SEC Proposes Rule Amendments to Remove References to Credit Ratings From Certain Exchange Act Rules

On April 27, 2011, the Securities and Exchange Commission ("SEC") issued proposed rules to remove certain references to credit ratings from the SEC's rules under the Securities Exchange Act of 1934, as amended (the "Exchange Act").[1] With its proposal, the SEC implements Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[2] which requires the SEC to "remove any reference to or requirement of reliance on credit ratings" from its regulations. The rules which would be impacted by the proposal are the Net Capital Rule and the Customer Protection Rule (both applicable to registered broker-dealers); Regulation M (an anti-manipulation rule applicable to distributions of securities); the instructions to the Financial and Operational Combined Uniform Single Report, or FOCUS Report, filed by registered broker-dealers; and, the rule governing the content of confirmations of securities trades which are required to be sent by broker-dealers to their customers.

The SEC is also requesting comment on potential standards of creditworthiness for use in defining the terms "mortgage related security" and "small business related security," which appear in Exchange Act Sections 3(a)(41) and 3(a)(53), respectively. Congress abrogated the existing standards in Section 939(e) of the Dodd-Frank Act.

The SEC is seeking comment within 60 days of publication in the Federal Register.

I. The Net Capital Rule: Exchange Act Rule 15c3-1

A. Calculation of the Net Capital Haircut

The Net Capital Rule, as set forth in Exchange Act Rule 15c3-1, establishes minimum capital requirements for broker-dealers. Under the Rule's "net liquid assets test," the broker-dealer must maintain an "actual net capital" that exceeds the broker-dealer's "required minimum net capital" at all times. When calculating "actual net capital," the broker-dealer subtracts prescribed percentages of the market value of its securities. This subtraction, known as a "haircut," accounts for the possibility of market fluctuations or unexpected illiquidity. As presently written, the Net Capital Rule imposes a lower haircut for certain securities that are highly rated by nationally recognized statistical rating organizations ("NRSROs").[3]

In order to comply with Section 939A of the Dodd-Frank Act, the SEC proposes that as a general rule broker-dealers take a 15% haircut on commercial paper, nonconvertible debt and preferred stock that is deemed to have a ready market.[4] However, broker-dealers may apply the same reduced haircut for commercial paper, nonconvertible debt and preferred stock presently available for assets with high credit ratings, but now only "pursuant to written policies that the broker or dealer establishes, maintains, and enforces to assess

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1 *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934*, Release Nos. 34-64352 (Apr. 27, 2011), available at http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

2 Pub. L. No. 111-203, 124 Stat. 1376 (2010), available at http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173.

3 To receive the reduced haircut, commercial paper must be rated in one of the three highest categories by at least two NRSROs. Nonconvertible debt and preferred stock must be rated in one of the four highest categories by at least two NRSROs.

4 All securities without a ready market will still be subject to a 100% haircut.

creditworthiness." Such written policies could consider a variety of factors and would be subject to regulatory examinations by the SEC and self-regulatory organizations. The SEC notes in its release that while the term "investment grade" would no longer appear in the proposed rules, the amendments "are meant to capture securities that should generally qualify for that designation, without placing undue reliance on third-party credit ratings."

B. Appendix A: Major Market Foreign Currency

Under Appendix A, broker-dealers' positions in "major market foreign currency" options receive favorable treatment in the calculation of net capital. To qualify as "major market foreign currency," there must be a "substantial inter-bank forward currency market" for it and the short-term debt of its issuing nation must be highly rated by at least two NRSROs. The SEC proposes to remove the reference to NRSROs from the definition.[5]

C. Appendix E: Alternative Net Capital Computation

Appendix E allows broker-dealers who meets certain qualifications to use an alternative method for computing capital called "alternative net capital" or "ANC" method. Presently, a broker-dealer using an ANC computation may determine counterparty risk according to either NRSRO ratings or its internal credit ratings. The SEC notes that all of the firms for which the use of the ANC standard has been approved already employ a non-NRSRO ratings-based method that would, under the proposed amendments, become the only option for calculating credit risk charges. Thus, to comply with Section 939A of the Dodd-Frank Act, the SEC proposes removing paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) of Appendix E, which base credit risk charges for counterparty risk on NRSRO ratings, and in place of these ratings, require a broker-dealer using the ANC computation to apply a credit risk weight of either 20%, 50%, or 150% with respect to an exposure to a given counterparty based on the internal credit rating the broker-dealer determines for the counterparty. As part of a broker-dealer's initial application to register with the SEC (or in an amendment to an application) the broker-dealer would have to seek SEC approval to apply counterparty risk weights of either 20%, 50% or 150%, which the SEC would then consider in light of the "strength" of the broker-dealer's internal rating system.[6]

D. Appendix F: Net Capital Deductions for OTC Derivatives Dealers

Appendix F allows over-the-counter ("OTC") derivatives dealers to use an alternative method for calculating net capital deductions under certain conditions. As part of this alternative method, OTC derivatives dealers must make deductions for counterparty risk (and, in certain cases, "concentration charges")[7] from their net capital. Presently, these credit risk deductions can be determined on the basis of either NRSRO ratings or the OTC derivatives dealer's own internal credit ratings. As it did with Appendix E, the SEC proposes to remove

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5 The SEC also proposes to remove the specific reference in Appendix A to the European Currency Unit (i.e., the Euro) as a major market foreign currency.

6 The SEC also proposes conforming amendments to Appendix G of Rule 15c3-1, which imposes certain requirements on the ultimate parent company of a broker-dealer that uses ANC computation. These conforming amendments would reflect the changes that the SEC proposes for Appendix E.

7 An OTC derivatives dealer must deduct a "concentration charge" from its net capital where "the net replacement value in the account of any one counterparty . . . exceeds 25% of the OTC derivates dealer's tentative net capital." *See* Rule 15c3-1, Appendix F.

references to NRSRO ratings in Appendix F. Instead, OTC derivates dealers would have to seek SEC approval to apply counterparty risk weights and concentration charges determined according to their internal models.[8]

II. Customer Protection Rule: Exchange Act Rule 15c3-3

The Customer Protection Rule, as set forth in Exchange Act Rule 15c3-3, is designed to prevent broker-dealers from misusing customer funds. It requires broker-dealers to periodically calculate how much of the money that they hold belongs to their customers ("credits"). The broker-dealer then subtracts from these credit the total amount of money owed by customers or by other broker-dealers relating to customer transactions ("debits"). If credits exceed debits, the broker-dealer must deposit the excess in a special "reserve account."

Under Note G to Exhibit A of the Rule, a broker-dealer may count towards its "debits" the amount of margin "required and on deposit" with a clearing agency or derivatives clearing organization that qualifies under one of several criteria. One criterion is that the clearing agency maintains the highest investment-grade rating from an NRSRO. The SEC proposes to eliminate this criterion, but this amendment is not expected to have any immediate practical impact. The Options Clearing Corporation, which is the only qualifying clearing agency, would continue to qualify under Note G through other criteria.

III. Regulation M: Market Manipulation

Regulation M to prohibits certain activities that would manipulate the market for an offering security. It makes it unlawful for an issuer or distribution participant to bid for, purchase, or attempt to induce any person to bid for or purchase a certain securities during a restricted period. However, Regulation M specifically excepts "investment grade nonconvertible and asset-backed securities" from this prohibition on the basis that it is difficult to distort the market for investment grade assets of this variety.

The SEC proposes to eliminate the investment grade exception to Regulation M while still preserving some exception for securities with the same "trading characteristics" those originally envisioned by the exception. Therefore, the SEC proposes to except nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities if they: (1) are "liquid relative to the market for that asset class"; (2) "[t]rade in relation to general market interest rates and yield spreads"; and (3) are "relatively fungible with securities of similar characteristics and interest rate yield spreads." In order to satisfy the exception, the determination must be based on "reasonable judgment" and verified by an "independent third party."[9]

IV. Exchange Act Rule 10b-10: Customer Confirmation Rule

Exchange Act Rule 10b-10 requires broker-dealers to disclose the basic terms of a transaction effected on behalf of a customer in writing. Under Rule 10b-10(a)(8), if the transaction is for a debt security that is unrated by an NRSRO, a broker-dealer must disclose that fact. The SEC proposes to eliminate this requirement.

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[8] The SEC also proposes conforming amendments to Part IIB of the FOCUS Report, which in part allows the use of NRSRO ratings in determining counterparty risk. These conforming amendments would reflect the changes that the SEC proposes for Appendix F.

[9] The Release notes that "[c]ounsel to, or other affiliates of, the underwriter or issuer, would not meet the independence requirement."

V. Request for Comment on Section 939(e) of the Dodd-Frank Act

Section 939(e) of the Dodd-Frank Act removed language from Section 3(a) of the Exchange Act that referenced credit ratings. Specifically, it removed the existing creditworthiness standards from the definitions of "mortgage related security" and "small business related security," which appear in Exchange Act Sections 3(a)(41) and 3(a)(53), respectively. The SEC has not yet proposed a rule to implement Section 939(e) and seeks comment on the creation of a new creditworthiness standard that does not rely on credit ratings.

VI. Conclusion

The SEC's proposed amendments are intended to implement the requirements of Section 939A of the Dodd-Frank Act, which requires the SEC to "remove any reference to or requirement of reliance on credit ratings." The proposal would affect several existing rules and forms as outlined above.

The SEC is also seeking comment on the implementation of Section 939(e) of the Dodd-Frank Act, which abrogated certain creditworthiness standards previously set forth in Section 3(a) of the Exchange Act.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.