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July 5, 2011

VIA E-MAIL: rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Release No. 34-64352; Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934 (the "Proposing Release")
File No. S7-15-11

Dear Ms. Murphy:

Thank you for the opportunity to comment on the above-referenced release.

We understand that Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Section 939A") directs the Securities and Exchange Commission (the "Commission") to remove references to or reliance on credit ratings in its rules and forms and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate. We are concerned, however, that the Commission's proposal to replace the exemption from Rules 101 and 102 of Regulation M for offerings of investment grade securities with the proposed standard based on a security's trading characteristics will impose disproportionate costs in circumstances where the risk of market manipulation is low. If adopted as proposed, distribution participants that have historically relied upon the current straightforward exemption for investment grade securities would be faced with the far more difficult task of assessing whether a security satisfies the proposed three-pronged exemption and the expense of verifying this assessment with an independent third party. These new hurdles seem inconsistent with the Commission's historical recognition that securities that trade at prices primarily driven by general market interest rates and spreads are not typically at risk for the type of conduct Regulation M seeks to prevent.

We therefore urge the Commission to simplify the new exemption by (1) removing the proposed third party verification requirement, (2) adding an alternative, easily determinable exemption, such as the debt WKSI standard initially proposed by the Commission in 2008 and (3) removing the liquidity condition from the exemption.

We discuss these points in more detail below.

As discussed in the Proposing Release, the proposed exemption eliminates the investment grade criterion as mandated by Dodd-Frank while also attempting to "codify the subset of trading characteristics" that make investment grade securities less prone to the type of manipulation that Regulation M seeks to prevent." (Proposing Release at 36). More specifically, the proposed exemption would apply to securities that are each of the following:

> (1) liquid relative to the market for that asset class,
>
> (2) trading at prices that are primarily driven by general market interest rates and spreads applicable to a broad range of similar securities, and
>
> (3) relatively fungible in terms of trading characteristics with similar securities (i.e., securities with similar interest rate yield spreads).

The Proposing Release does not provide definitive thresholds that would need to be met for a security to satisfy each of these three conditions and instead provides that those seeking to rely on the new exemption must utilize "reasonable factors of evaluation" in determining whether the exemption is available. (Proposing Release at 40).

In the 1996 Regulation M adopting release, *Anti-manipulation Rules Concerning Securities Offerings,* Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520 (Jan. 3, 1997) (the "Regulation M Adopting Release"), the Commission indicated that, in part due to suggestions that the application of its trading practice rules had become "needlessly complex and involved substantial compliance costs," it was adopting Regulation M to "relax restrictions in cases where either the risk of manipulation is small or the costs of the restrictions are disproportionate to the purposes they serve." (Regulation M Adopting Release at 520). A similar purpose led to the Commission's adoption of an exemption from Rules 101 and 102 of Regulation M and their predecessor, Exchange Act Rule 10b-6, for investment grade securities. This historical exemption was based on the premise that investment grade securities trade on the basis of their yields and credit ratings, and are largely fungible and, therefore, less likely to be subject to manipulation. (Proposing Release at 32-33 citing *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 18528 (Mar. 3, 1982), 47 FR 11482 (Mar. 16, 1982)) and *Prohibitions Against Trading by Persons Interested in a Distribution*, Exchange Act Release No. 19565 (Mar. 4, 1983), 48 FR 10628 (Mar. 14, 1983).

We appreciate the Commission's efforts to build upon this policy by crafting a new exemption that captures those trading characteristics that make investment grade securities less susceptible to manipulation. Assessing whether the exemption is available using the proposed three-pronged criteria, however, will require substantially more time, judgment and analysis than the current brightline investment grade standard. We are concerned that this three-pronged analysis and the accompanying independent third party verification requirement will require an unwarranted amount of time and expense in circumstances where the risk of market manipulation is low. This result strikes us as contrary to the Commission's stated intent in adopting Regulation M to "focus trading restrictions on those securities that present the greatest manipulative potential." (Regulation M Proposing Release at 524). In order to prevent this result, we suggest certain changes to the exemption criteria in order to simplify the application of the exemption and better balance its cost/benefit.

The independent third party verification requirement should be eliminated.

As proposed, a distribution participant's determination that a security qualifies for exemption from Rules 101 and 102 based on its trading characteristics would need to be verified by an independent third party. The release does not define who would qualify as independent for these purposes aside from noting that counsel to, or other affiliates of, the underwriter or issuer, would not meet this independence requirement, although this is not an exhaustive list. (Proposing Release at 40).

Distribution participants already have significant incentives to use care and precision to determine whether the exemption from Rules 101 and 102 of Regulation M is available—namely to avoid a violation of Regulation M and the general anti-fraud and anti-manipulation provisions of the securities laws. Imposing additional costs for an independent third party to verify this determination seems inconsistent with the purpose of the exemption, which is to avoid imposing costs and restrictions in offerings that bear a low risk of market manipulation. Offering participants are required to make significant determinations and exercise judgment in connection with the application of the federal securities laws in connection with nearly every offering, but the federal securities laws require few, if any, of these determinations to be verified by independent third parties. For example, companies seeking to rely on the exemptions from registration in Regulation D, Rule 144A and Regulation S must assess whether each condition for exemption is satisfied. Companies also make numerous materiality judgments, involving both quantitative and qualitative factors, in connection with securities offerings. These subjective and objective determinations have significant consequences, and securities participants often choose to consult outside experts to confirm these determinations, yet the securities laws do not require or condition their availability on an independent third party verification. To mandate that distribution participants bear the cost of obtaining a third party verification in order to claim a proposed exemption that is being provided due to the low risk profile of the securities in question is unusual and unnecessary. We therefore urge you to eliminate this requirement in the final rules.

The Commission also requests comment on whether it should restrict the independent third party verification role to those that would qualify as qualified independent underwriters or “QIUs” under FINRA’s rules. (Proposing release at 41). If the Commission decides to retain the independent third party verification requirement, we urge the Commission to make it clear in the adopting release that in addition to persons meeting the FINRA definition of QIU or any other registered broker-dealers, other qualified persons could serve as independent, third parties for purposes of the rule. This would give distribution participants flexibility to satisfy the third party verification requirement in the most efficient manner possible.

In addition to the proposed criteria based on a non-equity security’s trading characteristics, the Commission should adopt a more objective and easily verifiable alternative standard, such as the previously proposed debt WKSI standard.

As noted above, the proposed rules do not set out definitive thresholds to be met in order to satisfy each of the three prongs of the exemption but instead provide that those seeking to rely on the new exemption must utilize “reasonable factors of evaluation” in determining whether the exemption is available. We agree with this approach and believe companies should have the flexibility to assess whether a security meets these criteria based on the facts at hand. As we mentioned above, however, such an assessment will require more time, judgment and analysis than the current brightline investment grade criterion. As the Commission acknowledges, the application of Rules 101 and 102 of Regulation M to debt securities is limited. (Proposing Release at 33). For investment grade offerings, which the Commission recognizes are least likely to include the type of conduct Rules 101 and 102 of Regulation M seek to prevent, the expenditure of time and analysis necessary to determine whether an exemption from Regulation M is available may be cost prohibitive.

We therefore urge the Commission to *also* adopt the exemption criterion that it proposed in 2008 based on the well-known issuer (“WKSI”) concept. (See *Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations*, Exchange Act Release No. 58070 (Jul. 1, 2008), 73 FR 40088 (Jul. 11, 2008)). The determination of whether an offering qualifies for exemption based on the WKSI standard is relatively straightforward and will allow those involved in the distribution of securities issued by frequent debt issuers to efficiently assess the availability of the exemption without having to undertake a more complex and costly analysis. On the other hand, investment grade securities that do not qualify for exemption based on the WKSI standard should not necessarily lose exemption from Rules 101 and 102 of Regulation M, a concern expressed when the WKSI standard was proposed as a replacement for the investment grade exemption in 2008, if these securities alternatively qualify for the proposed exemption based on the security’s trading characteristics.

The Commission should remove the liquidity requirement from the proposed exemption.

The current exemption from Rules 101 and 102 of Regulation M for investment grade securities, like its predecessor in Exchange Act Rule 10b-6, is “based on the premise that [investment grade securities] are traded on the basis of their yields and credit ratings, are largely fungible and, therefore, are less likely to be subject to market manipulation.” (See Regulation M Adopting Release at page 527). These characteristics, i.e., trading on the basis of yield and fungibility, make up two of the criteria in the new exemption. The proposed exemption, however, also adds a third requirement, that the debt security be liquid relative to the market for that asset class. The addition of a liquidity condition is inconsistent with the historical basis for the exemption and will complicate the determination of whether the exemption is available. The addition of a new liquidity condition may also cause some investment grade securities that are currently exempt from Rules 101 and 102 of Regulation M to no longer qualify for exemption. This result seems contrary to the Commission's intention that the proposed new exemption "generally except the same types and amounts of securities that are currently excepted in Rules 101(c)(2) and 102(d)(2) without referencing credit ratings." (Proposing Release at 41).

While we agree with the Commission's assertion on page 37 of the Proposing Release that the existence of substantial liquidity is indicative of an established, efficient market with a large number of participants, which is less likely to be subject to the manipulation with which Regulation M is concerned, this is a different policy than fungibility, which has traditionally been the basis for the investment grade exemption. While the idea that substantial liquidity results in an efficient market and less risk of manipulation has historically been the basis for the actively-traded securities exemption, that exemption is generally applicable to equity securities for which objective standards of liquidity are easier to establish. Unlike equity securities, debt securities often trade in large blocks and do not trade with the volume associated with equity securities making their liquidity more difficult to assess. As such, we suggest that the Commission remove the liquidity criterion from the exemption intended to replace the investment grade exemption.

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We would be pleased to discuss our comments or any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Robert Colby, Michael Kaplan, Warren Motley, Richard Sandler, Richard Truesdell or Janice Brunner at 212-450-4000.

Very truly yours,

DAVIS POLK & WARDWELL LLP