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 a.m. and 3 p.m. 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 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.

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[1] Public Law 109–291, 120 Stat. 1327 (2006).

[2] Proposed Rules for Nationally 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 in 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).

[5] See President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (March 2008), available at *http://www.ustreas.gov* (''PWG Statement''); *The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008), available at *http://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 *http://www.iosco.org.*

[6] 17 CFR 240.15c3–1.

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 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

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 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]

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, 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

[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.

[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.

[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.

[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).

[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.

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 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) 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 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 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

[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%.

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

[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.

[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).

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 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, 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 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: the date of the transaction; the identity, price, and

[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).

[32] 15 U.S.C. 78s.

[33] 17 CFR 240.19b–4.

[34] 17 CFR 240.19b–5.

[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).

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 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 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 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—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

[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).

[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 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).

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 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 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 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 Capital Rule without reference to NRSRO ratings? Commenters who

[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).

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

[52] *See* 17 CFR 240.15c3–1e.

[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).

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 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 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

[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).

[57] *Id.*

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

In light of our effort to reduce undue reliance on NRSRO ratings, we believe that it is appropriate to alter the current exceptions in Rules 101 and 102 to eliminate the reference to NRSROs. We propose to remove Rules 101 and 102's current exceptions for investment grade nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities based on NRSRO ratings. In place of those exceptions, we propose new exceptions for nonconvertible debt securities and nonconvertible preferred securities based on the ''well-known seasoned issuer'' (''WKSI'') concept of Securities Act of 1933 (''Securities Act'') Rule 405.[63] We are also proposing to except asset-backed securities from Rules 101 and 102 if those securities are registered on Form S–3.[64]

The proposed exceptions continue to be based on the premise that these securities are traded on factors such as their yields and are largely fungible. In addition we believe that the marketplace is more likely to have access to a significant amount of useful and high-quality public information concerning these securities that may assist investors in assessing the creditworthiness of the issuer on their own without needing to unduly rely on a NRSRO.[65] We understand that WKSI and Form S–3 issuers are some of the largest and highest quality issuers of nonconvertible debt, nonconvertible preferred securities and asset-backed securities which makes default generally less likely. But the availability of this information or quality of underlying assets is not enough to justify the exceptions in and of itself, the security must also trade in such a way that it is resistant to manipulation. This is why we are proposing to continue to limit these exceptions to nonconvertible debt, nonconvertible preferred, and asset-backed securities as those securities trade largely on the basis of their yield and are largely fungible.

a. Proposed Rules 101(c)(2)(i) and 102(d)(2)(i)—Nonconvertible Debt and Preferred Securities

The proposed exceptions for nonconvertible debt and nonconvertible preferred securities would require that the issuer of such securities meet the requirements of the WKSI definition and meet the requirements for nonconvertible securities other than common equity in paragraph (1)(i)(B)(*1*)

[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).

[63] 17 CFR 230.405.

[64] Asset-backed securities are defined out of the WKSI standard at subparagraph (1)(iv) of the definition and, further, could not meet the requirements of (1)(i)(A) or (B) of the definition because they are generally one-time issuers. *Id.*

[65] *See* Securities Exchange Act Release No. 52056 (July 19, 2005); 70 FR 44722 (August 3, 2005). *See also* Note 61, *infra.*

of the definition of WKSI in Rule 405. As proposed, the exceptions would be available for nonconvertible debt or nonconvertible preferred securities issued by a WKSI issuer, regardless of the method the issuer used to attain WKSI status. However, in order to rely on the proposed exceptions, the security must be issued by an issuer who also meets the requirements of paragraph (1)(i)(B)(*1*) of the definition of WKSI in Rule 405.[66] This would require that the issuer 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.[67] This would limit the exceptions to securities whose issuers have an existing public market in nonconvertible securities other than common equity that is publicly known and followed and, thus, are less likely to be subject to manipulation.

With respect to these proposed exceptions for nonconvertible debt and non-convertible preferred securities utilizing a WKSI requirement, we have noted that WKSI issuers:

> [A]re followed by sophisticated institutional and retail investors, members of the financial press, and numerous sell-side and buy-side analysts that actively seek new information on a continual basis. Unlike smaller or less mature issuers, large seasoned public issuers tend to have a more regular dialogue with investors and market participants through the press and other media. The communications of these well-known seasoned issuers are subject to scrutiny by investors, the financial press, analysts, and others who evaluate disclosure when it is made.[68]

Thus, we believe that the nonconvertible debt and nonconvertible preferred securities that fall within the proposed exceptions should be resistant to manipulation because of their fungibility, trading based on yield, and this wide industry following.

b. Proposed Rules 101(c)(2)(ii) and 102(d)(2)(ii)—Asset-Backed Securities

The proposed changes to the asset-backed securities exceptions would require that the offer and sale of the security is registered using Form S–3.[69] We believe that the proposed amendments should provide exceptions to only those asset-backed securities that are approximately the equivalent quality of securities that are currently excepted from Rules 101 and 102. Additionally, the proposal is also based on the premise that asset-backed securities trade primarily on the basis of yield and that asset-backed securities investors are primarily concerned with the structure of the class of securities and the nature of the assets pooled to serve as collateral for those securities and, thus, such securities are less likely to be subject to manipulation.[70]

4. Bright-Line Alternative/Existing Benchmarks

We believe that the proposed amendments are appropriate replacements for the NRSRO investment grade standard for the following reasons. We believe that the proposals will capture securities that are more likely to be resistant to manipulation similar to the current exceptions because they are based on the same premises as the current exceptions (such as high liquidity and fungibility).[71] Second, the proposals provide a bright line demarcation and objective criteria for the exceptions. As both the WKSI and Form S–3 standards as utilized by this proposal are established benchmarks, they should be familiar to those persons subject to Rules 101 and 102 and easily applied by such persons seeking to rely on the proposed exceptions. Thus, we believe that the proposals are comparable in scope to the existing exceptions but use alternate benchmarks that provide an equally bright line that is not unduly reliant on NRSRO ratings.

5. Comments

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.

- Are the WKSI requirements appropriate for use in a trading (as opposed to disclosure) context? What effect(s) of the proposed exceptions, if any, would you anticipate in the investment grade debt market and the high-yield debt market?
- Should the Rule 101(c)(2) and 102(d)(2) exceptions be based on criteria other than the WKSI requirements for nonconvertible debt and nonconvertible preferred securities and Form S–3 registration for asset-backed securities?
- Would the WKSI nonconvertible debt and nonconvertible preferred securities excepted in the proposal be as resistant to manipulation as those same securities that meet the existing investment grade standard?
- Please provide comment as to whether the proposal would capture the same type and quantity of securities that fall within the current Rule 101(c)(2) and Rule 102(d)(2) exceptions.
- Do the proposed WKSI and Form S–3 benchmarks adequately identify nonconvertible debt, nonconvertible preferred securities, and asset-backed securities that are of high quality with low default risk? Please distinguish the characteristics of nonconvertible debt, nonconvertible preferred securities, and asset-backed securities that meet these proposed benchmarks and those that do not.
- Is the proposed WKSI criterion easily applied by all persons subject to Rules 101 and 102 with respect to nonconvertible debt and nonconvertible preferred securities issued by issuers who are WKSI by virtue of $700 million market value of common equity?
- Would persons other than issuers who are subject to Rules 101 and 102 have access to adequate information to determine if a particular security fits into the exceptions?
- Should asset-backed securities registered on Form S–3 be excepted from Rules 101 and 102 of Regulation M? Have there been developments in the asset-backed securities market that might indicate whether such securities should be eliminated from the proposed exceptions or should continue to be excepted from Rules 101 and 102?
- How frequently is the current asset-backed exception from Rules 101 and 102 relied upon?
- Is it appropriate to also except asset-backed securities registered on Form F–3? If yes, please explain.
- We ask for specific comment as to any relevant changes to the debt market since Regulation M was adopted in 1996 and the way debt issues are brought to market and trade.
- Do nonconvertible debt securities continue to trade based on their yield

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[66] A nonconvertible debt or nonconvertible preferred security issued by an issuer who is a WKSI based on the common equity calculation in paragraph (1)(i)(A) of the definition of WKSI in Rule 405 would still be able to rely on the proposed exception if the issuer can also meet the requirements of paragraph (1)(i)(B)(*1*) of the definition of WKSI in Rule 405.

[67] 17 CFR 230.405, paragraph (1)(i)(B)(*1*) of the definition of WKSI.

[68] Securities Exchange Act Release No. 52056 (July 19, 2005); 70 FR 44722 (August 3, 2005).

[69] The Commission is also proposing to revise the General Instruction I.B.5 to Form S–3 (which sets the eligibility requirements for asset-backed securities to use that form) to remove references to NRSROs. Securities Act Release No. 8940 (July 1, 2008) (File No. 27–18–08).

[70] These were the reasons that we originally excepted such securities. Securities Exchange Act Release No. 38067 (December 20, 1996); 62 FR 520 (January 3, 1997).

[71] *See* Securities Exchange Act Release Number 19565 (March 4, 1983); 48 FR 10628 (March 14, 1983); Securities Exchange Act Release Number 18528 (March 3, 1982); 47 FR 11482 (March 16, 1982); and Securities Exchange Act Release Number 38067 (December 20, 1996); 62 FR 520 (January 3, 1997).

and fungibility? Nonconvertible preferred securities? Asset-backed securities? Are there other factors that influence the trading of such securities?

IV. Request for Comment

We generally request comment on all aspects of our proposal to end our regulatory reliance on NRSRO credit ratings. In addition, we request comment on the following specific questions:

- Should we eliminate the NRSRO designation from all our rules or only from select rules? Commenters who believe that certain rules should retain references to NRSROs or NRSRO ratings should identify each rule they believe should retain the use of the NRSRO concept and explain the rationale for doing so.
- Does the use of the NRSRO designation in our rules cause investors to overly rely on NRSRO credit ratings? Would its elimination mitigate this over reliance?
- Does the use of the NRSRO designation in our rules adversely impact competition among credit rating agencies by favoring those agencies that are registered as NRSROs? Would its elimination mitigate this negative impact?

V. Paperwork Reduction Act

Certain provisions of the proposed amendments to the rules and forms contain ''collection of information requirements'' within the meaning of the Paperwork Reduction Act of 1995.[72] The hours and costs associated with preparing and filing the disclosure, filing the forms and schedules and retaining records required by these regulations constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The titles of the affected information forms are Rule 10b–10, ''Confirmation of Transactions,'' (OMB Control Number 3235–0444), Rule 15c3–1 (OMB Control Number 3235–0200), Rule 15c3–3 (OMB Control Number 3235–0078), Form ATS–R (OMB Control Number 3235–0509), Form PILOT (OMB Control Number 3235–0507), and Form X–17A–5, Financial and Operational Combined Uniform Single Report, Part IIB, OTC Derivatives Dealer (OMB Control Number 3235–0498). For the reasons discussed below, we do not believe the proposed amendments if adopted would result in a material or substantive revision to these collections of information.[73]

The proposed amendments to Form ATS–R and Form PILOT would revise the forms to provide that information which is currently reported as separate items, *i.e.*, investment grade debt corporate debt securities and non-investment grade corporate debt securities, would be combined and reported as a single item, *i.e.*, corporate debt securities. In all other respects, the information collected on these forms would remain unchanged. Accordingly, we do not believe the proposed amendment would result in a substantive revision to those collections of information if adopted.

The proposed amendment to Rule 10b–10 would eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. This proposed amendment would alter neither the general requirement that broker-dealers generate transaction confirmations and send those confirmations to customers, nor the potential use of information contained in confirmations by the Commission, self-regulatory organizations, and other securities regulatory authorities in the course of examinations, investigations and enforcement proceedings. Moreover, the proposed amendment is not expected to change the cost of generating and sending confirmations, and, we believe that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems. Accordingly, we do not believe the proposed amendment would result in a material or substantive revision to these collections of information if adopted.

The proposed amendment to Rule 15c3–1 would potentially modify broker-dealers' existing practices to impose additional recordkeeping burdens. The proposed amendment would replace NRSRO ratings-based criteria for evaluating creditworthiness with new subjective standards based on the broker-dealer's own evaluation of creditworthiness, although broker-dealers would still be able to refer to NRSRO ratings for those purposes. 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. As such, we believe that firms would be required to develop (if they have not already) criteria for assessing the creditworthiness of securities to be included in net capital calculations and apply those criteria to such securities. In addition, the expectation that the broker-dealer be able to explain that any securities used for net capital purposes meet the standards set forth in the proposed amendments would result in the creation and maintenance of records of those assessments.

We believe that all broker-dealers already have policies and procedures in place for evaluating the overall risk and liquidity levels of the securities they use for the purposes of the Net Capital Rule and that they keep records of the assessments of securities they make for net capital purposes; however, the proposed requirements, which specifically address credit risk, could result in additional burdens. The proposed amendments would apply to the approximately 550 broker-dealers that take haircuts on securities pursuant to the Net Capital Rule. We estimate that on average, broker dealers will spend ten hours developing a system of standards for evaluating creditworthiness for the purposes of the Net Capital Rule, resulting in an aggregate initial burden of 5,500 hours. This estimate is based on our belief that many of these broker-dealers already have their own criteria in place for evaluating creditworthiness, while others would continue to refer to NRSRO ratings as the basis of their creditworthiness decisions.

We further estimate that, on average, each broker-dealer will spend an additional ten hours a year reviewing, adjusting, and applying its own standards for evaluating creditworthiness, for a total of 5,500 annual hours across the industry. Once again, this estimate reflects our belief that many of these broker-dealers already have their own criteria in place, while others would continue to refer to NRSRO ratings. We also estimate that firms would employ compliance attorneys, in many cases relying on outside counsel, to review these standards, both initially and on an annual basis. We estimate the per-firm costs of outside counsel to be $2,700 initially and $1,350 on an annual basis, for an aggregate industry cost of $1,485,000 initially and $742,500 on an annual basis.[74]

[72] 44 U.S.C. 3501 *et seq.*

[73] 5 CFR 1320.5(g).

[74] For the purposes of this analysis, we are using salary data from the Securities Industry and Financial Markets Association (''SIFMA'') Report on Management and Professional Earnings in the Securities Industry 2007, which provides base salary and bonus information for middle management and professional positions within the securities industry, as modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size,

Continued

We generally request comment on all aspects of these proposed estimates. In addition, we request specific comment on the following items related to these estimates:

- Are we correct in our hours estimates and our belief that many broker-dealers already have their own criteria in place for evaluating creditworthiness?
- Are we correct in our belief that some broker-dealers would continue to refer to NRSRO ratings as the basis of their creditworthiness decisions?
- Are we correct in our estimation that broker-dealers would engage outside counsel to review their internally generated standards for creditworthiness? If not, how would firms review such standards and what would be the effect of such differing approaches on our burden estimates?

The proposed amendments to the appendices of Rule 15c3–1 include amendments to certain recordkeeping and disclosure requirements that are subject to the PRA. Specifically, the proposed amendments to Appendices E and F of Rule 15c3–1 and conforming amendments to Appendix G would remove the provisions permitting reliance on NRSRO ratings for the purposes of determining counterparty risk. As a result of these deletions, an entity that wished to use the approach set forth in these appendices 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 and make and keep current a record of the basis for the credit risk weight of each counterparty.

We do not believe that the removal of the option permitting reliance on NRSRO ratings would affect the small number of entities that currently elect to compute their net capital deductions pursuant to the alternative methods set forth in Appendix E or F. Although the collection of information obligations imposed by the proposed amendments are mandatory, applying for approval to use the alternative capital calculation is voluntary. 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 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.[75] 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. Since each entity already employs its own models to calculate market and credit risk and keeps current a record of the basis for the credit risk weight of each counterparty, the proposed amendments would therefore not alter the paperwork burden currently imposed by Appendices E and F.

The proposed amendment to Note G of Exhibit A to Rule 15c3–3 would potentially modify broker-dealers' existing practices to impose additional recordkeeping burdens. Currently, Note G to Exhibit A of Rule 15c3–3 allows a broker-dealer to include, as a debit in the formula for determining its reserve requirements, the amount of customer margin related to customers' positions in security futures products posted to a registered clearing or derivatives organization that meets one of four standards, including maintaining the highest investment grade rating from an NRSRO.[76] The proposed amendment would replace the NRSRO ratings-based standard with a requirement that the registered clearing or derivatives organization has the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk. As such, we believe that firms that previously relied on NRSRO ratings for the purposes of Note G would be required to develop criteria for assessing the creditworthiness of registered clearing or derivatives organizations and apply those criteria to such securities, although one means of complying with the proposed amendment would be for broker-dealers to refer to NRSRO ratings. In addition, the expectation that the broker-dealer be able to explain that any such clearing or derivatives organizations meets the standard set forth in the proposed amendment would result in the creation and maintenance of records of those assessments.

In the final release adding Note G to Exhibit A of Rule 15c3–3, we estimated that approximately 102 firms would be required to comply with the provisions of the Note.[77] In addition, we estimated in that release that under subparagraph (c) to Note G, each broker-dealer would spend approximately 0.25 hours to verify that the clearing organizations they used met the conditions of Note G, for an aggregate one-time total of 25.5 hours;[78] we believe that this estimate would apply to the verification of that status under the proposed amendment as well. We believe that the proposed amendment would impose an additional one-time burden for broker-dealers that chose to rely on the new standard of proposed Rule 15c3–3a(b)(1)(i). Given the additional options set forth in Note G, we estimate that only half, or 51, of the broker-dealers would choose this option, which we believe would result in the broker-dealer spending, on average, ten hours developing a system of standards for evaluating creditworthiness for the purposes of Note G, resulting in an aggregate initial burden of 510 hours.[79] We also estimate that firms would employ compliance attorneys, in many cases relying on outside counsel, to review these standards. We estimate the one-time costs of outside counsel to be $1,350 per firm, resulting in an aggregate industry cost of $68,850.[80]

We generally request comment on all aspects of these proposed estimates. In addition, we request specific comment on the following items related to these estimates:

employee benefits and overhead. We believe that the legal reviews required by the proposed amendments would be performed by compliance attorneys at an average rate of $270 per hour. Furthermore, we believe that the review process will entail ten hours of initial work and five hours on an annual basis of $270 × 10 = $2,700 × 550 = $1,485,000; $270 × 5 = $1,350 × 550 = $742,500.

[75] *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).

[76] *See* 17 CFR 240.15c3–3a, Note G, (b)(1)(i). 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 any of the other criteria 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, Note G, (b)(1)(ii)—(iv).

[77] *See Reserve Requirements for Margin Related to Security Futures Products,* Exchange Act Release No. 34–50295 (August 31, 2004), 69 FR 54182 at 54188 (September 7, 2004).

[78] 0.25 × 102 = 25.5.

[79] 10 × 51 = 510.

[80] For the purposes of this analysis, we are using salary data from the SIFMA Report on Management and Professional Earnings in the Securities Industry 2007. We believe that the legal reviews required by the proposed amendments would be performed by compliance attorneys at an average rate of $270 per hour. Furthermore, we believe that the review process will entail five hours of initial work. $270 × 5 = $1,350 × 51 = $68,850.

• Are we correct in our estimate of the number of broker-dealers that would be affected by the proposed amendment to Note G?

• Are we correct in our estimate of the percentage of such broker-dealers that choose to rely on proposed Rule 15c3–3a(b)(1)(i)?

• Are we correct in our belief that broker-dealers would engage outside counsel to review their internally generated standards for creditworthiness? If not, how would firms review such standards and what would be the effect of such differing approaches on our burden estimates?

The instructions to Form X–17A–5 Part IIB currently include a summary of the credit risk calculation in paragraph (d) of Rule 15c3–1f. Paragraph (d) of Rule 15c3–1f is proposed to be amended to remove that part of the credit risk calculation that is summarized in Form X–17A–5 Part IIB. Accordingly, we have proposed a conforming amendment to the form that would remove the summary of the credit risk calculation. The summary in the instructions provides additional information for the benefit of the filer and is not related to the information reported on the forms. Accordingly, we do not believe the proposed amendment would result in a substantive revision to these collections of information if adopted.

Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments to:

(1) Evaluate whether the proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility;

(2) Evaluate and provide relevant data regarding the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

(3) Enhance the quality, utility and clarity of the information to be collected; and

(4) Minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Budget (''OMB''), Room 3208, New Executive Office Building, Washington, DC 20503; and (2) Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090 with reference to File No. S7–17–08. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collection of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–17–08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE., Washington, DC 20549–1110.

VI. Costs and Benefits of the Proposed Rulemaking

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered institutions, including small institutions, as well as any other costs or benefits that may result from the adoption of these proposed amendments.

As discussed above, the proposed rule amendments are designed to address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings. The proposed amendments to Rule 3a1–1, Rule 10b–10, Rule 15c3–1, Rule 15c3–3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Form ATS–R, Form PILOT, and Form X–17A–5 Part IIB would eliminate the reference to and requirement for the use of NRSRO ratings in these rules.

A. Benefits

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to investors of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in our rules. An over-reliance on ratings can inhibit independent analysis and could possibly lead to investment decisions that are based on incomplete information. The purpose of the proposed rule amendments is to encourage investors to examine more than a single source of information in making an investment decision. Eliminating reliance on ratings in the Commission's rules could also result in greater investor due diligence and investment analysis. In addition, the Commission believes that eliminating the reliance on ratings in its rules would remove any appearance that the Commission has placed its imprimatur on certain ratings.

We expect that there would be little effect on broker-dealers or other market participants that are subject to the rules that are proposed to be amended. This is because the references to NRSROs in these rules would be no longer necessary, can be replaced with an alternative bright-line standard, or can be used as one possible interpretation of a subjective standard set forth in a proposed amendment to the rule.

The proposed amendments to Rule 3a1–1, Rules 300 and 301 of Regulation ATS, Form ATS–R, and Form PILOT would eliminate the separate definitions of and references to investment grade corporate debt securities and non-investment grade corporate debt securities and would replace them with a single category ''corporate debt securities.'' For reasons discussed above, the Commission preliminarily believes 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 to fulfill the purposes of those rules. The other classes of securities and the threshold levels themselves would remain unchanged. Therefore, the proposed amendments to Rule 3a1–1 and Regulation ATS are not expected to significantly affect the regulatory treatment of ATSs. With respect to the proposed changes to Form ATS–R and Form PILOT, we expect that combining investment grade and non-investment grade corporate debt securities into a single class for purposes of those two forms would have only minimal impact, because the total units and total dollar volume of corporate debt securities transacted would still have to be reported.

The proposed amendments to Rule 10b–10 to eliminate a requirement for transaction confirmations for debt securities (other than government securities) to inform customers if a security is unrated by an NRSRO. The other requirements of Rule 10b–10 would remain unchanged. Eliminating

this requirement would avoid giving credit ratings an imprimatur that may inadvertently suggest to investors that an unrated security is inherently riskier than a rated security. Accordingly, we anticipate that investors and the marketplace would benefit from the elimination of this requirement, in light of concerns about promoting over-reliance on securities ratings or creating confusion about the significance of those ratings. More generally, eliminating this requirement is consistent with the goal of promoting a dialogue between broker-dealers and their customers—prior to purchase—regarding the creditworthiness of issuers, and should help avoid promoting the use of credit ratings as an oversimplified shorthand that replaces a more complete discussion of credit quality issues.

We preliminarily believe that the proposed amendments to the Net Capital Rule, its appendices, and Exhibit A to the Customer Protection Rule would result in a better overall assessment of the risks associated with securities held by broker-dealers for the purposes of net capital calculations as well as of the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted. As the NRSROs themselves have stressed, the ratings they generate focus solely on credit risk, that is, the likelihood that an obligor or financial obligation will repay investors in accordance with the terms on which they made their investment.[81] Many broker-dealers already conduct their own risk evaluation. However, for those broker-dealers that do not, developing their own means of evaluating risk—including, as would be required by the proposed amendments to the Net Capital Rule, an evaluation of the degree of liquidity—would allow them to better incorporate the overall levels of various categories of risk associated with the securities they hold into their net capital calculations.

A separate evaluation of risk by the broker-dealer should lead to a better understanding of the risks associated with those securities which would, we believe, lead to increased operational efficiency and potentially lowered net capital charges for those broker-dealers that currently do not conduct their own risk evaluation. We believe that allowing broker-dealers to employ their own criteria in determining credit risk for net capital purposes would, by reducing the reliance on NRSRO ratings and therefore more closely aligning a broker-dealer's net capital-related risk assessments with its general internal risk assessments, increase operational efficiency. Furthermore, we believe that the proposed amendments could result in more closely tailored capital charges, and thus lowered costs, for broker-dealers while still being designed to ensure net capital requirements sufficient to require maintenance of capital to achieve the goals of the Net Capital Rule.

We believe that the same reasoning applies to the proposed amendment to Exhibit A of the Customer Protection Rule. Broker-dealers that utilize their own means of evaluating the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted would better be positioned to incorporate the overall levels of various categories of risk associated with those organizations into their assessments.

In the case of the amendments to Rules 101 and 102 of Regulation M, we believe the proposed rule amendments would have benefits that justify any costs, if adopted. Because the exceptions in Rules 101 and 102 are narrowly-tailored, the proposed amendments should continue to promote investor confidence in the offering process and the market as a whole by only excepting those securities that are resistant to manipulation. Market integrity would also continue to be promoted, which benefits the market and all participants. Also, since the proposals would be a bright-line, compliance with the proposed amendments would be easy for issuers and other persons subject to the rules. In fact, this proposal may lower costs for these people by eliminating the need to obtain an investment grade rating from a nationally recognized statistical rating organization. We believe that replacing the NRSRO investment grade requirement with the proposed exceptions should not result in broker-dealers hiring new compliance staff or making extensive systems changes because the proposals utilize existing bright-line benchmarks.

B. Costs

We anticipate that broker-dealers and other market participants could incur certain costs if the proposed amendments are adopted. Investors could incur additional costs if they perform a more detailed and comprehensive analysis before making an investment decision. Broker-dealers could incur additional costs if they perform their own risk evaluation, if they do not currently do so. Furthermore, the purpose of the proposal is to encourage investors not to place undue reliance on NRSRO ratings in making investment decisions. Investors could still choose to rely solely on NRSRO ratings without incurring additional costs.

The proposed amendments to Rule 3a1–1, Rules 300 and 301 of Regulation ATS, Form ATS–R, and Form PILOT would eliminate the separate definitions of and references to investment grade corporate debt securities and non-investment grade debt securities and would replace them with a single category ''corporate debt securities.'' We preliminarily believe that these changes would not impose any significant costs on market participants.

The proposed amendments to Rule 3a1–1 and Regulation ATS would marginally reduce the likelihood of an ATS meeting the thresholds in those rules. For example, under existing Rule 3a1–1, an ATS that currently 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 at least four of the preceding six calendar months could be required to register as an exchange. Under the proposed amendment to Rule 3a1–1, the Commission would no longer be able to require the ATS to register as an exchange, because its average daily dollar trading volume in corporate debt securities combined would be less than 40%. A potential cost of the proposed amendments to Rule 3a1–1 and Regulation ATS is that an ATS that exceeds one of the existing thresholds and thus becomes subject to additional regulatory requirements (in the case of Regulation ATS) or must register as an exchange (in the case of Rule 3a1–1) would no longer exceed the threshold and would not have to meet the attendant requirements. However, the Commission preliminarily believes that this possibility is remote, and that the proposed amendments are unlikely to impose any costs on investors, market participants, or the national market system generally.

We believe that any costs associated with the proposed changes to Form ATS–R and Form PILOT would be minimal. Respondents already determine and report the total units and

[81] *See, e.g., Inside the Ratings: What Credit Ratings Mean*, Fitch, August 2007 (''Inside the Ratings''), p. 1; Testimony of Michael Kanef, Group Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), p. 2; Testimony of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Market Services, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), p. 3.

total trading volume for investment grade and non-investment grade corporate debt securities separately. On the revised forms, respondents would report them together as a single item for ''corporate debt securities.'' The cost of the proposed changes to these forms would be the cost of adding these previously separate items together.

We do not expect the proposed amendment to result in any significant changes in the costs associated with Rule 10b–10. Broker-dealers will continue to generate transaction confirmations and send those confirmations to customers, and the proposed amendment if adopted would not be expected to change the cost of generating and sending confirmations. Moreover, we believe that broker-dealers may not need to incur significant costs if they choose not to input information that a debt security is unrated into their existing confirmation systems.

We believe that the costs of compliance with the proposed amendments to the Net Capital Rule and its appendices as well as to Note G of Exhibit A of the Rule 15c3–3 would be minimal for entities that already employ their own criteria in determining credit risk for net capital purposes. In the event the broker-dealer inaccurately evaluates the creditworthiness and liquidity of its positions, a potential cost could be that the broker-dealer is required to take a larger haircut on its proprietary positions, and therefore reserve additional capital. This could affect its ability to hold its positions or to add to its positions. As for broker-dealers that do not currently employ such criteria, if the proposed amendments are adopted, after considering comment, we could take the view that securities rated by NRSROs would meet the standards in the rules as amended and this would provide a way for broker-dealers that do not determine credit risk on their own to avoid incurring any additional costs. If we were to adopt the view that NRSRO rated securities meet the standard in the proposed amendments, it would mean that any potential costs would be wholly voluntary. While we encourage broker-dealers that have not yet developed their own credit risk evaluation procedures to do so, such actions would proceed at the time and pace desired by the broker-dealers.

We expect the costs of the proposal to modify Rules 101 and 102 of Regulation M to be minimal to most persons subject to those rules who could rely on the proposed amendments as they relate to nonconvertible debt and preferred securities. The proposed exceptions are only triggered when the conditions in the exceptions are met which would only occur in a limited number of situations. It is only when there is an offering of nonconvertible debt or nonconvertible preferred securities which qualifies as a distribution under Regulation M where a covered person bids for, purchases or attempts to induce another person to bid for or purchase the covered security during the applicable restricted period. Thus, there may be offerings of nonconvertible debt or preferred securities that do not constitute a distribution for purposes of Regulation M. In such case, the prohibitions of Regulation M are not triggered and neither the current nor the proposed exceptions would be necessary. Additionally, even if a distribution of the nonconvertible debt or nonconvertible preferred securities exists, a person subject to Regulation M's prohibitions could structure buying activity before or after the applicable restricted period so as not to incur any costs, even if minimal, associated with relying on the proposed exceptions. This holds true for asset-backed securities as well.

We believe that many of the issuers of these securities would already know if they are WKSI issuers based on the non-common equity standard because this analysis would have been already done as part of the offering process. Persons other than issuers who would be subject to Rules 101 and 102 should have access to the issuer's WKSI status as well via the issuer's 10K filings. Such persons should also be in a position with the issuer to obtain any other information needed to make a determination as to whether the proposed exception would apply to the security at issue. Thus, we believe that these persons should incur no significant costs under the proposal. There may be, however, costs to any person subject to Rules 101 or 102 to make minor system changes should the Commission adopt this proposal because of the proposed new standard.

We do believe, however, that there may be increased costs for issuers and other persons subject to Rules 101 and 102 as they relate to nonconvertible debt and preferred securities if that issuer is WKSI based on the common equity standard.[82] Since the issuer in that case would not need to determine the aggregate principal amount of their nonconvertible securities other than common equity for purposes of Securities Act disclosure, new analysis would need to be conducted and communicated to other persons subject to Rules 101 and 102 to rely on the exception. This could likely result in increased costs not completely offset by not needing to obtain an investment grade rating.

With respect to asset-backed securities, we believe that there should not be any significant increased costs to persons subject to Rules 101 and 102. All persons who are subject to those rules should know what form the issuer is using to register the offering, including whether Form S–3 is being used. Thus, no new analysis would need to be conducted. We also expect that there could be a small number of securities taken out of this exception as a result of the proposed change. Costs for such issuers, selling shareholders, underwriters, brokers, dealers, any other distribution participants, or affiliated purchasers of any of these persons affected by this change would be more significant, but we do not expect there to be a significant number of these persons. There could also be minimal costs to train broker-dealer and self-regulatory organization staff and to update broker-dealer policies and procedures and make system changes regarding the new exceptions.

C. Request for Comment

We request data to quantify the costs and the benefits above. We seek estimates of these costs and benefits, as well as any costs and benefits not already described, which could result from the adoption of the proposed amendments. Specifically, would the proposal result in lower costs associated with debt and preferred securities covered by the new exception? What new costs, if any, would be associated with the proposal for persons subject to Rules 101 and 102 where the nonconvertible debt and nonconvertible preferred securities are issued by issuers who are WKSI based on the common equity standard? What costs, if any, would be related to the change for asset-backed securities? For these issues, what is the cost of determining the aggregate principal amount of nonconvertible debt securities other than common equity and then communicating the exception to other persons subject to Rules 101 and 102? Would any securities that currently fall within the existing exceptions not meet the exceptions as proposed? Would the proposal affect the cost to broker dealers of generating transaction confirmations? Do investors benefit from the notification on the transaction confirmation? Does the confirmation help promote conversations about broker-dealers and their customers

[82] 17 CFR 230.405. The common equity standard is at subparagraph (1)(i)(A) of the definition of ''well-known seasoned issuer.''

regarding unrated securities? Are there alternative means to promote such conversations that would not create over-reliance on NRSRO ratings?

VII. Consideration of the Burden on Competition, Promotion of Efficiency, and Capital Formation

Section 3(f) of the Exchange Act [83] requires the Commission, whenever it engages in rulemaking and is required to consider or to determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. In addition, Section 23(a)(2) of the Exchange Act [84] requires the Commission, when promulgating rules under the Exchange Act, to consider the impact any such rules would have on competition. Section 23(a)(2) further provides that the Commission may not adopt a rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposed amendments would remove the reference to NRSRO ratings in several of our rules and forms. These include Rules 3a1–1, 10b–10, 15c3–1, 15c3–3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS–R and PILOT. The purpose of the proposed amendments is to address concerns that the references to NRSRO ratings in our rules and forms contributed to any over-reliance on credit ratings by investors.

We preliminarily believe that the proposed amendments to Rule 3a1–1 and Rules 300 and 301 of Regulation ATS would be unlikely to create any adverse impact on efficiency, competition, or capital formation. The Commission preliminarily believes that combining investment grade and non-investment grade corporate debt securities into a single class of securities for purposes of the thresholds in those rules is unlikely to affect whether an ATS crosses one of those thresholds. Moreover, the other classes of securities for which the thresholds are applied—and the levels of the thresholds themselves—would remain unchanged.

The proposed changes to Form ATS–R and Form PILOT would simplify reporting for ATSs and self-regulatory systems that operate pilot trading systems. Form ATS–R and Form PILOT respondents are already required to determine and report the volumes of corporate debt securities. A single reporting item for ''corporate debt securities'' would replace the existing separate entries for ''investment grade corporate debt securities'' and ''non-investment grade corporate debt securities.'' Therefore, we preliminarily believe that the changes to Form ATS–R and Form PILOT would be unlikely to have any significant impact on efficiency, competition, or capital formation.

We do not believe that the proposed amendment to Rule 10b–10 would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed deletion of paragraph (a)(8) of that rule would not be expected to impose any significant additional costs upon broker-dealers (which in any event would not be prohibited from voluntarily including information that a particular debt security is unrated by an NRSRO). For similar reasons, we do not believe that this proposed amendment would impose any significant adverse effects on efficiency, competition or capital formation.

We preliminarily believe that the proposed amendments to the Net Capital Rule and its appendices or to Note G of Exhibit A of the Rule 15c3–3 would serve to promote efficiency and capital formation. As noted above, we believe that by relying on their own means of evaluating risk, broker-dealers would better incorporate the overall levels of risk associated with the securities they hold into their Net Capital Rule. In turn, we believe, this better understanding would more closely align a broker-dealer's net capital-related risk assessments with its general internal risk assessments and lead to increased operational efficiency, potentially lowered net capital charges, and a more efficient allocation of capital. In addition, broker-dealers that developed their own means of evaluating the long-term financial strength and general creditworthiness of clearing organizations to which customers' positions in security futures products are posted for purposes of Note G to Exhibit A of Rule 15c3–3 would better be positioned to incorporate the overall levels of various categories of risk associated with those organizations into their assessments, creating a more efficient means of evaluating those organizations for the sake of the Rule 15c3–3 than simply relying on NRSRO credit ratings alone. We do not anticipate that the proposed amendments to the Net Capital Rule and its appendices or to Note G of Exhibit A of Rule 15c3–3 would have any impact on competition.

We preliminarily believe that the proposed amendments to Rules 101 and 102 of Regulation M are intended to promote capital formation. The proposed amendments should promote continued investor confidence in the offering process by proposing an exception from Regulation M's Rule 101 and 102 prohibitions limited to those securities which are resistant to manipulation. Such investor confidence in our markets should promote continued capital formation. We believe that the proposals should foster continued market integrity which should also translate into capital formation by only allowing for non-manipulative buying activity during distributions. Issuers of nonconvertible debt, nonconvertible preferred securities and asset-backed securities who fall within the proposed exceptions may be encouraged to engage in capital formation knowing that the proposed exceptions are available for their buying activity as well as the buying activity of distribution participants. Because the proposal eliminates the need to obtain an investment grade rating by an NRSRO, a hurdle to both relying on the exception and capital formation would be eliminated, which would also promote capital formation.

The proposal would provide an alternative to obtaining an investment grade rating but still would provide clear guidance to all persons subject to those rules. We preliminarily believe that the proposed Regulation M amendments would promote market efficiency by providing continued clarity to issuers, distribution participants, and their affiliated purchasers as to the scope of permissible activity by providing a bright line test for compliance with the proposed exceptions comparable to the existing exception. In addition, the proposals continue to utilize existing benchmarks so as not to trigger inefficiencies that might result from use of a new standard. The proposal would also eliminate the need to obtain an investment grade rating from an NRSRO to rely on the exception, which will eliminate a potential inefficiency in the capital raising process. For these reasons, the Commission preliminarily believes that the proposed exceptions will promote efficient capital formation and competition.

We have considered the proposed amendments to Rules 101 and 102 of Regulation M in light of the standards cited in Section 23(a)(2) and believe preliminarily that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act. We preliminary believe that the use of the existing WSKI and

[83] 15 U.S.C. 78c(f).

[84] 15 U.S.C. 78w(a)(2).

Form S–3 standards would mean that any additional burdens the proposal may place on market participants should be minimal as market participants are already familiar with and utilize these benchmarks in other contexts. Additionally, the proposals would apply equally to all issuers, distribution participants, and their affiliated issuers. Thus, no person covered by Regulation M should be put at a competitive disadvantage, and the proposal would not impose a significant burden on competition not necessary or appropriate in furtherance of the Act.

We generally request comment on the effects of the proposed amendments to Rules 3a1–1, 10b–10, 15c3–1, 15c3–3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS–R and PILOT on efficiency, competition, and capital formation. Commenters should provide analysis and empirical data to support their views.

VIII. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act of 1980 [85] 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.[86] Pursuant to Section 605(b) of the Regulatory Flexibility Act (''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,[87] or, if not required to file such statements, a broker or 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.[88]

An alternative trading system that complies with Regulation ATS must, among other things, register as a broker-dealer.[89] Thus, the Commission's definition of small entity as it relates to broker-dealers also would apply to ATSs. An ATS that approaches the volume thresholds for investment grade or non-investment grade corporate debt securities in Rule 3a1–1 or Regulation ATS would be very large and thus unlikely to be a small entity or small organization. With respect to the proposed changes to Form ATS–R, even if an ATS is a ''small entity'' or ''small organization'' for purposes of the RFA, the only change being proposed to the form is to eliminate the distinction between investment grade and non-investment grade corporate debt securities and to require reporting for the combined class of corporate debt securities. We believe this would impose only negligible costs on ATSs, even if they were small entities or small organizations.

Similarly, SROs are the only respondents to Form PILOT and are not ''small entities'' for purposes of the RFA. Accordingly, no small entities would be affected by the proposed amendments to Form PILOT.

We believe that the proposed amendment to Rule 10b–10 will not have a significant economic impact on a substantial number of small entities. While some broker-dealers that effect transactions in the debt securities currently subject to paragraph (a)(8) of that rule may be small entities, the proposed amendment should not result in any significant change to the cost of providing confirmations to customers in connection with those transactions.

The proposed amendments to the securities haircut provisions in paragraphs (E), (F), and (H) of Rules 15c3–1(c)(2)(vi), if adopted, would not have a significant economic impact on a small number of entities. If the Commission adopts the proposed amendments, we would take the view in the adopting release that securities rated by NRSROs as currently required would meet the amended standards. Thus, the proposed amendments would allow for compliance without reference to the standards that are currently in the rule (*i.e.*, NRSRO ratings), but broker-dealers that wish to use them would still be accommodated. Accordingly, the rule would not have any economic impact on small entities because they would not have to change their current practices.

The proposed amendments to the Appendices E and F to Rule 15c3–1 (which include conforming amendments to Appendix G of Rule 15c3–1 and the General Instructions to Form X–17A–5, Part IIB), if adopted, would not apply to small entities. Appendices E and G apply to broker-dealers that are part of a consolidated supervised entity and Appendix F and Form X–17A–5, Part IIB apply to OTC Derivatives Dealers that have applied to the Commission for authorization to compute capital charges as set forth in Appendix F in lieu of computing securities haircuts pursuant to Rule 15c3–1(c)(2)(vi). All of these brokers or dealers would be larger than the definition of a small broker dealer in Rule 0–10.

The proposed amendments to Rule 15c3–3a, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments to Rule 15c3–3a would apply only to broker-dealers that clear and carry positions in security futures products in securities accounts for the benefit of customers. None of those broker-dealers affected by the rule is a small entity as defined in Rule 0–10 (confirming this with OEA).

With respect to the amendments to Rules 101 and 102 of Regulation M, it is unlikely that any broker-dealer that is defined as a ''small business'' or ''small organization'' as defined in Rule 0–10 [90] could be an underwriter or other distribution participant as they 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.[91] 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 3a1–1, 10b–10, 15c3–1, 15c3–3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS–R and PILOT could have an effect on small entities that has not been considered. We request that commenters describe the nature of any

[85] 5 U.S.C. 603(a).

[86] 5 U.S.C. 605(b).

[87] *See* 17 CFR 240.17a–5(d).

[88] *See* 17 CFR 240.0–10(c).

[89] *See* 17 CFR 242.301(b)(1).

[90] 17 CFR 240.0–10.

[91] 17 CFR 240.0–10(a).

impact on small entities and provide empirical data to support the extent of such impact.

IX. Statutory Basis and Text of the Proposed Amendments

The amendments to Rules 3a1–1, 10b–10, 15c3–1, 15c3–3, Rules 101 and 102 of Regulation M, Rules 300 and 301 of Regulation ATS, and Forms ATS–R, Pilot, 17–H, and X–17A–5 Part IIB under the Act are being proposed pursuant to the Sections 7,[92] 17(a),[93] 19(a)[94] of the Securities Act, Sections 2,[95] 3,[96] 9(a),[97] 10,[98] 11,[99] 11A(c),[100] 12,[101] 13,[102] 14,[103] 15,[104] 15(c),[105] 15(g),[106] 17,[107] 17(a),[108] 23(a),[109] 30,[110] and 36(a)(1)[111] of the Exchange Act, and Sections 23,[112] 30,[113] and 38[114] of the Investment Company Act of 1940.

List of Subjects in 17 CFR Parts 240, 242, and 249

Broker, Reporting and recordkeeping requirements, Securities.

Text of Amendment

In accordance with the foregoing, 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, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Amend § 240.3a1–1 by revising paragraphs (b)(3)(v), (b)(3)(vi), and (b)(3)(vii) and by removing (b)(3)(viii) to read as follows:

§ 240.3a1–1 Exemption from the definition of ''Exchange'' under Section 3(a)(1) of the Act.

* * * * *

(b) * * *

(3) * * *

(v) Corporate debt securities, which shall mean any securities that:

(A) Evidence a liability of the issuer of such securities;

(B) Have a fixed maturity date that is at least one year following the date of issuance; and

(C) Are not exempted securities, as defined in section 3(a)(12) of the Act, (15 U.S.C. 78c(a)(12));

(vi) Foreign corporate debt securities, which shall mean any securities that:

(A) Evidence a liability of the issuer of such debt securities;

(B) Are issued by a corporation or other organization incorporated or organized under the laws of any foreign country; and

(C) Have a fixed maturity date that is at least one year following the date of issuance; and

(vii) Foreign sovereign debt securities, which shall mean any securities that:

(A) Evidence a liability of the issuer of such debt securities;

(B) Are issued or guaranteed by the government of a foreign country, any political subdivision of a foreign country, or any supranational entity; and

(C) Do not have a maturity date of a year or less following the date of issuance.

3. Section 240.10b–10 is amended by removing paragraph (a)(8) and redesignating paragraph (a)(9) as paragraph (a)(8).

4. Section 240.15c3–1 is amended by revising the introductory text of paragraphs (c)(2)(vi)(E), (c)(2)(vi)(F)(*1*), and (c)(2)(vi)(F)(*2*), and by revising paragraph (c)(2)(vi)(H) to read as follows:

§ 240.15c3–1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *

(2) * * *

(vi) * * *

(E) *Commercial paper, bankers acceptances and certificates of deposit.* In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited, and is subject to a minimal amount of credit risk and has sufficient liquidity such that it can be sold at or near its carrying value almost immediately, or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(F) (*1*) *Nonconvertible debt securities.* In the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date, which are not traded flat or in default as to principal or interest and which are subject to no greater than moderate credit risk and have sufficient liquidity such that they can be sold at or near their carrying value within a reasonably short period of time, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

* * * * *

(*2*) A broker or dealer may elect to exclude from the above categories 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, and which are subject to no greater than moderate credit risk and have sufficient liquidity such that they can be sold at or near their carrying value within a reasonably short period of time, if such securities have maturity dates:

* * * * *

(H) In the case of cumulative, non-convertible preferred stock ranking prior to all other classes of stock of the same issuer, which is subject to no greater than moderate credit risk and has sufficient liquidity such that it can be sold at or near its carrying value within a reasonably short period of time and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

* * * * *

5. Section 240.15c3–1e is amended by removing paragraphs (c)(4)(vi)(A) through (c)(4)(vi)(D) and redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C).

6. Section 240.15c3–1f is amended by:

a. Removing the phrase ''by a nationally recognized statistical rating

[92] 15 U.S.C. 77g.
[93] 15 U.S.C. 77q(a).
[94] 15 U.S.C. 77s(a).
[95] 15 U.S.C. 78b.
[96] 15 U.S.C. 78c.
[97] 15 U.S.C. 78i(a).
[98] 15 U.S.C. 78j.
[99] 15 U.S.C. 78k.
[100] 15 U.S.C. 78k–1(c).
[101] 15 U.S.C. 78*l*.
[102] 15 U.S.C. 78m.
[103] 15 U.S.C. 78n.
[104] 15 U.S.C. 78*o*.
[105] 15 U.S.C. 78*o*(c).
[106] 15 U.S.C. 78*o*(g).
[107] 15 U.S.C. 78q.
[108] 15 U.S.C. 78q(a).
[109] 15 U.S.C. 78w(a).
[110] 15 U.S.C. 78dd.
[111] 15 U.S.C. 78mm(a)(1).
[112] 15 U.S.C. 80a–23.
[113] 15 U.S.C. 80a–29.
[114] 15 U.S.C. 80a–37.

organization (''NRSRO'')'' in paragraph (d)(2)(i);

b. Removing the phrase ''by an NRSRO'' in paragraphs (d)(2)(ii), (d)(3)(i), and (d)(3)(ii); and

c. Revising the first and second sentences of paragraph (d)(4).

The revision reads as follows:

§ 240.15c3–1f Optional market and credit risk requirements for OTC derivatives dealers (Appendix F to 17 CFR 240.15c3–1).

* * * * *

(d) * * *

(4) Counterparties may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. Based on the strength of the OTC derivatives dealer's internal credit risk management system, the Commission may approve the application. * * *

* * * * *

7. Section 240.15c3–1g is amended by revising paragraph (a)(3)(i)(F) to read as follows:

§ 240.15c3–1g Conditions for ultimate holding companies of certain brokers or dealers (Appendix G to 17 CFR 240.15c3–1).

* * * * *

(a) * * *

(3) * * *

(i) * * *

(F) Credit risk weights shall be determined according to the provisions of paragraphs (c)(4)(vi)(A) of § 240.15c3–1e.

* * * * *

8. Section 15c3–3a is amended by revising Note G paragraph (b)(1)(i) to read as follows:

§ 240.15c3–3a Exhibit A—formula for determination reserve requirement of brokers and dealers under § 240.15c3–3.

* * * * *

Note G. * * *

(b) * * *

(1) * * *

(i) Has the highest capacity to meet its financial obligations and is subject to no greater than minimal credit risk; or

* * * * *

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

9. 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.

10. Section 242.101 is amended by revising paragraph (c)(2) to read as follows:

§ 242.101 Activities by distribution participants.

* * * * *

(c) * * *

(2) *Nonconvertible and asset-backed securities.* Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, if:

(i) For nonconvertible debt securities and nonconvertible preferred securities, the issuer of such securities meets the requirements of ''well-known seasoned issuer'' as that term is used in § 230.405 of this chapter, but only if such issuer also meets the requirements of paragraph (1)(i)(B)(*1*) of that definition; or

(ii) For asset-backed securities, the offer and sale of the security is registered using Form S–3 (§ 239.13 of this chapter); or

* * * * *

11. Section 242.102 is amended by revising paragraph (d)(2) to read as follows:

§ 242.102 Activities by issuers and selling security holders during a distribution.

* * * * *

(d) * * *

(2) *Nonconvertible and asset-backed securities.* Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, if:

(i) For nonconvertible debt securities and nonconvertible preferred securities, the issuer of such securities meets the requirements of ''well-known seasoned issuer'' as that term is used in § 230.405 of this chapter, but only if such issuer also meets the requirements of paragraph (1)(i)(B)(*1*) of that definition; or

(ii) For asset-backed securities, the offer and sale of the security is registered using Form S–3 (§ 239.13 of this chapter); or

* * * * *

12. Section 242.300 is amended by revising paragraph (i), removing paragraph (j), and redesignating paragraph (k) as paragraph (j).

The revision reads as follows:

§ 242.300 Definitions.

* * * * *

(i) *Corporate debt security* shall 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 Act (15 U.S.C. 78c(a)(12)).

* * * * *

13. Section 242.301 is amended by:

a. Adding the word ''or'' to the end of paragraph (b)(5)(i)(C);

b. Revising paragraph (b)(5)(i)(D);

c. Removing paragraph (b)(5)(i)(E);

d. Adding the word ''or'' to the end of paragraph (b)(6)(i)(C);

e. Revising paragraph (b)(6)(i)(D); and

f. Removing paragraph (b)(6)(i)(E).

The revisions read as follows:

§ 242.301 Requirements for alternative trading systems.

* * * * *

(b) * * *

(5) * * *

(i) * * *

(D) With respect to corporate debt securities, 5 percent or more of the average daily volume traded in the United States.

* * * * *

(6) * * *

(i) * * *

(D) With respect to corporate debt securities, 20 percent or more of the average daily volume traded in the United States.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

14. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a *et seq.*, 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

15. Amend Form X–17A–5 Part IIB General Instructions (referenced in § 249.617) by removing the phrase ''by a nationally recognized statistical rating organization ('NRSRO')'' and the phrase ''by an NRSRO'' wherever it appears in the section ''Credit risk exposure'' under the heading ''Computation of Net Capital and Required Net Capital'' and before the heading ''Aggregate Securities and OTC Derivatives Positions.''

Note: The text of Form X–17A–5 Part IIB does not and this amendment will not appear in the Code of Federal Regulations.

16. Form ATS–R (referenced in § 249.638) is amended by:

a. In the instructions to the form, Section B, revising the second term and removing the third term; and

b. In Section 4 of the form, revising Line L, to read ''Corporate debt securities,'' removing Line M, and redesignating Lines N and O as Lines M and N.

Note: The text of Form ATS–R does not and this amendment will not appear in the Code of Federal Regulations.

The revision reads as follows:

Form ATS–R, Quarterly Report of Alternative Trading System Activities

Form ATS–R Instructions

B. * * *

Corporate Debt Securities—shall mean any securities that (1) evidence a liability of the issuer of such securities; (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 Act (15 U.S.C. 78c(a)(12)).

* * * * *

17. Form PILOT (referenced in § 249.821) is amended by:

a. In the instructions to the form, Section B, revising the second term and removing the third term; and

b. In Section 9 of the form, revising Line J, to read ''Corporate debt securities,'' removing Line K, and redesignating Lines L, M, N and O as Lines K, L, M and N.

Note: The text of Form PILOT does not and this amendment will not appear in the Code of Federal Regulations.

The revision reads as follows:

Form PILOT, Initial Operation Report, Amendment to Initial Operation Report and Quarterly Report for Pilot Trading Systems Operated by Self-Regulatory Organizations

Form PILOT Instructions

B. * * *

Corporate Debt Securities—shall mean any securities that (1) evidence a liability of the issuer of such securities; (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 Act (15 U.S.C. 78c(a)(12)).

By the Commission.

Dated: July 1, 2008.

Florence E. Harmon,

Acting Secretary.

[FR Doc. E8–15280 Filed 7–10–08; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229, 230, 239, and 240

[Release No. 33–8940; 34–58071; File No. S7–18–08]

RIN 3235–AK18

Security Ratings

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: This is one of three releases that the Commission is publishing simultaneously relating to the use of security ratings by nationally recognized statistical rating organizations in its rules and forms. In this release, the Commission proposes to replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on security ratings (for example, Forms S–3 and F–3 eligibility criteria) with alternative requirements. In addition, the Commission requests comment on its rules relating to the disclosure of security ratings.

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 S7–18–08 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 S7–18–08. 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 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 a.m. and 3 p.m. 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 available publicly.

FOR FURTHER INFORMATION CONTACT: Steven Hearne, Eduardo Aleman, or Katherine Hsu, Special Counsels in the Office of Rulemaking, Division of Corporation Finance, at (202) 551–3430, 100 F Street NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to Regulation S–K,[1] and rules and forms under the Securities Act of 1933 (Securities Act),[2] and the Securities Exchange Act of 1934 (Exchange Act).[3] In Regulation S–K, the Commission is proposing to amend Items 10,[4] 1100,[5] 1112,[6] and 1114.[7] Under the Securities Act, the Commission is proposing to amend Rules 134,[8] 138,[9] 139,[10] 168,[11] 415,[12] 436,[13] Form S–3,[14] Form S–4,[15] Form F–1,[16] Form F–3,[17] Form F–4,[18] and Form F–9.[19] The Commission is also proposing to amend Schedule 14A [20] under the Exchange Act.

I. Background

On June 16, 2008, in furtherance of the Credit Rating Agency Reform Act of 2006,[21] the Commission published for notice and public comment two rulemaking initiatives.[22] The first proposes additional requirements for nationally recognized statistical rating organizations (NRSROs) that were directed at reducing conflicts of interest in the credit rating process, fostering competition and comparability among credit rating agencies, and increasing transparency of the credit rating

[1] 17 CFR 229.10 through 1123.
[2] 15 U.S.C. 77a *et seq.*
[3] 15 U.S.C. 78a *et seq.*
[4] 17 CFR 229.10.
[5] 17 CFR 229.1100.
[6] 17 CFR 229.1112.
[7] 17 CFR 229.1114.
[8] 17 CFR 230.134.
[9] 17 CFR 230.138.
[10] 17 CFR 230.139.
[11] 17 CFR 230.168.
[12] 17 CFR 230.415.
[13] 17 CFR 230.436.
[14] 17 CFR 239.13.
[15] 17 CFR 239.25.
[16] 17 CFR 239.31.
[17] 17 CFR 239.33.
[18] 17 CFR 239.34.
[19] 17 CFR 239.39.
[20] 17 CFR 240.14a–101.
[21] Pub. L. No. 109–291, 120 Stat. 1327 (2006).
[22] *Proposed Rules for Nationally Recognized Statistical Rating Organizations,* Release No. 34–57967 (Jun. 16, 2008).