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SEC Proposes Rule Amendments Intended to Reduce Reliance on NRSRO Ratings and Improve Investment Analysis

Introduction

The Securities and Exchange Commission ("SEC") published three releases (the "Releases")[1] on July 1, 2008, regarding the use of credit ratings issued by nationally recognized statistical rating organizations ("NRSROs") in the SEC's rules and forms. The publication of the Releases followed two related rulemaking initiatives by the SEC in June 2008 concerning NRSROs—one proposal that would impose additional requirements for NRSROs and a second proposal regarding rating symbols of structured finance products.[2]

In Release 28327, the SEC proposed amendments (the "Amendments") to four rules under the Investment Company Act of 1940 (the "1940 Act") and one rule under the Investment Advisers Act of 1940 (the "Advisers Act"). The Amendments are intended to reduce investor and market participant reliance on NRSRO ratings by removing references to NRSROs and credit ratings issued by NRSROs from Rules 2a-7, 3a-7, 5b-3, and 10f-3 under the 1940 Act and Rule 206(3)-3T under the Advisers Act. The SEC noted in Release 28327 that "an over-reliance on ratings can inhibit independent analysis and could possibly lead to investment decisions that are based on incomplete information." Although the Amendments would remove the specific use of credit ratings issued by NRSROs from the conditions of these rules, Release 28327 states that ratings, reports, analyses, and other assessments issued by NRSROs and other persons could still be considered by funds and investment advisers when evaluating credit risk.

The comment period on the Amendments runs through September 5, 2008.

Proposed Amendments to Rule 2a-7

Rule 2a-7 currently establishes three basic criteria with respect to the composition of a money market fund's portfolio: maturity, quality, and diversification (the "Risk Limiting Provisions"). With respect to portfolio quality, a money market fund may only purchase securities that (i) are denominated in U.S.

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1 *See* Rel. No. 34-58070 (July 1, 2008) (proposing to amend rules and forms under the Securities Exchange Act of 1934 (the "Exchange Act") that refer to NRSROs); Rel. No. 33-8940 (July 1, 2008) (proposing to amend rule and form requirements under the Securities Act of 1933 (the "Securities Act") and the Exchange Act that rely on security ratings); and Rel. No. IC-28327 (July 1, 2008) (as discussed in this *Dechert OnPoint*, "Release 28327").

2 *See* Rel. No. 34-57967 (June 16, 2008); *see also Dechert OnPoint* 2008-12, "Increased SEC Scrutiny of NRSROs And SEC Report Leads to New Rule Proposals Designed to Increase Accountability, Transparency and Competition in the Industry" (July 2008), *available at* http://www.dechert.com/library/FSG_12_NRSRO_7_08.pdf.

dollars,[3] (ii) pose minimal credit risk to the fund, and (iii) are "Eligible Securities" under Rule 2a-7.[4] Determining whether a security is an Eligible Security currently involves different considerations for "Rated Securities," "Unrated Securities," and securities that are subject to "Guarantees" and "Demand Features."[5]

To be considered an Eligible Security under current Rule 2a-7, a Rated Security must have received a rating from the "Requisite NRSROs"[6] that is in one of the two highest short-term rating categories.[7] An Unrated Security must have been determined by the fund's board of directors, or its delegate, to have been of comparable quality to a rated Eligible Security.[8] With respect to a security that is subject to a Guarantee, the Guarantee must have received a rating from an NRSRO or must have been issued by a guarantor that has received a rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security to the Guarantee.[9] Additionally, with respect to a security that is subject to a "Conditional Demand Feature,"[10] among other conditions, the underlying security or any guarantee of the security (or the comparable debt securities of the issuer or guarantor) must have received either a rating from the Requisite NRSROs in the two highest categories (short- or long-term, as applicable) or, if unrated, must have been determined by the board or its delegate to have been of comparable quality to a security that has been rated in the two highest categories by the Requisite NRSROs.

The Amendments would remove all references to NRSROs, Requisite NRSROs, Rated Securities, and Unrated Securities from Rule 2a-7, and would combine prongs (ii) and (iii) above by revising the definition of Eligible Security to mean a security that "the fund's board of directors determines presents minimal credit risks (which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations)." With respect to Conditional Demand Features, the Amendments would require the fund's board to de-

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3 Rule 2a-7(c)(3)(i). The SEC staff has stated, however, that it would not recommend enforcement action if funds that invested only in debt securities denominated in a specified foreign currency (the Pound Sterling, Deutsche Mark, Canadian Dollar, and the Euro) held themselves out as money market funds and otherwise complied with the terms of Rule 2a-7. *See* Five Arrows Short-Term Investment Trust (pub. avail. Sept. 26, 1997) and SSgA International Liquidity Fund (pub. avail. Dec. 2, 1998).

4 A more complete discussion of Rule 2a-7's requirements can be found at CLIFFORD E. KIRSCH, MUTUAL FUND REGULATION Chapter 22 "Money Market Funds" (The Practising Law Institute 2nd ed. 2008), *reproduced with permission at* http://www.dechert.com/library/Mutual%20Fund%20Regulation_%20Murphy.pdf.

5 To qualify as a Rated Security, the security (or a guarantee of that security) must have received a short-term rating from an NRSRO, or have been issued by an issuer (or guarantor in the case of a guarantee) that has received a short-term rating from an NRSRO with respect to a class of debt obligations (or any debt obligation within that class) that is comparable in priority and security with the security (or guarantee). Rule 2a-7(a)(19)(i) and (ii). The terms "Unrated Security," "Guarantee," and "Demand Feature" are defined in Rule 2a-7(a)(28), Rule 2a-7(a)(15), and Rule 2a-7(a)(8), respectively.

6 "Requisite NRSROs" means any two NRSROs that have issued a rating with respect to a security or a class of debt obligations of the issuer of the security or, if only one NRSRO has issued such a rating, that NRSRO. Rule 2a-7(a)(21).

7 Rule 2a-7(a)(10)(i). Additionally, the Rated Security must have a remaining maturity of 397 calendar days or less. *Id.*

8 Rule 2a-7(a)(10)(ii). An Unrated Security that had a remaining maturity of more than 397 calendar days when it was issued, but currently has a remaining maturity of 397 calendar days or less, cannot be determined to be an Eligible Security if it has received a long-term rating from any NRSRO that is not within that NRSRO's three highest long-term rating categories unless the security also has received a long-term rating from the Requisite NRSROs in one of the three highest rating categories. Rule 2a-7(a)(10)(ii)(A). An unrated asset backed security ("ABS") can be determined to be an Eligible Security if and only if substantially all of the qualifying assets of the ABS consist of obligations of one or more municipal issuers. Rule 2a-7(a)(10)(ii)(B).

9 Rule 2a-7(a)(10)(iii)(A). This rating is not required, however, if the Guarantee is issued by a person that, directly or indirectly, controls, is controlled by or is under common control with the issuer of the security (other than a sponsor of a special purpose entity with respect to an ABS), or the security is a repurchase agreement that is collateralized fully, or the Guarantee is itself a government security. Rule 2a-7(a)(10)(iii)(A)(1)-(3). The determination of whether a security that is subject to a Guarantee may be determined to be an Eligible Security under Rule 2a-7 may be based solely on whether the Guarantee is an Eligible Security. Rule 2a-7(c)(3)(iii).

10 The term "Conditional Demand Feature" is defined in Rule 2a-7(a)(6).

termine that the "underlying security or any guarantee of such security presents minimal credit risks (which determination must be based on factors pertaining to credit quality)."[11]

The Amendments would also revise the definition of "First Tier Security" under Rule 2a-7. An Eligible Security may be deemed to be a First Tier Security or a Second Tier Security.[12] The distinction between a First Tier Security and a Second Tier Security is significant because Rule 2a-7 imposes different diversification requirements on an Eligible Security based on whether the security is a First Tier Security or a Second Tier Security. Currently, a rated security that has received a short-term rating from the requisite NRSROs in the highest short-term rating category for debt obligations would be considered to be a First Tier Security. The term First Tier Security also currently includes a government security, a security that is issued by a registered money market fund, or an unrated security deemed to be of comparable quality to a security meeting the requirements for a First Tier Security, as determined by the fund's board or its delegate. The Amendments would revise the definition of a First Tier Security to mean "a security the issuer of which the fund's board of directors has determined has the highest capacity[13] to meet its short-term financial obligations."

Rule 2a-7 does not currently address the impact of market liquidity on an Eligible Security, although money market funds are limited to investing no more than 10% of their net assets in illiquid securities under a long-standing position of the SEC.[14] The Amendments would codify this position. Specifically, proposed Rule 2a-7(c)(5) would require a money market fund to "hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions." The proposed new rule would expressly limit money market funds to investing no more than 10% of their total assets in illiquid securities. Proposed Rule 2a-7(a)(17) would define "liquid security" to mean "a security that can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund." Although this Amendment would require a money market fund's board to monitor the fund's investments in illiquid instruments on an ongoing basis, it generally would not force a fund to liquidate any portfolio instrument where the fund would suffer a loss on the sale.

In addition to the Risk Limiting Provisions, Rule 2a-7 contains specific procedures regarding downgrades, defaults, and certain other events. Currently, with respect to downgrades, if either a portfolio security ceases to be a First Tier Security or the fund's investment adviser becomes aware that any unrated security or Second Tier Security held in the fund's portfolio has been given a rating by any NRSRO that is below the second highest short-term rating category, the fund's board is required to promptly reassess whether that security continues to present minimal credit risk and must take such action as it deems is in the best interests of the fund and its shareholders. The reassessment is not required, however, if in accordance with the fund's procedures, the security is disposed of (or matures) within five business days of the event requiring reassessment.[15] The Amendments would replace this provision with a requirement that such reassessments take place "[i]n the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) becomes aware of any information about a portfolio security or an issuer of a portfolio security that may suggest that the security may not continue to present minimal credit risks." The Amendments would not require a money market fund to dispose of a portfolio security that has been determined to no longer present minimal credit risks.

Finally, Rule 17a-9 under the 1940 Act provides an exemption from Section 17(a) of the 1940 Act to permit an affiliate of a money market fund to purchase from the fund a security that is no longer an Eligible Security. The Amendments propose new Rule 2a-

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11 Although the fund's board would remain ultimately responsible for the minimal credit risk determination and its oversight under the Amendments, Rule 2a-7 would continue to permit the responsibility for determining minimal credit risk to be delegated by the board to the fund's investment adviser.

12 "Second Tier Security" means any "eligible security" that is not a First Tier Security. Rule 2a-7(a)(22). The Amendments would not change the meaning of a Second Tier Security under Rule 2a-7.

13 Release 28327 contains no definition or guidance regarding the meaning of "highest capacity."

14 *See* Rel. No. IC-21837 (Mar. 21, 1996) at n. 65.

15 Special rules also currently exist for certain securities subject to demand features. *See* Rule 2a-7(c)(6)(i)(C).

7(c)(7)(iii)(B), which would require a money market fund to promptly notify the SEC by email of any such purchase.[16]

Proposed Amendments to Rule 3a-7

Perceived failures with respect to NRSRO ratings of "securities collateralized or linked to subprime residential mortgages" and a desire to "improve the quality of credit ratings determined by NRSROs generally and, in particular, for structured finance products such as RMBS and CDOs" were cited by the SEC as driving forces behind the proposed rules and rule amendments announced in the Releases.[17] As such, it is not surprising that Rule 3a-7 under the 1940 Act ("Rule 3a-7"), which was adopted to facilitate the issuance and development of structured finance products,[18] is among the rules that would be the most affected by the SEC's proposals.[19] Rule 3a-7 facilitates structured financings by excepting from the definition of an "investment company" under the 1940 Act "Issuers of Asset-Backed Securities" (*i.e.*, structured finance vehicles) that comply with the conditions set forth in the rule. Although many structured finance vehicles choose, instead, to rely on an exception from the definition of an "investment company" other than Rule 3a-7,[20] Rule 3a-7 allows a structured finance vehicle to securitize a potentially broader range of assets or access a broader market of investors than might be available under an alternate exception.[21]

When Rule 3a-7 was adopted, concerns that a broad swath of the investing public would be exposed to potentially risky ABS were allayed by, among other things, allowing only investment grade tranches of fixed income ABS to be offered freely to the public and limiting the riskier (*i.e.*, junior) tranches of fixed income ABS (as well as any equity securities issued by the structured finance vehicle) to progressively more sophisticated categories of investors. In order to differentiate between relatively more secure and relatively riskier tranches, the SEC used NRSRO ratings. Under current Rule 3a-7, a structured finance vehicle may sell fixed income ABS to the general public provided that such securities are rated by at least one NRSRO, "in one of the four highest rating categories assigned long-term debt or in an equivalent short-term category."[22] Riskier fixed income securities may be

16 It should be noted that the SEC staff has issued no-action positions regarding affiliate buy-outs of securities that remain Eligible Securities, but that have dropped in price due to market illiquidity. However, the proposed amendments to Rule 17a-9 would not incorporate this relief into the rule.

17 Rel. No. 34-57967 at text accompanying nn. 14 and 15. The term "RMBS" refers to "residential mortgage backed securities," *i.e.*, securities collateralized by a pool of residential mortgage interests which may include, but are not limited to, interests in sub-prime loans. The term "CDO" refers to "collateralized debt obligations," *i.e.*, securities collateralized by a pool of debt obligations which may include a wide variety of securities, including RMBS and interests issued by other CDOs. Securities (including RMBS) issued by securitization vehicles are commonly referred to as "asset backed securities" or "ABS."

18 The Releases (and this *Dechert OnPoint*) use the term "structured finance product" to refer "to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction [including but not limited to ABS] such as RMBS and to other types of structured debt instruments such as CDOs, including synthetic and hybrid CDOs." The term "structured finance vehicle," as used in this *Dechert OnPoint*, refers to any issuer of a structured finance product.

19 Structured finance vehicles are inherently within the general definition of an investment company provided by Section 3(a)(1)(A) of the 1940 Act (as an issuer which is primarily engaged in the business of investing, reinvesting or trading in securities) and Section 3(a)(1)(C) of the 1940 Act (as an issuer which is engaged in the business of investing, reinvesting, owning, holding or trading in securities and owns investment securities in excess of 40% of its total assets) and, as such, absent an available exception (or exemptive relief), such issuers would be required to register under, and comply with the substantive requirements of, the 1940 Act. In Release 28327, the SEC noted that "[a]lmost none of the structured financings, however, are able to operate under the [1940] Act's requirements."

20 Other exceptions are available to certain types of structured finance vehicles. For example, a structured finance vehicle that requires all investors to be "qualified purchasers" and that is not making (or proposing to make) a public offering could rely on Section 3(c)(7) of the 1940 Act. Similarly, a structured finance vehicle whose securities are backed by mortgages on and other interests in real estate can, in certain circumstances, rely on Section 3(c)(5)(C) of the 1940 Act. However, these exceptions impose restrictions with which many structured finance vehicles cannot (or do not choose to) comply.

21 On the other hand, Rule 3a-7 imposes certain restrictions with respect to the purchase or sale of assets serving as collateral for securities issued. As a result, structured finance vehicles unable to rely on Section 3(c)(5) of the 1940 Act often seek to comply with Section 3(c)(7) of the 1940 Act.

22 Rule 3a-7(a)(2).

sold to institutional accredited investors while any securities (fixed income or equity) may be sold only to "qualified institutional buyers" ("QIBs") and "persons . . . involved in the organization or operation" of the structured finance vehicle or such persons' affiliates ("vehicle insiders").[23] To further protect investors in Rule 3a-7 structured finance vehicles, the SEC imposed certain requirements with respect to the purchase and sale of securitized assets and the safekeeping of cash flows derived from those assets. In each case, these requirements referenced the maintenance of the NRSRO ratings assigned to the fixed income ABS issued by the structured finance vehicle. Thus, under existing Rule 3a-7, a purchase or sale of securitized assets is allowed only if, among other things, it would "not result in a downgrading in the rating" and cash flows from collateral must be "deposited periodically in a segregated account . . . consistent with the rating of the outstanding fixed income securities."[24]

Consistent with the goal of the Amendments to reduce or eliminate reliance on NRSRO ratings in SEC rules, the SEC's proposed Amendments to Rule 3a-7 would eliminate references to NRSROs and ratings in Rule 3a-7.[25] In the case of the purchase and sale restrictions and the safekeeping requirements, described above (and consistent with many of the other Amendments proposed in the Releases), references to the rating would be generalized to reflect the purpose behind including a rating requirement in the Rule – *i.e.*, preservation of credit quality consistent with full and timely payment. Thus, the requirement that a purchase or sale not "result in a downgrade in the rating" would be replaced by the requirement that "the issuer has procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed income securities"[26] and the requirement that "cash flows derived from eligible assets . . . be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the outstanding fixed income securities" would be replaced with a requirement that such account be "consistent with the full and timely payment of the outstanding fixed income securities."[27] The proposed amendment requiring that "the issuer has procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed income securities" appears to go beyond the SEC's intention to reduce or eliminate reliance on NRSRO ratings. NRSRO ratings rate the likelihood of full and timely payment of principal and interest on securities based on the structure of the transaction. It is not clear that the issuer having "procedures which ensure that acquisition or disposition of assets do not adversely affect full and timely payment of the outstanding fixed income securities" is the same standard. Since the SEC's proposed language is ambiguous and could be read to prohibit or restrict selling securitized assets at a loss even when that is the appropriate investment decision to make, we expect comment letters will deal with concerns raised by this proposed language.

By contrast, citing the fact that many structured finance vehicles have chosen to rely on Section 3(c)(7) rather than Rule 3a-7 and that "securities issued by financing vehicles that rely on rule 3a-7, even when highly rated, generally are not marketed to retail investors" the SEC has proposed to simply eliminate the ability of the general public to acquire ABS issued by a structured finance vehicle relying on Rule 3a-7,[28]

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23 *See* Rule 3a-7(a)(2)(i) and (ii).

24 Rule 3a-7(a)(3)(ii) and (a)(4)(iii), respectively.

25 As in current Rule 3a-7, the proposed Amendments would retain the exclusion of "any rating organization rating the issuer's securities" from the class of persons who can acquire non-fixed income securities issued by the structured finance vehicle under Rule 3a-7(a)(2)(ii) which permits such securities to be sold to, among others, vehicle insiders.

26 Unlike (for example) the compliance program rules adopted under the 1940 Act and the Advisers Act (*i.e.*, Rule 38a-1 and Rule 206(4)-7, respectively), which require that relevant policies and procedures be (i) "reasonably designed" to achieve the desired goals (in that case, preventing violation of the Federal Securities Laws or the Advisers Act, respectively) and (ii) "written," the Amendment to Rule 3a-7(a)(3)(ii) to require that an issuer who acquires or disposes of eligible assets have "procedures to ensure full and timely payment" does not include a "reasonably designed" qualifier nor require that such procedures be "written." Release 28327 does not contain any guidance as to the content of such procedures but notes the SEC's belief that "almost all issuers currently have these procedures in place." Release 28327 at p. 31.

27 *Id.* at p. 16.

28 Since structured finance vehicles relying on Section 3(c)(7) are, by terms of that exception, limited to selling to qualified purchasers in private offerings, the effect of the Amendments would be to exclude retail investors from any structured finance vehicle that was not able to rely on Section 3(c)(5) of the 1940 Act. Section 3(c)(5) excepts from the definition of an investment company issuers who, among other things, securitize mortgages

rather than offering an alternative means of assuring that retail investors are not exposed to overly risky ABS.[29] Consequently, if the Amendments are adopted as proposed, retail investors will not be permitted purchasers of investment grade rated fixed income ABS under Rule 3a-7 although fixed income ABS may be sold to institutional accredited investors and any securities (fixed income or equity) may be sold to QIBs and persons involved in the operation or organization of the structured finance vehicle.

The SEC solicited comments as to this approach and is clearly concerned with (i) maintaining distinctions between investment companies, on one hand, and structured finance vehicles on the other and (ii) retaining the exception if the SEC's premise that few Rule 3a-7 compliant structured finance vehicles, in fact, sell ABS to the general public is incorrect. As currently proposed, however, the Amendments do not contain a grandfathering provision to maintain a retail market for re-sales of interests acquired pursuant to the current rule. If the Amendments are adopted as proposed, any retail investors who acquired investment grade ABS consistent with current Rule 3a-7(a)(2) might have difficulty selling those securities, as the Amendments would require that structured finance vehicles and underwriters "exercise[] reasonable care to ensure that such securities . . . will be resold" only to institutional accredited investors, QIBs or vehicle insiders.[30]

Proposed Amendments to Rule 5b-3

Rule 5b-3(a) permits a fund to treat the acquisition of a repurchase agreement as the acquisition of the underlying securities – and not of an interest in the counterparty – for purposes of determining the issuer's identity under Sections 5(b)(1) and 12(d)(3) of the 1940 Act; provided, however, that the seller's obligation to repurchase the securities from the fund is "collateralized fully." Currently, for the seller's obligation to be "collateralized fully," the collateral must consist of cash items, government securities, securities that are rated in the highest rating category by the "requisite NRSROs" at the time the repurchase agreement is entered into, or unrated securities determined by the fund's board or delegate to be of comparable quality. The Amendments would remove all references to NRSROs, Requisite NRSROs, and Unrated Securities. As an alternative, the Amendments would require collateral other than cash items and government securities to consist of securities that the fund's board or delegate determines at the time the repurchase agreement is entered into: "(1) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time; (2) are subject to no greater than minimal credit risk; and (3) the issuer of which has the highest capacity to meet its financial obligations."

Additionally, Rule 5b-3(b) permits a fund to treat the acquisition of a "refunded security" – that is, a debt security, the principal and interest payments of which are paid by U.S. government securities that have been irrevocably placed in an escrow account and pledged only to the payment of the debt security[31] – as the acquisition of the escrowed U.S. government securities (the "deposited securities"). The Amendments would require an independent CPA to certify, without exception, to the escrow agent at the time the deposited securities are placed in the escrow account (or at the time a substitution of the deposited securities is made) that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the "refunded securities." Under current Rule 5b-3, this certification is not required if the "refunded security" has received a rating from an

and other liens on or interests in real estate. Thus, notwithstanding that among the SEC's goals underlying this and the related rule proposals with respect to NRSROs (as expressed in the June 16, 2008 Release), to "address concerns about the integrity of [the NRSROs'] credit rating procedures and methodologies in light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages," issuers of mortgage backed securities would have comparatively greater access to the general public markets than issuers securing most other types of interests.

29 A potential, alternative approach posited by the SEC in its request for comments would more closely resemble the approach taken in some of the other Amendments discussed in this *Dechert OnPoint – i.e.*, substituting the reasoned judgment of an appropriate person as to the credit quality of the securities in question for the rating requirement – in this case by "permit[ting] offerings to the general public if a sponsor or trustee conducts an independent statistical analysis of the anticipated cash flows." Release 28327 at p. 17.

30 The SEC cited this (and a general reduction in liquidity of structured finance securities) as a potential cost of the Amendments but one which the SEC, despite noting that "[t]hese costs are difficult to assess," felt to be "minor" on the grounds that the retail "market, if it exists, represents a very small amount of all structured finance products." *Id.* at p. 42.

31 Rule 5b-3(c)(4).

NRSRO that is in the highest category for debt obligations.

Proposed Amendments to Rule 10f-3

Rule 10f-3 allows a fund to purchase securities that Section 10(f) of the 1940 Act would otherwise prohibit (*i.e.*, securities for which an affiliated underwriter is acting as a principal underwriter during the existence of an underwriting or selling syndicate for the securities), provided that certain conditions are met. One such condition is for the purchased securities to be of a specific type, such as being "eligible municipal securities."[32] The Amendments would revise the definition of "eligible municipal securities" under Rule 10f-3 by removing references to NRSRO credit ratings and instead requiring municipal securities to be not only subject to "no greater than moderate credit risk," as determined by the fund's board, but also sufficiently liquid to "be sold at or near their carrying value within a reasonably short period of time." If the issuer of the municipal securities has been in operation for less than three years, the Amendments would require the municipal securities to be "subject to a minimal or low amount of credit risk."

Proposed Amendments to Rule 206(3)-3T

Rule 206(3)-3T was adopted in the wake of a court decision vacating prior rulemaking which would have provided that most broker-dealers receiving asset based compensation (as opposed to commissions or commission equivalents) for a package of services including brokerage and non-discretionary advice would not be subject to the Advisers Act (including, in particular, the Section 206(3) limitations with respect to principal transactions between an adviser and its client).[33] In the absence of the prior rulemaking, such broker-dealers are also required to register as investment advisers (such entities are commonly referred to as "Dual Registrants") and, at least with respect to those accounts being charged an asset based fee (or with respect to which advice is provided that is not solely incidental to brokerage services and/or is specially compensated) would be subject to the prohibition on principal transactions absent written notice to, and consent of, the client prior to completion of the transaction. In many cases, this prohibition is inconsistent with the services typically provided by a broker-dealer to its brokerage customers. To preserve the ability of Dual Registrants to service "[c]ustomers who depend both on access to principal transactions with their brokerage firms and on the protections associated with a fee-based (rather than transaction-based) compensation structure," the SEC adopted, on a temporary basis, Rule 206(3)-3T.

Rule 206(3)-3T allows Dual Registrants to continue to engage in principal trades provided that, among other things, the Dual Registrant makes certain disclosures to its client and receives the client's oral or written consent prior to the trade. However, Dual Registrants may not rely on the rule to purchase from or sell to a client on a principal basis, securities for which the Dual Registrant (or a person controlling, controlled by or under common control with the Dual Registrant) is issuer or underwriter unless the security in question is "an investment grade debt security."[34] The SEC restricted a Dual Registrant that issued or underwrites a security from relying on Rule 206(3)-3T for principal transactions in that security because "the broker-dealer's incentives to 'dump' securities it is underwriting are greater for sales by a broker-dealer acting as an underwriter [and a] broker-dealer acting as issuer has similar, if not greater, proprietary interests that are likely to adversely affect the objectivity of its advice."[35] The SEC reasoned that "investment grade debt securities," which are defined as "a non-convertible debt security that, at the time of sale, is

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32 Rule 10f-3(a)(3) defines "eligible municipal securities" to mean "municipal securities," as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 (the "Exchange Act") but qualifies this definition with the limitations discussed above.

33 *Temporary Rule Regarding Principal Trades with Certain Advisory Clients*, Rel. No. IA-2653 (Sept. 24, 2007) ("206(3)-3T Release"); *see also Dechert OnPoint* 2007-34, "Temporary Rule Regarding Principal Trades with Certain Advisory Clients and Proposed Interpretive Rule Under the Advisers Act Affecting Broker-Dealers" (November 2007), *available at* http://www.dechert.com/library/FS_34_11-07_Temporary_Rule_Regarding_Principal.pdf (discussing Rule 206(3)-3T and related interpretive guidance); *Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) ("*FPA*"); *Dechert OnPoint* 2007-14, "SEC Not to Appeal Decision Vacating Broker-Dealer Exemption Rule" (May 2007), *available at* http://www.dechert.com/library/FS_14_05-07_SEC_Will_Not_Appeal_Decision.pdf (discussing *FPA*); *Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Rel. No. IA-2376 (Apr. 12, 2005).

34 Rule 206(3)-3T(a)(2).

35 206(3)-3T Release.

rated in one of the four highest rating categories of at least two [NRSROs],"[36] present less of a concern as such securities "may be less risky and therefore less likely to be 'dumped' on clients."

Thus, as was the case with Rule 3a-7(a)(2), the use of the rating criteria in Rule 206(3)-3T is intended to serve as a proxy for the relative risk of the securities. As such, and consistent with the approach taken by many of the other Amendments discussed above, the SEC proposed to amend Rule 206(3)-3T(c) to remove reference to the rating requirement and substitute the Dual Registrant's determination that the security in question is "subject to no greater than moderate credit risk and sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time."[37] Dual Registrants choosing to avail themselves of 206(3)-3T to transact with clients, on a principal basis, in investment grade debt securities issued or underwritten by the Dual Registrant or an entity controlling, controlled by, or under common control with the Dual Registrant, would be required to "adopt and implement written policies and procedures reasonably designed to . . . address the [Dual Registrant]'s methodology for determining whether a security is of investment grade quality."[38] If the Amendments to Rule 206(3)-3T are adopted as proposed, such policies and procedures could not "rely exclusively on NRSRO ratings to determine whether a security is investment grade;" however, such procedures could "refer to" or allow a Dual Registrant to consider "ratings, reports, analyses, and other assessments issued by NRSROs . . . for the purpose of evaluating credit risk and liquidity."[39]

Conclusion

Many of the rules proposed to be amended do not rely solely on NRSRO ratings, but rather use those ratings as one criterion for qualifying funds or transactions for exemptive relief. The SEC has concluded, in light of recent market events, that references to NRSRO credit ratings in Rules 2a-7, 3a-7, 5b-3, and 10f-3 under the 1940 Act and Rule 206(3)-3T under the Advisers Act may have encouraged investors and market participants to place undue reliance on credit ratings instead of simply providing, as originally intended, a clear reference point to regulators, investors, and market participants alike. To address the SEC's concern that investors may interpret the use of credit ratings issued by NRSROs in these rules as the SEC's endorsement of the quality of such credit ratings, and that any failures in the ratings process may impact market participants that operate pursuant to these rules, the Amendments would remove references to credit ratings issued by NRSROs and, as applicable, replace such references with more subjective determinations intended to require independent credit analysis by responsible parties.

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36 Rule 206(3)-3T(c).

37 Release 28327. The SEC's view appears to be that securities which are less risky tend to be more readily marketable and less likely to be "dumped" on a client who relies on the adviser, as a fiduciary, to act in the client's best interests. For example, in proposing Amendments to Rule 10f-3 (which would replace a rating condition with a requirement that the relevant securities be determined to be "sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time and . . . subject to no greater than moderate credit risk"), the SEC noted that "the rationale behind the rating requirement was to prevent the purchase of less seasoned securities and reduce the risk of unloading unmarketable securities on the fund." *Id.* at text accompanying n. 67.

38 *Id.* at p. 27.

39 *Id.* at n. 78.

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