

**MEMO# 25482**

September 13, 2011

# **SEC Issues Advance Notice of Proposed Rulemaking on Treatment of Asset-Backed Issuers; Call Scheduled for September 27**

[25482]

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 66-11  
SEC RULES COMMITTEE No. 78-11 RE: SEC ISSUES ADVANCE NOTICE OF PROPOSED RULEMAKING ON TREATMENT OF ASSET-BACKED ISSUERS; CALL SCHEDULED FOR SEPTEMBER 27

The Securities and Exchange Commission (the "Commission") recently issued an advance notice of proposed rulemaking soliciting comment on possible amendments to Rule 3a-7 under the Investment Company Act of 1940 (the "Investment Company Act") (the "ANPR"). [1] Rule 3a-7 provides certain asset-backed issuers with a conditional exclusion from the definition of "investment company" under the Investment Company Act. The ANPR explains that possible amendments the Commission may consider could reflect developments since Rule 3a-7 was adopted in 1992, recent developments affecting asset-backed issuers, including passage of the Dodd-Frank Act and the Commission's recent rulemakings regarding asset-backed issuers. The ANPR also withdraws the Commission's 2008 proposal to amend Rule 3a-7. [2] The Commission has requested comments on the ANPR by November 7, 2011. A summary of the significant issues raised by the ANPR is provided below.

We will hold a conference call on Tuesday, September 27 at 2 pm eastern time to discuss a possible comment letter from the ICI. The dial-in number is 877-675-5901 and the passcode is 22408. Please let Jennifer Odom ([jodom@ici.org](mailto:jodom@ici.org) or 202/326-5833) know if you will participate on the call. You may also provide comments directly to Sarah Bessin ([Sarah.Bessin@ici.org](mailto:Sarah.Bessin@ici.org) or 202/326-5835).

## **NRSRO Conditions**

The ANPR explains that the existing conditions of Rule 3a-7 are intended to distinguish asset-backed issuers from registered investment companies and address investor

protection concerns under the Investment Company Act. The rule includes three conditions that refer to credit ratings by nationally recognized statistical rating organizations (“NRSROs”). [3] The Commission explains that these conditions were included in the rule not principally as standards of creditworthiness, but because the Commission believed that credit ratings can serve as a type of proxy for the relevant investor protections provided under the Investment Company Act. The Commission requests comment on whether these conditions have been effective in achieving those goals, or whether they should be eliminated and/or other conditions adopted in their place, particularly in light of the Dodd-Frank Act’s requirement that the Commission remove references to credit ratings in its rules and substitute alternate standards of creditworthiness, [4] and concerns raised during the financial crisis about NRSRO’s credit rating procedures and methodologies.

## Conditions to Address Investor Protection Concerns

The Commission requests comment on whether conditions should be added to Rule 3a-7 to directly address investor protection concerns under the Investment Company Act. For example, to address concerns about abusive practices, such as self-dealing and overreaching by insiders, misevaluation of assets, and inadequate asset coverage, the Commission suggests the following possible approaches:

- Impose specific requirements or limitations on the structure and operations of an asset-backed issuer relying on the rule in order to prevent these potential types of abuses from occurring. For example, the rule could specify the particular manner in which the issuer’s asset should be selected and valued to avoid potential “dumping” of assets and misvaluation.
- A principle-based approach, for example, requiring that the parameters of the issuer’s organization and operations be set out in its organizational documents. [5]

The ANPR addresses the benefits of an independent review of the asset-backed issuer’s structure and operations. The Commission explains that it is considering a condition that would require an asset-backed issuer to obtain an opinion from an independent evaluator, [6] prior to the sale of its fixed-income securities, stating that the independent evaluator reasonably believes, based on information available at the time the fixed-income securities are first sold and taking into account the characteristics of the securitized assets underlying the offering, that the asset-backed issuer is structured and would be operated in a manner such that the expected cash flow generated from the underlying assets would likely allow the asset-backed issuer to have the cash flow at times and in amounts sufficient to service expected payments on the fixed-income securities. [7] The Commission notes that the opinion would not serve as a guarantee that the securitization will produce such cash flow.

The opinion would be similar to the opinion that has been proposed under the ABS Re-Proposal. The Commission states that while the purpose of the independent review underlying the opinion in the ABS Re-Proposal would be different than the purpose of the Rule 3a-7 review, one review could satisfy both requirements.

The Commission also explains that Rule 3a-7 contains several conditions designed to address the safekeeping of the issuer’s eligible assets and the cash flow derived from those assets. The Commission requests comment on whether the rule should be amended to strengthen the provisions relating to the preservation and safekeeping of the asset-backed issuer’s assets and cash flow.

In addition, the Commission requests comment on whether other existing or proposed rules

applicable to asset-backed issuers under the federal securities laws may address investor protection concerns under the Investment Company Act and could serve as substitutes for the rating references in the rule. The ANPR mentions the following provisions as potential requirements under Rule 3a-7:

- Rule 193 under the Securities Act of 1933 (“Securities Act”), which generally requires an asset-backed issuer to perform a review of the assets underlying any asset-backed securities that will be registered under the Securities Act;
- The proposed requirement under the Commission’s recent re-proposal of shelf-eligibility conditions for asset-backed securities (“ABS Re-Proposal”) that the issuer’s underlying transaction agreements provide for a “credit risk manager” to review the underlying assets in specified circumstances;
- The prohibition in Section 27B of the Securities Act against an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security, from engaging in any transaction that would involve or result in any material conflict of interest with any investor for one year after closing; and
- The credit risk retention requirements federal regulators recently proposed pursuant to Section 941 of the Dodd-Frank Act for sponsors of asset-backed securities.

## **Eligibility to Use Rule 3a-7**

Currently, any asset-backed issuer that can meet the conditions of Rule 3a-7 can rely on the rule. The Commission requests comment on whether it should further limit eligibility for reliance on the rule by requiring a Rule 3a-7 issuer to also meet the requirements of Regulation AB or the shelf eligibility requirements. The Commission requests comment on related matters including:

- Whether the conditions of Rule 3a-7 should distinguish between issuers that meet the shelf eligibility conditions and those that do not;
- Whether asset-backed issuers that currently are able to publicly offer their securities would no longer be able to do so if Rule 3a-7 were limited to issuers that meet the shelf eligibility requirements;
- Whether asset-backed issuers that privately offer their securities in reliance on Rule 3a-7 would no longer be able to do so if the rule was limited in this manner; and
- The effects on the asset-backed securities market in general, on capital formation, and on investors if the availability of Rule 3a-7 were limited to issuers of asset-backed securities as defined in Regulation AB or included the further limitations found in the shelf eligibility requirements.

## **Holders of Rule 3a-7 Issuers’ Securities**

The ANPR addresses two issues relating to the status of a holder of securities of an asset-backed issuer relying on Rule 3a-7. First, the Commission expresses concern that certain companies that purchase equity and residual interests in collateralized loan obligations and collateralized debt obligations issued by Rule 3a-7 issuers may, in fact, be in the business of investing in securities. Such a company, however, may not meet the definition of “investment company” in the Investment Company Act. For example, if the company is a majority holder of a Rule 3a-7 issuer, it would not be deemed to be holding “investment securities” of that issuer for purposes of Section 3(a)(1)(C) of the Investment Company Act, and therefore may not trigger the threshold for owning or holding investment securities that would cause it to be an investment company under the Investment Company Act. [\[8\]](#)

The Commission requests comment on whether Rule 3a-7 should be amended to specify that a Rule 3a-7 issuer would be deemed an investment company for the limited purpose of determining the status of a company investing in that issuer pursuant to Section 3(a)(1)(C) of the Investment Company Act. Amending Rule 3a-7 in this manner would require an investing company that holds a majority interest in a Rule 3a-7 issuer to treat securities of the Rule 3a-7 issuer as investment securities in determining its status under the Investment Company Act.

The Commission also requests comment on whether it should instead take the approach of deeming a Rule 3a-7 issuer to be an investment company, but exempting it from the requirements of the Investment Company Act, provided the issuer meets Rule 3a-7's conditions. The Commission notes this approach also would require a holder of the Rule 3a-7 issuer's securities to treat those securities as investment securities for purposes of determining the holder's status under the Investment Company Act.

Second, the Commission explains that business development companies ("BDCs") may be sponsoring and investing in Rule 3a-7 issuers, and that it does not believe that Rule 3a-7 issuers are the type of companies in which Congress intended BDCs to invest. To address this concern, the Commission requests comment on whether Rule 3a-7 should be amended to provide expressly that a Rule 3a-7 issuer is an "investment company" for purposes of the definition of "eligible portfolio company" under the Investment Company Act, which, among other things, requires that a company not be an investment company under Section 3(c) of the Investment Company Act or be excluded from the definition of investment company under Section 3(c). [\[9\]](#)

## **Asset-Backed Issuers Relying on Section 3(c)(5)(C)**

The Commission states that certain asset-backed issuers rely on the exclusion from the definition of investment company in Section 3(c)(5)(C) of the Investment Company Act rather than on Rule 3a-7. The Commission explains that Section 3(c)(5)(C) was intended to exclude from the definition of investment company certain factoring, discounting and mortgage companies, and did not specifically contemplate asset-backed issuers. The ANPR includes a series of questions regarding, among other things, why certain asset-backed issuers rely on Section 3(c)(5)(C) rather than Rule 3a-7, whether the Commission should limit the availability of 3(c)(5)(C) to those companies for which it was originally intended, and what the implications would be for asset-backed issuers, the securitization market, and on capital formation of imposing such a limitation.

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### **endnotes**

[\[1\]](#) Treatment of Asset-Backed Issuers under the Investment Company Act, Investment Company Act Release No. 29779 (August 31, 2011), available at <http://www.sec.gov/rules/concept/2011/ic-29779.pdf>. On the same day the Commission issued the ANPR, it also issued an interpretive release regarding mortgage-related pools that rely on the exclusion from the definition of investment company under Section 3(c)(5)(C) of the Investment Company Act (including real estate investment trusts, or REITs). The Commission has requested comments on that release by November 7, 2011.

See Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments, Investment Company Act Release No. 29778 (August 31, 2011), available at <http://www.sec.gov/rules/concept/2011/ic-29778.pdf>.

[2] That proposal would have replaced the references to credit ratings in Rule 3a-7 with a prohibition on the sale of securities of Rule 3a-7 issuers to anyone other than certain institutional investors. See ANPR, *supra*, note 1, at n.8.

[3] A Rule 3a-7 issuer generally must have fixed-income securities rated by at least one NRSRO in one of its four highest rating categories; any acquisition or disposition of eligible assets in which the issuer invests may not result in a downgrade of the credit ratings on the issuer's fixed-income securities; and cash flows from the eligible assets must be deposited in a segregated account maintained or controlled by an independent trustee, consistent with the ratings of the issuer's fixed-income securities.

[4] Section 939A of the Dodd-Frank Act. The Commission notes, however, that these conditions generally were not intended to serve as standards of creditworthiness.

[5] The Commission acknowledges that Regulation AB generally requires asset-backed issuers to describe much of the information the Commission contemplates "although perhaps not with the same degree of specificity that could be required under this approach." ANPR, *supra* note 1, at n.66.

[6] The ANPR states that potentially any independent person, including an NRSRO, that has the expertise and experience in structuring or evaluating asset-backed issuers and their securities, could serve as the independent evaluator.

[7] The Commission suggests that, alternatively, the rule could require the issuer itself to provide a similar certification in its offering documents, but only after considering the views of an independent evaluator that has reviewed the structure and the intended operations of the issuer.

[8] Section 3(a)(1)(C) of the Investment Company Act defines an "investment company" as an issuer that engages or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of the issuer's assets (excluding Government securities and cash items) on an unconsolidated basis. "Investment securities" are defined in Section 3(a)(2) of the Investment Company Act to include all securities except, as relevant, securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the private investment company exclusions of the Investment Company Act.

[9] See Section 2(a)(46)(B) of the Investment Company Act (defining eligible portfolio company). The Commission states, however, that it understands that BDCs that invest in Rule 3a-7 issuers typically do not treat those issuers as eligible portfolio companies, and requests comment on whether its understanding is correct.

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