

Further, distribution participants, issuers, selling shareholders, and affiliated purchasers would need to obtain an independent third party to verify this initial assessment. This process would create new costs to be borne by distribution participants, issuers, selling shareholders, and affiliated purchasers when relying on the proposed revised exceptions to hire such a party and review this verification. Distribution participants, issuers, selling shareholders, and affiliated purchasers seeking an independent third party verification that the issue meets the criteria required to obtain the proposed exceptions may find that the price of the independent third party verification could potentially lead to other economic effects. These effects could include, for instance, the potential for the verifier to be liable for claims if the exception is disputed after it has been relied upon. While difficult to quantify, the Commission preliminarily estimates that it is possible for the verifier's potential liability to be a significant multiple of the compliance-hours-cost-estimate provided for PRA purposes, and will depend upon the perceived risk in asserting that the security is liquid relative to the market for that asset class, trades in relation to general market interest rates and yield spreads, and is relatively fungible with securities of similar characteristics and interest rate yield spreads. These are new costs not currently borne by distribution participants, issuers, selling shareholders, or their affiliated purchasers. If potential liability leads to increased costs in obtaining an independent third party, some persons who currently rely on the exception may determine that it is no longer cost effective to qualify for the exception. This may have the effect of limiting the instances in which the exception is utilized, which in turn may expand the scope of the restrictions of Rules 101 and 102 of Regulation M. Thus, the increase in costs resulting from the third party verification may, in effect, narrow the exceptions for those who currently rely on them.

The Commission also expects that there could be a small number of securities taken out of this exception as a result of the proposed change. Costs for 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 in that these persons may now be required to comply with Rule 101 or 102 of Regulation M where they did not have to before. As a result of this change, these affected parties and their affiliated purchasers would be prohibited from bidding for, purchasing, or attempting to induce any person to bid for or purchase the covered security during the restricted period. However, the Commission does not expect there to be a significant number of these persons. Further, these persons may be able to rely on a different exception from Rule 101 or 102 depending on the circumstances.

D. RULE 10b-10

1. Benefits

The proposed amendments to Rule 10b-10 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, the Commission anticipates 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.

2. Costs

The Commission does 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, the Commission believes 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.

E. REQUEST FOR COMMENT ON ECONOMIC ANALYSIS

The Commission requests data to quantify the costs and the benefits above. The Commission seeks 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.

- The Commission seeks specific comments on the economic analysis outlined above with respect to Rule 15c3-1, its Appendices and Rule 17a-4. Are there any additional costs associated with these proposed amendments that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.
- The Commission seeks specific comments on the economic analysis outlined above with regard to Exhibit A to Rule 15c3-3. Are there any additional costs associated with the proposed amendment that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

- The Commission seeks specific comments on the economic analysis outlined above with regard to the proposed revised exceptions to Rules 101 and 102 of Regulation M. What new costs would the proposed revised exceptions create for those seeking to rely on them? Are there any costs not already accounted for in this proposal created by the proposed revised exceptions?
- The Commission seeks specific comments on the economic analysis outlined above with regard to the Rule 10b-10. Are there any additional costs associated with this proposal that were not factored into the above analysis? Commenters should provide specific examples of cost estimates.

VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), the Commission must advise OMB as to whether the proposed regulation constitutes a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of \$100 million or more (either in the form of an increase or decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation. If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review.

The Commission requests comment on the potential impact of the proposed rules and form on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VII. INITIAL REGULATORY FLEXIBILITY ANALYSIS

Section 3(a) of the Regulatory Flexibility Act of 1980¹³⁰ 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.¹³¹ 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,¹³² 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.¹³³

The proposed amendments to the securities haircut provisions in paragraphs (E), (F), and (H) of Rules 15c3-1(c)(2)(vi) and the conforming amendment to Rule 17a-4, if adopted, would not have a significant economic impact on a small number of entities. The Commission preliminarily believes that a broker-dealer with less than \$500,000 in total capital holds very few positions and, in particular, a small number of debt securities. Thus, the Commission

¹³⁰ 5 U.S.C. 603(a).

¹³¹ 5 U.S.C. 605(b).

¹³² See 17 CFR 240.17a-5(d).

¹³³ See 17 CFR 240.0-10(c).

preliminarily believes that there are few small entities that will be subject to these new rules. In addition, if there are small broker-dealers that hold these debt positions, they are already required to examine the risk associated with their debt securities when taking haircuts on these securities. The proposed amendments could alter this process but it would not be a new process that the small broker-dealer would have to comply with. Accordingly, the rule would not have any significant economic impact on small entities because even if they have to change their current process, they are still required to examine the risk associated with their debt securities.

The proposed amendment to Appendix A to Rule 15c3-1 will not be a burden to small entities. Although the definition of major market foreign currency will change, the currencies that meet the definition will not change.

The proposed amendments to the Appendices E and F to Rule 15c3-1 (which include conforming amendments to Appendix G to 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 Exhibit A to Rule 15c3-3, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed amendments to Exhibit A to Rule 15c3-3 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 0-10.¹³⁴

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 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. The Commission believes 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, the Commission believes that these amendments would not impose a significant economic impact on a substantial number of small entities.

The Commission believes 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 Commission encourages written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to Rule 15c3-1, Appendices A, E, F, and G to Rule 15c3-1, Exhibit A to Rule 15c3-3, Rule 17a-4, the General Instructions to Form X-17A-5, Part IIB, Rules 101 and 102 of Regulation M, and Rule 10b-10,

¹³⁴ The main clearing organization, the OCC, requires its members to have total capital of \$2.5 million, far above the \$500,000 total capital threshold for a small business in Rule 0-10.

could have an effect on small entities that has not been considered. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

VIII. STATUTORY BASIS AND TEXT OF THE PROPOSED AMENDMENTS

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, Sections 3(b), 15, 23(a), and 36 (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm), thereof, and Sections 939 and 939A of the Dodd-Frank Act, the Commission is proposing to amend §§ 240.10b-10, 240.15c3-1, 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g, 240.15c3-3a, 240.17a-4, 242.101, 242.102, and Form X-17A-5 Part IIB General Instructions under the Exchange Act.

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

Brokers, Fraud, 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 is amended by adding the following citations in numerical order and by adding “Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o–7 note)” to the sub-authorities for §§ 240.10b-10, 240.15c3-1, and 240.17a-4.

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, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; 18 U.S.C. 1350 and 12 U.S.C. 5221(e)(3), unless otherwise noted.

* * * * *

Sections 240.15c3-1a, 240.15c3-1e, 240.15c3-1f, 240.15c3-1g are also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o-7 note).

* * * * *

Section 240.15c3-3a is also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o-7 note).

* * * * *

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

3. Section 240.15c3-1 is amended by revising paragraphs (c)(2)(vi)(E) introductory text, (c)(2)(vi)(F)(1) introductory text, (c)(2)(vi)(F)(2) introductory text, and (c)(2)(vi)(H).

The revisions read as follows:

(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 has only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, 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 have only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, 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 have only a minimal amount of credit risk as determined by the broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, 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 has only a minimal amount of credit risk as determined by the

broker or dealer pursuant to written policies and procedures the broker or dealer establishes, maintains, and enforces to assess creditworthiness, 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.

4. Section 240.15c3-1a is amended by removing the phrase “whose short term debt is rated in one of the two highest categories by at least two nationally recognized statistical rating organizations and” and removing the sentence “For purposes of this section, the European Currency Unit (ECU) shall be deemed a major market foreign currency” from paragraph (b)(1)(i)(C).

5. Section 240.15c3-1e is amended by:

- a. revising the introductory text in paragraph (c)(4)(vi);
- b. removing paragraphs (c)(4)(vi)(A) through (c)(4)(iv)(D);
- c. redesignating paragraphs (c)(4)(vi)(E), (F), and (G) as paragraphs (c)(4)(vi)(A), (B), and (C), respectively; and
- d. revising newly redesignated paragraph (c)(4)(vi)(A).

The revisions read as follows:

§ 240.15c3–1e Deductions for market and credit risk for certain brokers or dealers (Appendix E to 17 CFR 240.15c3-1).

* * * * *

(c) * * *

(4)(vi) Credit risk weights of counterparties. A broker or dealer that computes its deductions for credit risk pursuant to this Appendix E shall apply a credit risk weight for transactions with a counterparty of either 20%, 50%, or 150% based on an internal credit rating the broker or dealer determines for the counterparty.

(A) As part of its initial application or in an amendment, the broker or dealer may request Commission approval to apply a credit risk weight of either 20%, 50%, or 150% based on internal calculations of credit ratings, including internal estimates of the maturity adjustment. Based on the strength of the broker's or dealer's internal credit risk management system, the Commission may approve the application. The broker or dealer must make and keep current a record of the basis for the credit rating of each counterparty;

* * * * *

6. Section 240.15c3-1f is amended by:

a. removing the phrase from paragraph (d)(2), "the counterparty factor. The counterparty factors are:" and adding in its place "a counterparty factor of 20%, 50%, or 100% based on an internal credit rating the OTC derivatives dealer determines for the counterparty."; and

b. revising paragraphs (d)(3)(i), (d)(3)(ii), (d)(3)(iii), and (d)(4).

The revisions read as follows:

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

* * * * *

(d) * * *

(3) * * *

(i) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt or commercial paper that would apply a 20% counterparty factor under (d)(2)(i) of this section, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(ii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 50% counterparty factor under (d)(2)(ii) of

this section, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(iii) For counterparties for which an OTC derivatives dealer assigns an internal rating for senior unsecured long-term debt that would apply a 100% counterparty factor under (d)(2)(iii) of this section, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital.

(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. The OTC derivatives dealer must make and keep current a record of the basis for the credit rating for each counterparty.

* * * * *

7. Section 240.15c3-1g(a)(3)(i)(F) is amended by removing the phrase "paragraphs (c)(4)(vi)(D) and (c)(4)(vi)(E)" and adding in its place "paragraph (c)(4)(vi)(A) and paragraph (c)(4)(vi)(B)".

8. Section 240.15c3-3a is amended by removing paragraph (b)(1)(i) of Note G and redesignating paragraphs (b)(1)(ii), (iii), and (iv) as paragraphs (b)(1)(i), (ii), and (iii), respectively.

9. Section 240.17a-4 is amended by:

- a. Removing the phrase from paragraph (b)(12), "§240.15c3-1e(c)(4)(vi)(D) and (E)" and adding in its place "§240.15c3-1e(c)(4)(vi)"; and
- b. Adding paragraph (b)(13).

The addition reads as follows:

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

* * * * *

(b) * * *

(13) The written policies and procedures the broker-dealer establishes, maintains, and enforces to assess creditworthiness for the purpose of §240.15c3-1(c)(2)(vi)(E), (F)(1), (F)(2), and (H).

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

10. The general authority citation for Part 242 is revised and the following citations are added in numerical order 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), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, 80a-37, unless otherwise noted.

* * * * *

Sections 242.101 and 242.102 are also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 U.S.C. 78o–7 note).

* * * * *

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

§ 242.101 Activities by distribution participants.

* * * * *

(c) * * *

(2) Certain nonconvertible and asset-backed securities. Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are determined and demonstrated by the distribution participant or affiliated purchaser, and verified by an independent third party, utilizing reasonable factors of evaluation to:

- (i) Be liquid relative to the market for that asset class;
- (ii) Trade in relation to general market interest rates and yield spreads; and
- (iii) Be relatively fungible with securities of similar characteristics and interest rate yield spreads; or

* * * * *

12. 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) Certain nonconvertible and asset-backed securities. Nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities, that are determined and demonstrated by the issuer, selling security holder, or affiliated purchaser, and verified by an independent third party, utilizing reasonable factors of evaluation to:

- (i) Be liquid relative to the market for that asset class;
- (ii) Trade in relation to general market interest rates and yield spreads; and
- (iii) Be relatively fungible with securities of similar characteristics and interest rate yield spreads; or

* * * * *

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

13. The authority citation for Part 249 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 78a et seq., 7201 et. seq., 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Section 249.617 is also issued under Pub. L. No. 111-203, §§939, 939A, 124. Stat. 1376 (2010) (15 U.S.C. 78c, 15 USC 78o-7 note).

* * * * *

14. Amend Form X-17A-5 Part IIB General Instructions (referenced in § 249.617) by:

- a. removing Schedule IV: Internal Credit Rating Conversion; and
- b. removing all but the first sentence in the section “Credit risk exposure” under the heading “Computation of Net Capital and Required Net Capital,” and adding a second sentence that reads “The counter-party charge is computed using the credit risk weights assigned to the OTC derivatives dealer’s internal calculations by the Commission under paragraph (d)(2) of Appendix F.”

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

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By the Commission.

Elizabeth M. Murphy
Secretary

April 27, 2011