SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 242, and 249

[Release No. 34-58070; File No. S7-17-08]

RIN 3235-AK17

REFERENCES TO RATINGS OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of three releases that the Securities and Exchange Commission ("Commission") is publishing simultaneously relating to the use in its rules and forms of credit ratings issued by nationally recognized statistical rating organizations ("NRSROs"). In this release, the Commission proposes to amend various rules and forms under the Securities Exchange Act of 1934 ("Exchange Act") that rely on NRSRO ratings. The proposed amendments are designed to address concerns that the reference to NRSRO ratings in Commission rules and forms may have contributed to an undue reliance on NRSRO ratings by market participants.

DATES: Comments should be received on or before September 5, 2008.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-17-08 on the subject line; or
- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper comments:

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

All submissions should refer to File Number S7-17-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, Thomas K. McGowan, Assistant Director, Randall W. Roy, Branch Chief, , and Joseph I. Levinson, Attorney (Net Capital Requirements and Customer Protection) at (202) 551-5510; Michael Gaw, Assistant Director, Brian Trackman, Special Counsel, and Sarah Albertson, Attorney (Alternative Trading Systems) at (202) 551-5602; Paula Jenson, Deputy Chief Counsel, Joshua Kans, Senior Special Counsel, Linda Stamp Sundberg, Senior Special Counsel (Confirmation of Transactions) at (202) 551-5550; Josephine J. Tao, Assistant Director, Elizabeth A. Sandoe, Branch Chief, and Bradley Gude, Special Counsel (Regulation M) at (202) 551-5720; or Catherine Moore, Counsel to the Director at (202) 551-5710, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549-6628.

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

On June 16, 2008, in furtherance of the Credit Rating Agency Reform Act of 2006,[1] the Commission published for notice and comment two rulemaking initiatives.[2] The first proposes additional requirements for NRSROs[3] that were directed at reducing conflicts of interests in the credit rating process, fostering competition and comparability among credit rating agencies, and increasing transparency of the credit rating process.[4] The second is designed to improve investor understanding of the risk characteristics of structured finance products. Those proposals address concerns about the integrity of the credit rating procedures and methodologies of NRSROs in light of the role they played in determining the credit ratings for securities that were the subject of the recent turmoil in the credit markets.

Today's proposals comprise the third of these three rulemaking initiatives relating to credit ratings by an NRSRO that the Commission is proposing. This release, together with two companion releases, sets forth the results of the Commission's review of the requirements in its rules and forms that rely on credit ratings by an NRSRO. The proposals also address recent recommendations issued by the President's Working Group on Financial

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[1] Pub. L. No. 109-291, 120 Stat. 1327 (2006).

[2] Proposed Rules for National Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008).

[3] As described in more detail below, an NRSRO is an organization that issues ratings that assess the creditworthiness of an obligor itself or with regard to specific securities or money market instruments, has been existence as a credit rating agency for at least three years, and meets certain other criteria. The term is defined in section 3(a)(62) of the Securities Exchange Act. A credit rating agency must apply with the Commission to register as an NRSRO, and currently there are nine registered NRSROs.

[4] See Press Release No. 2008-110 (June 11, 2008).

Markets ("PWG"), the Financial Stability Forum ("FSF"), and the Technical Committee of the International Organization of Securities Commissions ("IOSCO").[5] Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to ratings in its rules and forms has, in effect, placed an "official seal of approval" on ratings that could adversely affect the quality of due diligence and investment analysis. The Commission believes that today's proposals could reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions

II. BACKGROUND

The Commission first used the term NRSRO in our rules in 1975 in the net capital rule for broker-dealers, Rule 15c3-1 under the Exchange Act ("Net Capital Rule")[6] as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, we have used the designation in a number of regulations under the federal securities laws. Although we originated the use of the term NRSRO for a narrow purpose in our own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation, rules issued by other financial regulators, in the United States and abroad, and private financial contracts.

Referring to NRSRO ratings in regulations was intended to provide a clear reference point to both regulators and market participants. Increasingly, we have seen clear

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[5] See President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (March 2008), available at www.ustreas.gov ("PWG Statement"); The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (April 2008), available at www.fsforum.org ("FSF Report"); Technical Committee of the International Organization of Securities Commissions, Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets (March 2008), page 9, available at www.iosco.org.

[6] 17 CFR 240.15c3-1.

disadvantages of using the term in many of our regulations. Foremost, there is a risk that investors interpret the use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities. In addition, as demonstrated by recent events,[7] there has been increasing concern about ratings and the ratings process. Further, by referencing ratings in the Commission's rules, market participants operating pursuant to these rules may be vulnerable to failures in the ratings process. In light of this, the Commission proposes to amend the regulations.

We have identified a small number of rules and forms, however, where we believe it is appropriate to retain the reference to NRSRO ratings. These rules and forms generally relate to non-public reporting or recordkeeping requirements we use to evaluate the financial stability of large brokers or dealers or their counterparties and are unlikely to contribute to any undue reliance on NRSRO ratings by market participants.[8]

III. PROPOSED AMENDMENTS

We are proposing to remove references to NRSROs in the following rules and forms: Rule 3a1-1, Rule 10b-10, Rule 15c3-1, Rule 15c3-3, Rules 101 and 102 of Regulation M, Regulation ATS, Form ATS-R, Form PILOT, and Form X-17A-5 Part IIB.

A. Proposed Amendments to Rule 3a1-1, Regulation ATS, Form ATS-R, and Form PILOT

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[7] See Proposed Rules for National Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 57967.

[8] These include Rules 15c3-1g(c)(1)(i), 15c3-1g(e)(2)(i), 17i-5, and 17i-8, which impose certain recordkeeping and reporting requirements for ultimate holding companies of broker-dealers and of supervised investment bank holding companies, and Forms 17-H and X-17A-5 Part IIB, which require reports regarding the risk exposures of large broker-dealers and OTC derivatives dealers.

In 1998, we established a new framework for the regulation of exchanges and alternative trading systems ("ATSs").[9] That framework allowed an ATS to choose whether to register as a national securities exchange or to register as a broker-dealer and comply with the requirements of Regulation ATS. As part of this framework, we adopted Rule 3a1-1 under the Exchange Act,[10] Regulation ATS,[11] and Forms ATS and ATS-R.

Rule 3a1-1(a) provides an exemption from the Exchange Act definition of "exchange" – and thus the requirement to register as an exchange – for a trading system that, among other things, is in compliance with Regulation ATS.[12] Rule 3a1-1(b) contains an exception to the exemption from the exchange definition. Under this exception, the Commission may require a trading system that is a "substantial market" to register as a national securities exchange if it finds that such action is necessary or appropriate in the public interest or consistent with the protection of investors.[13] Specifically, the Commission may – after notice to an ATS and an opportunity for it to respond – require the ATS to register as an exchange if, during three of the preceding four calendar quarters, the ATS had: (1) 50% or more of the average daily dollar trading volume in any security and 5% or more of the average daily dollar trading

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9 See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("Regulation ATS Adopting Release").

10 17 CFR 240.3a1-1.

11 17 CFR 242.300 to 242.303.

12 See 17 CFR 240.3a1-1(a)(2).

13 See 17 CFR 240.3a1-1(b); Regulation ATS Adopting Release, 63 FR at 70857.

volume in any class of securities; or (2) 40% or more of the average daily dollar volume in any class of securities.[14]

As the Commission explained in the Regulation ATS Adopting Release, it was reserving the right to require a "dominant" ATS to register as an exchange.[15] The Commission noted, for example, that "it may not be consistent with the protection of investors or in the public interest for a trading system that is the dominant market, in some important segment of the securities market, to be exempt from registration as an exchange if competition cannot be relied upon to ensure fair and efficient trading structures."[16] The Commission also stated that it might be necessary to require an ATS to register as an exchange if it "would create systemic risk or lead to instability in the securities markets' infrastructure."[17] The Commission made clear that its authority under Rule 3a1-1 was discretionary: "Although the standard for denying or withholding the exemption is based on objective factors, the Commission has discretion to initiate any process to consider whether to revoke a particular entity's exemption under the rule."[18] Thus, while observing that some ATSs likely were above the volume thresholds of Rule 3a1-1, the Commission did not at the time believe it was appropriate to revoke the exemption for any such ATS.[19]

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14 See 17 CFR 240.3a1-1(b)(1).

15 See 63 FR at 70857.

16 Id. at 70858.

17 Id.

18 Id. at 70857-58.

19 See id. at 70858.

The Commission set forth eight classes of securities in any one of which an ATS might achieve "dominant" status: (1) equity securities; (2) listed options; (3) unlisted options; (4) municipal securities; (5) investment grade corporate debt securities; (6) non-investment grade corporate debt securities; (7) foreign corporate debt securities; and (8) foreign sovereign debt securities.[20] Under the definitions provided in Rule 3a1-1, investment grade and non-investment grade corporate debt securities have three elements in common. They are securities that: (1) evidence a liability of the issuer of such security; (2) have a fixed maturity date that is at least one year following the date of issuance; and (3) are not exempted securities, as defined in Section 3(a)(12) of the Exchange Act.[21] The distinguishing characteristic of an investment grade corporate debt security under our current rules is that it has been rated in one of the four highest categories by at least one NRSRO. A non-investment grade corporate debt security under our current rules is a corporate debt security that has not received such a rating.

We preliminarily believe that distinguishing investment grade corporate debt securities and non-investment grade corporate debt securities as separate classes of securities under Rule 3a1-1 is not necessary to fulfill the purposes of that rule. We preliminary believe instead that combining all corporate debt securities into a single class for purposes of assessing whether an alternative trading system is "dominant" is appropriate. Accordingly, we propose to amend Rule 3a1-1 by replacing paragraphs (b)(3)(v) and (b)(3)(vi) which define investment grade corporate debt securities and non-investment grade debt securities,

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[20] See 17 CFR 240.3a1-1(b)(3).

[21] Compare 17 CFR 240.3a1-1(b)(3)(v) with 17 CFR 240.3a1-1(b)(3)(vi).

respectively, with a single category "corporate debt securities" in paragraph (b)(3)(v).[22] This new definition would retain verbatim the three elements common to the existing definitions of investment grade and non-investment grade debt securities. The 5% and 40% thresholds also would remain unchanged. Under the proposed amendment to Rule 3a1-1, the Commission could, for example, determine that an ATS must register as an exchange if the system had – during three of the preceding four calendar quarters – 50% or more of the average daily dollar trading volume in any security and 5% or more of the average daily dollar trading volume in corporate debt securities, or 40% of the average daily dollar trading volume in corporate debt securities.[23]

The Commission preliminarily believes that exceeding a volume threshold for a combined class of all corporate debt securities would be a sufficient indication that an ATS should be required to register as an exchange, and that it is not necessary or appropriate to assess trading volumes in the narrower segments of investment grade and non-investment grade corporate debt securities. While the proposed amendment could reduce the likelihood that an ATS could be required to register as an exchange,[24] we preliminarily believe that this

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[22] Existing paragraphs (b)(3)(vii) and (b)(3)(viii) would be unchanged but redesignated as paragraphs (b)(3)(vi) and (b)(3)(vii), respectively.

[23] The other six classes of securities – equity securities, listed options, unlisted options, municipal securities, foreign corporate debt securities, and foreign sovereign debt securities – would remain unchanged. Therefore, as under existing Rule 3a1-1, the Commission also could determine that an ATS must register as an exchange if the system exceeded either volume threshold in any of these other classes of securities.

[24] For example, under existing Rule 3a1-1, an ATS that has 40% of the average daily dollar trading volume in non-investment grade corporate debt securities and 0% of the average daily dollar trading volume in investment grade corporate debt securities for three consecutive months could be required by the Commission to register as an exchange. Under the proposed amendment, the Commission could not do so because the ATS's combined average daily dollar trading volume in corporate debt securities would be less than 40%.

change would nevertheless be appropriate. At this time, there does not appear to be a continuing need to analyze "dominance" in separate classes of investment grade and non-investment grade corporate debt securities, particularly in view of the fact that the Commission would continue to analyze for dominance in six other classes of securities (in addition to the new single class for corporate debt securities). The Commission notes that, in over nine years since the adoption of Rule 3a1-1, the Commission has never determined to require an ATS to register as an exchange because it had become "dominant." Moreover, the Commission would continue to be able to exercise discretion about whether to revoke the exemption for any ATS that exceeded either threshold in Rule 3a1-1. The Commission seeks comment on whether, in light of the proposed combination of investment grade and non-investment grade corporate debt securities into a single class, it should adopt lower thresholds at which an ATS that trades corporate debt securities should be required to register as an exchange. If so, what should those thresholds be and why?

We are proposing similar changes to Regulation ATS, which establishes certain requirements applicable to ATSs that choose to register as broker-dealers and comply with Regulation ATS in lieu of exchange registration. Rule 301(b)(5) of Regulation ATS imposes a "fair access" requirement, whereby an ATS that exceeds certain volume thresholds in any class of securities must establish written standards for granting access to trading on its system and not unreasonably prohibit or limit any person in respect to access to the services it offers.[25] The fair access standard applies if an ATS has 5% or more of the average daily volume during at least four of the preceding six calendar months in any of the following: (1)

[25] See 17 CFR 242.301(b)(5).

any individual NMS stock;[26] (2) any individual equity security that is not an NMS stock and for which transactions are reported to a self-regulatory organization; (3) municipal securities; (4) investment grade corporate debt securities; and (5) non-investment grade corporate debt securities.[27] The terms investment grade and non-investment grade debt security are defined in Rule 300 of Regulation ATS.

We propose to amend Rules 300 and 301(b)(5) to establish a single class of corporate debt securities and to eliminate the existing separate classes of investment grade and non-investment grade corporate debt securities. Accordingly, paragraphs (i) and (j) of Rule 300 would be replaced with a new paragraph (i) defining "corporate debt security" to mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; and (3) is not an exempted security, as defined in Section 3(a)(12) of the Exchange Act. Existing paragraphs (i)(D) and (i)(E) of Rule 301(b)(5) would be replaced with a new paragraph (i)(D) providing that an ATS must comply with the access requirements set out in Rule 301(b)(5) if, with respect to corporate debt securities, such system accounts for 5% or more of the average daily volume traded in the United States for the requisite number of months. The 5% threshold at which an

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[26] See 17 CFR 240.600(a)(47) (defining "NMS stock").

[27] In proposing Regulation ATS, the Commission requested comment "on whether categories of debt securities should be further divided based on an instrument's maturity, credit rating, or other criteria." Securities Exchange Act Release No. 39884 (April 21, 1998), 63 FR 23504, 23519 (April 29, 1998). However, in adopting Regulation ATS, the Commission did not employ these narrower classes of debt securities. See Regulation ATS Adopting Release, 63 FR at 70873.

ATS would have to grant fair access to its system also would remain unchanged.[28] As with the proposed changes to Rule 3a1-1, the other classes of securities would remain unchanged.

In addition, Rule 301(b)(6) of Regulation ATS[29] requires an ATS that exceeds certain volume thresholds in any class of securities to comply with standards regarding the capacity, integrity, and security of its automated systems. Five classes of securities are currently identified in Rule 301(b)(6): (1) NMS stocks; (2) equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization; (3) municipal securities; (4) investment grade corporate debt securities; and (5) non-investment grade corporate debt securities.[30] Consistent with the other proposed changes to Regulation ATS, the Commission also proposes to eliminate separate classes for investment grade and non-investment grade debt securities in Rule 301(b)(6) and replace them with a single category for "corporate debt securities," which would be defined in Rule 300. Existing paragraphs (i)(D) and (i)(E) of Rule 301(b)(6) would be replaced with a new paragraph (i)(D) providing that an ATS must comply with the capacity, integrity, and security requirements of Rule 301(b)(6) if, with respect to corporate debt securities, such system accounts for 20% or more of the average daily volume traded in the United States for the requisite number of months. The 20% threshold and the other three classes of securities would remain unchanged.

For the same reasons we are proposing to amend Rule 3a1-1, we preliminarily believe that these proposed amendments to Regulation ATS would be appropriate, and that a volume

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[28] When the Commission originally adopted Regulation ATS, it set the fair access threshold at 20%. It later lowered the threshold to 5% in connection with the adoption of Regulation NMS. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37550 (June 29, 2005).

[29] 17 CFR 242.301(b)(6).

[30] 17 CFR 242.301(b)(6)(i).

threshold for a combined class of all corporate debt securities would be sufficient for the fair access requirement and the capacity, integrity, and security requirements. The Commission preliminarily believes that the purposes of Regulation ATS would still be fulfilled if investment grade and non-investment grade corporate debt securities were combined into a single class. ATSs would continue to be subject to the fair access requirements and the capacity, integrity, and security requirements with respect to the other existing classes of securities and at the same volume thresholds (5% and 20%, respectively). The Commission seeks comment on whether, in light of the proposed combination of investment grade and non-investment grade corporate debt securities into a single class, it should adopt lower thresholds for fair access and the capacity, security, and integrity requirements under Regulation ATS. If so, what should those thresholds be and why?

We are also proposing revisions to Form ATS-R, which is used by ATSs to report certain information about their activities on a quarterly basis.[31] Currently, Form ATS-R requires each ATS to report the total unit volume and total dollar volume in the previous quarter for various categories of securities, including investment grade and non-investment grade corporate debt securities. Consistent with the proposed amendments to Regulation ATS described above, we also propose to revise Form ATS-R to eliminate the separate categories for investment grade and non-investment grade corporate debt securities, and instead create a single category for "corporate debt securities." As with the proposed changes to Regulation ATS, "corporate debt securities" would be defined in the instructions to Form ATS-R to mean any security that: (1) evidences a liability of the issuer of such security; (2) has a fixed maturity date that is at least one year following the date of issuance; and (3) is not

[31] Each ATS must file a Form ATS-R within 30 days of the end of each calendar quarter, and within ten days of a cessation of operations. See 17 CFR 242.301(b)(9).

an exempted security, as defined in Section 3(a)(12) of the Exchange Act. Because separate classes for investment grade and non-investment grade corporate debt securities are proposed to be eliminated for purposes of the thresholds in Rule 3a1-1 and Rules 301(b)(5) and 301(b)(6) of Regulation NMS, no purpose would be served by requiring ATSs to separately report their trading volumes for investment grade and non-investment grade debt securities on Form ATS-R. The figures for the separate classes would be added together and reported as a single item on the amended form. The Commission is not proposing any other changes to Form ATS-R.

We are also proposing to revise Form PILOT consistent with the proposed changes to Form ATS-R. Ordinarily, Section 19 of the Exchange Act[32] and Rule 19-4 thereunder[33] require a self-regulatory organization ("SRO") to file with the Commission proposed rule changes on Form 19b-4 regarding any changes to any material aspect of its operations, including any trading system. Rule 19b-5 under the Exchange Act[34] sets forth a limited exception to that requirement by permitting an SRO to operate a pilot trading system without filing proposed rule changes with respect to that system if certain criteria are met. One of those criteria is that the SRO file a Form PILOT in accordance with the instructions on that form. Like Form ATS-R, Form PILOT currently requires quarterly reporting of trading activity by classes of securities, including investment grade and non-investment grade corporate debt securities. For the same reasons we propose to amend Rule 3a1-1 and Regulation ATS, we also propose to revise Form PILOT to eliminate these two categories,

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32 15 U.S.C. 78s.

33 17 CFR 240.19b-4.

34 17 CFR 240.19b-5.

replacing them with a single category of "corporate debt securities." Corporate debt securities would be defined identically in Form PILOT and Form ATS-R. The Commission preliminarily believes that it is appropriate to obtain trading volumes from pilot trading systems for the combined class of corporate debt securities, and that separate reporting of the two classes is not necessary to adequately monitor the development of pilot trading systems. The Commission notes that, in over nine years since Rule 19b-5 and Form PILOT were adopted, no SRO has ever established a pilot trading system pursuant to Rule 19b-5 to trade corporate debt securities.

We generally request comment on all aspects of the proposed elimination of the reference to NRSRO ratings in Rule 3a1-1, Regulation ATS, Form ATS-R, and Form PILOT. In addition, we request comment on the following specific questions:

- Would the proposed amendments to Rule 3a1-1 have any significant impact on investors, market participants, the national market system, or the public interest?
- Would the proposed amendments to Regulation ATS have any significant impact on investors, market participants, the national market system, or the public interest?
- Would the proposed amendments affecting the fair access standards have other consequences, whether on investors, market participants, the national market system, or the public interest? Have investors experienced difficulty obtaining access to ATSs trading corporate debt securities? Would the proposed amendments impair or limit current investor access to ATSs?
- Would the proposed changes to Regulation ATS as they relate to the capacity, integrity, and security requirements have any adverse impact on investors, market participants, or the national market system as a whole?

- In view of the proposed combination of investment grade and non-investment grade corporate debt securities into a single class for purposes of Rule 3a1-1 and Regulation ATS, should the Commission also lower the thresholds in those rules for the combined class of corporate debt securities? If so, what should those thresholds be? Why are those suggested thresholds appropriate?
- Should the Commission retain investment grade and non-investment grade corporate debt securities as separate classes of securities under Rule 3a1-1 and Regulation ATS and instead use a different definitions of those terms that do not rely on NRSRO ratings? If so, how should investment grade and non-investment grade be defined?
- Would the proposed amendments to Form ATS-R or Form PILOT have any significant impact on investors, market participants, the national market system, or the public interest?

B. Proposed Amendments to Rule 10b-10

We propose to amend Rule 10b-10,[35] the transaction confirmation rule for broker-dealers, to delete paragraph (a)(8) of that rule.[36] Rule 10b-10 generally requires broker-dealers that effect transactions for customers in securities, other than U.S. savings bonds or municipal securities, which are covered by Municipal Securities Rulemaking Board rule G-15 (which applies to all municipal securities brokers and dealers), to provide customers with written notification, at or before the completion of each transaction, of certain basic transaction terms. This transaction confirmation must disclose, among other information:

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35 17 CFR 240.10b-10.

36 Consistent with that change, we also are proposing to redesignate paragraph (a)(9) of the rule, related to broker-dealers that are not members of the Securities Investor Protection Corporation ("SIPC"), as paragraph (a)(8).

the date of the transaction; the identity, price, and number of shares bought or sold[37]; the capacity of the broker-dealer;[38] the dollar price or yield at which a transaction in a debt security was effected;[39] and, under specified circumstances, the amount of compensation paid to the broker-dealer and whether the broker-dealer receives payment for order flow.[40]

The rule's requirements, portions of which have been in effect for over 60 years, provide basic investor protections by conveying information that allows investors to verify the terms of their transactions, alerts investors to potential conflicts of interest with their broker-dealers, acts as a safeguard against fraud, and provides investors a means to evaluate the costs of their transactions and the execution quality.[41]

Paragraph (a)(8) of Rule 10b-10 requires transaction confirmations for debt securities, other than government securities, to inform the customer if the security is unrated by an NRSRO. When we adopted paragraph (a)(8) in 1994, it was intended to prompt a dialogue between the customer and the broker-dealer if the customer had not previously been informed of the unrated status of the debt security. We stated that this disclosure was not intended to suggest that an unrated security is inherently riskier than a rated security.[42] Upon

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37 See 17 CFR 240.10b-10(a)(1) (the confirmation must also include either the time of the transaction or the fact that it will be furnished upon written request).

38 See 17 CFR 240.10b-10(a)(2).

39 See 17 CFR 240.10b-10(a)(5) and (6).

40 See, e.g., 17 CFR 240.10b-10(a)(2)(i)(B), (C) and (D).

41 See Securities Exchange Act Release No. 34962 (November 10, 1994), 59 FR 59612, 59613 (November 17, 1994).

42 See Securities Exchange Act Release No. 34962 (November 10, 1994), 59 FR 59612 (November 17, 1994) (File No. S7-6-94).

further consideration and in light of present concerns regarding undue reliance on NRSRO ratings and confusion about the significance of those ratings, we believe it would be appropriate to delete this requirement. However, in proposing to no longer require broker-dealers to include in transaction confirmations the information that a debt security is unrated, we do not mean to suggest that information about an issuer's creditworthiness is not a relevant subject for discussion and consideration prior to purchasing a debt security. We would encourage investors to seek to understand all of the risks of securities, including credit-related risks, before buying. In addition, we note that deleting this requirement would not prevent broker-dealers from voluntarily continuing to include this information in transaction confirmations.

We generally request comment on all aspects of the proposed elimination of the NRSRO reference in Rule 10b-10. In addition, we request comment on the following specific questions:

- Have investors have found confirmation disclosure about the fact that a debt security is not rated by an NRSRO to be useful?
- Are there any possible alternatives to deletion that would address concerns about undue reliance on NRSRO ratings or avoid confusion about the significance of those ratings? For example, should the confirmation disclose that the security is rated or not rated by an NRSRO, as the case may be, instead of just that the security is not rated?

C. Proposed Amendments to Rule 15c3-1

Under the Net Capital Rule, broker-dealers are required to maintain, at all times, a minimum amount of net capital. The rule generally defines "net capital" as a broker-dealer's

net worth (assets minus liabilities), plus certain subordinated liabilities, less certain assets that are not readily convertible into cash (e.g., fixed assets), and less a percentage (haircut) of certain other liquid assets (e.g., securities).[43] Broker-dealers are required to calculate net worth using generally accepted accounting principles.

In computing their net capital under the provisions of the Net Capital Rule, broker-dealers are required to deduct from their net worth certain percentages of the market value of their proprietary securities positions. A primary purpose of these "haircuts" is to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions. We apply a lower haircut to certain types of securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute since those securities typically were more liquid and less volatile in price than securities that were not so highly rated.[44]

We are proposing to remove, with limited exceptions, all references to NRSROs from the Net Capital Rule.[45] The broker-dealers subject to the Net Capital Rule are sophisticated

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[43] See 17 CFR 240.15c3–1(c)(2).

[44] See 17 CFR 240.15c3-1(c)(2)(vi)(E) (haircuts applicable to commercial paper), 17 CFR 240.15c3-1(c)(2)(vi)(F) (haircuts applicable to nonconvertible debt securities), and 17 CFR 240.15c3-1(c)(2)(vi)(H) (haircuts applicable to cumulative nonconvertible preferred stock). The term NRSRO is also used in appendices to the Net Capital Rule. See 17 CFR 240.15c3-1a(b)(1)(i)(C) (defining the term "major market foreign currency") and 17 CFR 240.15c3-1f(d) (determining the capital charge for credit risk arising from certain OTC derivatives transactions).

[45] In 2003, the Commission published a concept release in which we sought comment on the use of NRSRO ratings in our rules, and specifically sought comment on eliminating the minimum quality standards established with the use of NRSRO ratings in Exchange Act Rule 15c3-1. See Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Securities Exchange Act Release No. 47972 (June 4, 2003), 68 FR 35258 (June 12, 2003). (Comments on the concept release are available at: http://www.sec.gov/rules/concept/s71203.shtml.) As discussed above, recent events have

market participants regulated by at least one SRO.[46] As regulated entities, broker-dealers must meet certain financial responsibility requirements, including maintaining minimum amounts of liquid assets as net capital, safeguarding customer funds and securities, and making and preserving accurate books and records. Accordingly, we preliminarily believe that broker-dealers would be able to assess the creditworthiness of the securities they hold without undue hardship and, therefore, that exclusive reliance on NRSRO ratings for the purposes of the Net Capital Rule is no longer necessary, although broker-dealers that wish to continue to rely on such ratings may do so.

We are proposing the substitution of two new subjective standards for the NRSRO ratings currently relied upon under the Net Capital Rule. For the purposes of determining the haircut on commercial paper,[47] we propose to replace the current NRSRO ratings-based criterion -- being rated in one of the three highest rating categories by at least two NRSROs -- with a requirement that the instrument be subject to a minimal amount of credit risk and have sufficient liquidity such that it can be sold at or near its carrying value almost immediately. For the purposes of determining haircuts on nonconvertible debt securities as well as on preferred stock,[48] we propose to replace the current NRSRO ratings-based criterion -- being rated in one of the four highest rating categories by at least two NRSROs --

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highlighted the need to revisit our reliance on NRSRO ratings in the context of these developments. See also the extensive discussion of market developments in the Release No. 57967.

46 The SROs regulating broker-dealers include the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board, and the national securities exchanges.

47 See 17 CFR 240.15c3-1(c)(2)(vi)(E).

48 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(1) and (c)(2)(vi)(H).

with a requirement that the instrument be subject to no greater than moderate credit risk and have sufficient liquidity such that it can be sold at or near its carrying value within a reasonably short period of time. This latter formulation would apply as well to long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof or nonconvertible debt securities having a fixed interest rate and a fixed maturity date and which are not traded flat or in default as to principal or interest.[49]

We preliminarily believe that these new standards would continue to advance the purpose the NRSRO ratings-based standards were designed to advance, which is to enable broker-dealers to make net capital computations that reflect the market risk inherent in the positioning of those particular types of securities. The prior standards- being rated in one of the three or four highest rating categories by at least two NRSROs- were designed based on the practice of many credit rating agencies to have at least eight categories for their debt securities with the top four commonly referred to as "investment grade."[50] While the proposed standards, like the prior standards, do not use the term "investment grade," they are meant to serve the same purpose as the prior standards. As such, the category of securities that have "no greater than moderate credit risk" and can be sold at or near their carrying value within a reasonably short period of time should encompass all investment grade securities. The proposed new criteria for commercial paper to be used for net capital purposes are securities that are "subject to a minimal amount of credit risk" and can be sold at or near their carrying value almost immediately. In each case, the proposed liquidity

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49 See 17 CFR 240.15c3-1(c)(2)(vi)(F)(2).

50 See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007).

standard would reflect the fact that only liquid assets are relevant for the purposes of the Net Capital Rule.

We further believe that broker-dealers have the financial sophistication and the resources necessary to make the basic determinations of whether or not a security meets the requirements in the proposed amendments and to distinguish between securities subject to minimal credit risk and those subject to moderate credit risk. The broker-dealer would have to be able to explain how the securities it used for net capital purposes meet the standards set forth in the proposed amendments.

Notwithstanding our belief that broker-dealers have the financial sophistication and the resources to make these determinations, we believe it would be appropriate, as one means of complying with the proposed amendments, for broker-dealers to refer to NRSRO ratings for the purposes of determining haircuts under the Net Capital Rule. As such, if we adopt the proposed amendments, after considering comments, we expect to take the view in the adopting release that securities rated in one of the three highest categories by at least two NRSROs would satisfy the requirements of proposed new paragraph (c)(2)(vi)(E) and securities rated in one of the four highest rating categories by at least two NRSROs to satisfy the requirements of proposed new paragraphs (c)(2)(vi)(F) and (c)(2)(vi)(H). We emphasize, however, that references to such NRSRO ratings would be just one means of satisfying the requirements of the proposed amendments but would not the only means of doing so.

We are also proposing to remove references to NRSRO ratings from Appendices E and F to Rule 15c3-1 and make conforming changes to Appendix G of Rule 15c3-1 and the General Instructions to Form X-17 A-5, Part IIB.[51] Appendix E of the Net Capital Rule sets

[51] 17 CFR 240.15c3-1e, 240.15c3-1f, and 240.15c3-1g; see 17 CFR 249.617.

forth a program that allows a broker-dealer to use an alternative approach to computing net capital deductions, subject to certain conditions, most importantly the broker-dealer's ultimate holding company consenting to group-wide Commission supervision as a consolidated supervised entity ("CSE").[52] Appendix F to the Net Capital Rule sets forth a similar program for OTC derivatives dealers. In each case, the program sets forth an alternative means of establishing net capital requirements under the Net Capital Rule by which the broker-dealer or OTC derivatives dealer, as applicable, may elect to determine counterparty risk. This may be done either based on NRSRO ratings by requesting Commission approval to determine credit risk weights based on internal calculations.

We are proposing to delete the provisions of Appendices E and F permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, a broker-dealer that is part of a CSE or a OTC derivatives dealer that wished to use the approach set forth Appendix E or F, respectively, to determine counterparty risks would be required, as part of its initial application to use the alternative approach or in an amendment, to request Commission approval to determine credit risk weights based on internal calculations. Based on the strength of the broker-dealer/CSE or OTC derivatives dealer's internal credit risk management system, we may approve the application. A broker-dealer or OTC derivatives dealer that obtained such approval would be required to make and keep current a record of the basis for the credit risk weight of each counterparty. To date, a total of seven entities have applied for and been granted permission to use the methods set forth in Appendix E, while five have applied for and been granted permission to use the methods set forth in Appendix F. We do not currently anticipate that any additional firms

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[52] See 17 CFR 240.15c3-1e.

will apply for permission to use either Appendix E or Appendix F. All of the approved firms have already developed models to calculate market and credit risk under the alternative net capital calculation methods set forth in the appendices as well as internal risk management control systems.[53] As such, each firm already employs the non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for determining counterparty credit risk under Appendices E and F. We are also proposing conforming amendments to Appendix G of Rule 15c3-1 and the General Instructions to Form X-17 A-5, Part IIB. The proposed amendments would delete references to the provisions of Appendices E and F, respectively, that are proposed to be deleted.

We generally request comment on all aspects of the proposed elimination of the use of NRSRO ratings in the Net Capital Rule. In addition, we request comment on the following specific questions:

- Would internal evaluations of individual debt securities by broker-dealers for purposes of determining the capital charges ("internal processes") instead of reliance on NRSRO ratings accomplish the stated goals of the Commission's net capital requirements?
- What are the benefits, other than those we have identified, of the use of internal processes?
- Besides the use of internal processes by broker-dealers, are there potential alternate means of establishing creditworthiness for the purposes of the Net

[53] See, e.g., Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Securities Exchange Act Release No. 49830 (June 8, 2004), 69 FR 33428 at 33456 (June 21, 2004).

Capital Rule without reference to NRSRO ratings? Commenters who believe that this is the case should include detailed descriptions of such alternate means.

- Are we correct in our preliminary belief that broker-dealers have the financial sophistication and the resources necessary to generate internal processes and make the basic determinations of whether or not a security is meets the requirements in the proposed amendments and to distinguish between securities subject to minimal credit risk and those subject to moderate credit risk? If not, how should the proposed rule be modified to address those concerns?
- What would be the potential consequences of using internal processes for purposes of the net capital rule and how could these be addressed? For example, one concern is that a broker-dealer would have an incentive to downplay the credit risk associated with a particular security in order to minimize capital charges. How could this concern be addressed?
- If we provided for the use of internal processes, should we require that the persons responsible for developing a broker-dealer's internal processes and applying them to individual securities for the purposes of the Net Capital Rule be separate from employees who perform other functions for the broker-dealer, such as making proprietary investment decisions for the broker-dealer?
- What would be the appropriate level of regulatory oversight for broker-dealers employing internal processes?
- Should we require any policies and procedures with regard to the basic determinations as to whether a security meets the standards in the proposed amendments?

- Should we explicitly define the terms used in the proposed new standards in Rules 15c3-1(c)(2)(vi)(E), (F), and (H)?
- If we adopt the proposed standards, would broker-dealers find it useful to employ market-based models, including models using credit spreads to satisfy the requirements of the proposed standards? Should we provide guidance about the use of these models?
- What is the likelihood that small broker-dealers would purchase credit ratings or the models used to develop those ratings from large broker-dealers?
- If we adopt the proposed amendments after considering comments, should we take the view in the adopting release that securities rated in one of the three highest categories by at least two NRSROs satisfy the requirements of proposed new paragraph (c)(2)(vi)(E) and securities rated in one of the four highest rating categories by at least two NRSROs to satisfy the requirements of proposed new paragraphs (c)(2)(vi)(F) and (c)(2)(vi)(H)? Commenters should include detailed descriptions of any subset of broker-dealers they believe should be able to continue to rely on NRSRO ratings and the rationale therefor.
- What factors should we take into account when considering the potential regulatory compliance costs of removing references to NRSROs from the Net Capital Rule? Commenters should include detailed descriptions of any potential costs.

D. Proposed Amendment to Rule 15c3-3

Note G to Exhibit A of Rule 15c3-3 under the Exchange Act (the "Customer Protection Rule"), which provides the formula for the determination of broker-dealers'

reserve requirements, allows a broker-dealer to include as a debit in the formula the amount of customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization that maintains the highest investment grade rating from an NRSRO.[54] This standard, which is one of four different means by which a registered clearing or derivatives organization can be judged to meet the requirements of paragraph (b)(1) of Note G,[55] is consistent with the customer protection function of Rule 15c3-3 and is necessary because of the unsecured nature of the customer positions in security futures products margin debit. We propose to replace this standard with a requirement that the registered clearing or derivatives organization to which customers' positions in security futures products are posted has the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk.

We preliminarily believe that these new standards would continue to advance the purpose the NRSRO-ratings standard was designed to advance, namely to ensure both of the long-term financial strength of a clearing organization to which customers' positions in security futures products are posted and its general creditworthiness.[56] Although the rule was

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54 17 CFR 240.15c3-3a(b)(1)(i).

55 A broker-dealer may also include customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization (1) that maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits; (2) that maintains at least $3 billion in margin deposits; or (3) which does not meet the other requirements but which the Commission has agreed, upon a written request from the broker-dealer, that the broker-dealer may utilize. 17 CFR 240.15c3-3a(b)(1)(ii) - (iv).

56 See Rule 15c3–3 Reserve Requirements for Margin Related to Security Futures Products, Securities Exchange Act Release No. 50295 (August 31, 2004), 69 FR 54182, 54185 (September 7, 2004).

originally designed to provide an indication of long-term financial strength and general creditworthiness from an independent source,[57] we preliminarily believe that broker-dealers, as sophisticated market participants and regulated entities that are subject to financial responsibility requirements, have the financial sophistication and the resources necessary to make this determination. The broker-dealer would have to be able to explain how the registered clearing or derivatives organization to which customers' positions in security futures products are posted meets the standard in the proposed amendment.

We also believe, however, that it would be appropriate, as one means of complying with the proposed amendment, for broker-dealers to refer to NRSRO ratings for the purposes of paragraph (b) of Note G. As such, if we adopt the proposed amendments after considering comments, we expect to take the view in the adopting release that we would continue to consider a registered clearing agency or derivatives clearing organization that maintains the highest investment-grade rating from an NRSRO to satisfy the requirements of that provision. We emphasize, however, that the references to such NRSRO ratings would be just one means of satisfying the requirements of the proposed amendments and would not be the only means of doing so.

We request comment on the following specific questions in connection with Exhibit A to the Customer Protection Rule:

- As an alternative to relying on an NRSRO rating to distinguish the creditworthiness of a registered clearing agency or derivatives clearing organization, should we prescribe a minimum net worth or asset test for the organizations? Alternatively, should we prescribe a test based on a minimum level of members of the organization

[57] Id.

or minimum level of clearing deposits held by the organization? Commenters that support any of these proposals should provide details (e.g., the minimum levels in dollar amounts) as to how they should be implemented.

- Would it be more appropriate to delete current paragraph (b)(1)(i) of Note G to Exhibit A to the Customer Protection Rule in its entirety? Put differently, do the guidelines offered by current paragraphs (b)(1)(ii) - (iv) of Note G in and of themselves provide sufficient means by which a registered clearing or derivatives organization could be judged to meet the requirements of paragraph (b)(1) of Note G?
- If we adopted the proposed amendment to Note G to Exhibit A of Rule 15c3-3, should we explicitly define the terms used in the proposed new standard?
- Is it appropriate to allow broker-dealers to make the determination of whether a clearing organization possesses the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk? If not, what are suggested ways that the proposed rule could be amended to address that concern?
- Should we require any policies and procedures with regard to the determination whether a registered clearing or derivatives organization meets the standard in the proposed amendment?
- What would be the potential consequences of allowing broker-dealers to determine whether a clearing organization possessed the highest capacity to meet its financial obligations and was subject to no greater than minimal credit risk and how could these be addressed? For example, one concern is that a broker-dealer would have an incentive to downplay the credit risk associated with a particular clearing

organization in order to be able to post customers' positions in security futures products to it. How could this concern be addressed?

- If we adopt the proposed amendments after considering comments, should we take the view in the adopting release that we would consider a registered clearing agency or derivatives clearing organization that maintains the highest investment-grade rating from an NRSRO to satisfy the requirements of that provision? Commenters should include detailed descriptions of any subset of broker-dealers they believe should be able to continue to rely on NRSRO ratings and the rationale therefore.
- What factors should we take into account when considering the potential regulatory compliance costs of removing references to NRSROs from paragraph (b)(1) of Note G to Rule 15c-3a? Commenters should include detailed descriptions of any potential costs.

E. Proposed Amendments to Rules 101 and 102 of Regulation M

1. Regulation M

As a prophylactic, anti-manipulation set of rules, Regulation M is designed to protect the integrity of the securities trading market as an independent pricing mechanism by prohibiting activities that could artificially influence the market for the offered security. Rules 101 and 102 of Regulation M specifically prohibit issuers, selling security holders, underwriters, brokers, dealers, other distribution participants, and any of their affiliated purchasers, from directly or indirectly bidding for, purchasing, or attempting to induce

another person to bid for or purchase, a covered security until the applicable restricted period has ended.[58]

2. Current Rule 101(c)(2) and Rule 102(d)(2) Exceptions

Both rules currently except "investment grade nonconvertible and asset-backed securities."[59] These exceptions apply to 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.[60] The current exceptions for certain investment grade debt and preferred securities rated by a NRSRO were originally based on the premise that these securities are traded on the basis of their yields and credit ratings, are largely fungible and, thus, are less likely to be subject to manipulation.[61] With respect to asset-backed securities, the current exceptions were premised on the fact that asset-backed securities also trade primarily on the basis of yield and credit rating and that asset-backed securities investors are concerned with "the structure of the class of securities and the nature of the assets pooled to serve as collateral for those securities."[62]

3. Proposed Amendments' Elimination of the NRSRO Reference

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58 "Covered security" is defined as "any security that is the subject of a distribution or any reference security." 17 CFR 242.100.

59 17 CFR 242.101(c)(2) and 242.102(d)(2).

60 Id.

61 Securities Exchange Act Release No. 19565 (March 4, 1983); 48 FR 10628 (March 14, 1983). See also Securities Exchange Act Release No. 18528 (March 3, 1982); 47 FR 11482 (March 16, 1982).

62 Securities Exchange Act Release No. 38067 (December 20, 1996); 62 FR 520 (January 3, 1997).