cause a major increase in costs or prices, or have a significant adverse effect on competition, investment, or innovations. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

Statutory Basis and Text of Proposed Amendments

Pursuant to the Exchange Act, 15 U.S.C. 78a *et seq.,* and particularly Sections 3(b), 15, 23(a), and 36 (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm) thereof, and Sections 939 and 939A of the Dodd-Frank Act, the Commission is proposing to amend Exchange Act Rules 101 and 102.

List of Subjects in 17 CFR Part 240 and 242

Broker-dealers, Fraud, Issuers, Reporting and recordkeeping requirements, Securities.

Text of Rule Amendments

For the reasons in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78*l*, 78m, 78n, 78n-1, 78o, 78o-4, 78o-

[199] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78*ll*, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.,* and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111-203, 939A, 124 Stat. 1376 (2010); and Pub. L. 112-106, sec. 503 and 602, 126 Stat. 326 (2012), unless otherwise noted.

* * * * *

Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w);

* * * * *

2. Amend § 240.17a-4 by adding paragraph (b)(17) to read as follows:

§240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(b) * * *

(17) The written probability of default determination pursuant to § 242.101(c)(2)(i) of this chapter (Rule 101 of Regulation M).

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PART 242 – REGULATIONS M, SHO, ATS, AC, NMS, AND SBSR AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

3. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78*l*, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

4. Amend § 242.101 by revising paragraph (c)(2) to read as follows:

§ 242.101 Activities by distribution participants.

* * * * *

(c) * * *

(2) *Certain nonconvertible and asset-backed securities.* (i) The nonconvertible debt securities and nonconvertible preferred securities of issuers for which the probability of default, estimated as of the day of the determination of the offering pricing and over the horizon of 12 calendar months from such day, is less than 0.055%, as determined and documented in writing by the distribution participant using a structural credit risk model; *provided, however,* that, for purposes of this paragraph, the term "structural credit risk model" shall mean any commercially or publicly available model that calculates the probability that the value of the issuer may fall below a threshold based on an issuer's balance sheet; or

(ii) Asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3 (17 CFR 239.45).

* * * * *

§ 242.102 [Amended]

5. Amend § 242.102 by removing and reserving paragraph (d)(2).

By the Commission.

Dated: March 23, 2022.

Vanessa A. Countryman,

Secretary.