

SECURITIES AND EXCHANGE COMMISSION

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Treatment of Asset-Backed Issuers under the Investment Company Act

AGENCY: Securities and Exchange Commission.

ACTION: Advance notice of proposed rulemaking; withdrawal.

SUMMARY: The Commission is considering proposing amendments to Rule 3a-7 under the Investment Company Act of 1940 ("Investment Company Act" or "Act"), the rule that provides certain asset-backed issuers with a conditional exclusion from the definition of investment company. Amendments to Rule 3a-7 that the Commission may consider could reflect market developments since 1992, when Rule 3a-7 was adopted, and recent developments affecting asset-backed issuers, including the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Commission's recent rulemakings regarding the asset-backed securities markets. The Commission is withdrawing its 2008 proposal to amend Rule 3a-7, which was published at 73 FR 40124 (July 11, 2008).

DATES: Comments should be received on or before [insert date that is 60 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:
Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/concept.shtml>);
or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-35-11 on the subject line; or

- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-35-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (<http://www.sec.gov/rules/concept.shtml>). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm.

All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Rochelle Kauffman Plesset, Senior Counsel, at (202) 551-6840 or Nadya Roytblat, Assistant Chief Counsel, at (202) 551-6825, Office of the Chief Counsel, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

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I. INTRODUCTION AND EXECUTIVE SUMMARY

Asset-backed issuers¹ typically meet the definition of investment company under the Investment Company Act, but generally cannot operate under certain of the Act's requirements and restrictions.² In 1992, the Commission adopted Rule 3a-7 under the Investment Company Act specifically to exclude from the definition of investment company certain asset-backed issuers that meet the rule's conditions.³ These conditions were designed to incorporate then-existing practices in the asset-backed securities market that we believed served to distinguish

¹ We use the term "asset-backed issuer" in this release to refer generally to any issuer of fixed-income securities the payments on which depend primarily on the cash flows generated by a specified pool of underlying financial assets. *See also infra* section III.A.2.d.ii for a discussion of the definition of "asset-backed securities" under other federal securities laws.

² *See infra* note 29.

³ 17 CFR 270.3a-7.

asset-backed issuers from registered investment companies and addressed investor protection under the Investment Company Act.⁴

Rule 3a-7 includes several conditions that refer to credit ratings by nationally recognized statistical rating organizations ("NRSROs" or "rating agencies"). One such condition is that certain of the asset-backed issuer's fixed-income securities receive certain credit ratings by at least one rating agency. These conditions were included in Rule 3a-7 not principally as standards of credit-worthiness, but, because we believed that rating agencies, when providing a rating assessing the credit risk of an asset-backed issuer, evaluated whether the issuer was structured in a manner that also addressed investor protection under the Investment Company Act.⁵

The Dodd-Frank Act,⁶ enacted in 2010, generally requires the Commission to review any references to or requirements regarding credit ratings in its regulations, remove these references or requirements and substitute other appropriate standards of credit-worthiness in place of the credit ratings.⁷ Even though the ratings-related conditions in Rule 3a-7 generally were not intended to serve as standards of credit-worthiness, we are issuing this advance notice of

⁴ The conditions also were intended to accommodate future innovations in the securitization market, consistent with investor protection. *See Exclusion from the Definition of Investment Company for Structured Financings*, Investment Company Act Release No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] ("Adopting Release") at text accompanying n.8. Rule 3a-7 effectuated the recommendation made by the Division of Investment Management's staff in its report, *Protecting Investors: A Half Century of Investment Company Regulation*, The Treatment of Structured Finance under the Investment Company Act 1-101 (May 1992) ("Protecting Investors Report"). The Protecting Investors Report contains a discussion of the issues raised by asset-backed issuers under the Investment Company Act and the state of the asset-backed securities market prior to the Rule's adoption.

⁵ *See* Adopting Release, *supra* note 4 at n.42 and accompanying text. *See also infra* note 38.

⁶ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁷ Section 939A of the Dodd-Frank Act.

proposed rulemaking in response to these requirements and in light of market developments since Rule 3a-7 was adopted. We also are withdrawing our 2008 proposal to amend Rule 3a-7.⁸

The Dodd-Frank Act also directed the Commission to undertake a number of rulemakings related to the asset-backed securities market.⁹ Prior to the passage of the Dodd-Frank Act, in April 2010, the Commission proposed comprehensive revisions to the offering process, disclosure, and reporting requirements for asset-backed securities under the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”).¹⁰ The Commission recognized that many of the problems giving rise to the recent financial crisis involved structured finance and proposed a number of changes designed to improve investor

⁸ In 2008, the Commission proposed to replace the references to credit ratings in Rule 3a-7 with a prohibition on the sale of securities of issuers relying on Rule 3a-7 to anyone other than certain institutional investors (“retail sales prohibition”). *References to Ratings of Nationally Recognized Statistical Rating Organizations*, Investment Company Act Release No. 28327 (July 1, 2008) [73 FR 40124 (July 11, 2008)] (“2008 NRSRO Proposing Release”) at nn.36-47 and accompanying text. Commenters generally opposed the retail sales prohibition, suggesting, among other things, that the retail sales prohibition would have unnecessarily precluded offerings to retail investors and impeded the liquidity and growth of the asset-backed securities market. *See, e.g.*, comment letter from Dechert LLP to the Commission (Sept. 5, 2008), File No. S7-19-08 (“Dechert Comment Letter”); comment letter from Mayer Brown LLP to Florence E. Harmon, Acting Secretary (Sept. 4, 2008), File No. S7-19-08; comment letter from the American Bar Association to Florence E. Harmon, Acting Secretary (Sept. 12, 2008), File No. S7-19-08. In a 2009 release, the Commission deferred consideration of this proposal. *See References to Ratings of Nationally Recognized Statistical Rating Organizations*, Investment Company Act Release No. 28940 (Oct. 5, 2009) [74 FR 52374 (Oct. 9, 2009)] at text following n.64. Based, in part, on the comments received, we have decided to withdraw from further consideration the amendments to Rule 3a-7 proposed in the 2008 NRSRO Proposing Release.

⁹ A summary of these Dodd-Frank Act provisions is available at <http://www.sec.gov/spotlight/dodd-frank/assetbackedsecurities.shtml>. *See also Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Securities Exchange Act Release No. 64514 (May 18, 2011) [76 FR 33420 (June 9, 2011)] (proposal requiring third parties retained to conduct due diligence related to asset-backed securities to provide a certification containing specified information to the NRSRO that is producing a rating for the asset-backed securities); *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Securities Act Release No. 9175 (Jan. 20, 2011) [76 FR 4489 (Jan. 26, 2011)] (“Section 943 Release”) (adopting rules requiring securitizers of asset-backed securities to disclose the history of fulfilled and unfulfilled repurchase requests related to their outstanding asset-backed securities and disclosure by NRSROs of representations, warranties and enforcement mechanisms available to investors in an asset-backed securities offering); *Issuer Review of Assets in Offerings of Asset-Backed Securities*, Securities Act Release No. 9176 (Jan. 20, 2011) [76 FR 4231 (Jan. 25, 2011)] (adopting rules requiring issuers of asset-backed securities to conduct a review of the assets underlying those securities and make certain disclosures about those reviews).

¹⁰ *Asset-Backed Securities*, Securities Act Release No. 9117 (Apr. 7, 2010) [75 FR 23328 (May 3, 2010)] (“2010 ABS Proposing Release”).

protection and promote more efficient asset-backed markets.¹¹ Among other things, the Commission proposed to amend: the disclosure requirements of Regulation AB to require that more information be provided to investors about the assets being securitized; the eligibility requirements for public offerings of asset-backed securities conducted through “shelf registration” by replacing the existing requirement that the securities receive an investment grade rating with new requirements; and the safe harbors under the Securities Act for exempt offerings and exempt resales of asset-backed securities.¹² In light of the requirements of the Dodd-Frank Act and the comments subsequently received on the 2010 ABS Proposing Release, the Commission has issued a release revising and re-proposing certain of the proposals in the 2010 ABS Proposing Release.¹³ The 2011 ABS Re-proposal requests comment on whether, to be eligible for shelf registration under the Securities Act, an asset-backed issuer should, among other requirements, meet the conditions of Rule 3a-7.

The Commission also believes that it is appropriate to consider amending Rule 3a-7, among other things, to determine the role, if any, that credit ratings should continue to play in the context of Rule 3a-7. In the aftermath of the recent financial crisis, NRSROs' credit rating procedures and methodologies raised a number of concerns in light of the role the NRSROs played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages, and the Commission has engaged in various regulatory initiatives to address these concerns.¹⁴ The

¹¹ *Id.*

¹² *Id.* See *infra* section III.A.2.d.

¹³ *Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment*, Securities Act Release No. 9244 (July 26, 2011) [76 FR 47948 (Aug. 5, 2011)] (“2011 ABS Re-proposal”).

¹⁴ See, e.g., 2008 NRSRO Proposing Release, *supra* note 8. See also Summary Report of Issues Identified in the Staff’s Examinations of Select Credit Rating Agencies (July 2008). The report can be accessed at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

potential amendments to Rule 3a-7 could include replacing references to credit ratings with conditions that are tailored to address Investment Company Act-related concerns. The Commission also is considering amending Rule 3a-7 to address two issues, detailed below, that have arisen relating to the potential Investment Company Act status of certain holders of securities of asset-backed issuers that rely on Rule 3a-7.

To assist the Commission in its review of the treatment of asset-backed issuers under the Investment Company Act, the Commission is issuing this advance notice of proposed rulemaking and soliciting broad public comment on these issues. The Commission also invites commenters to address any other issues relating to the treatment of asset-backed issuers, the protection of investors under the Investment Company Act and capital formation that they believe may warrant Commission attention.

II. BACKGROUND

A. Asset-Backed Issuers as Investment Companies

An issuer of asset-backed securities typically is a special purpose entity that acquires and holds a pool of income-producing financial assets and issues non-redeemable debt obligations or equity securities with debt-like characteristics (“fixed-income securities”), the payment of which depends primarily on the cash flow generated by the pooled financial assets. An asset-backed issuer that has more assets, or expects to receive more income, than needed to make full payment on the fixed-income securities also may sell interests in the residual or additional cash flow.¹⁵

¹⁵ For a more complete explanation of the structure of an asset-backed issuer and the roles of the various parties that may be involved in the organization and operation of the issuer, *see, e.g.*, 2010 ABS Proposing Release, *supra* note 13; Kravitt, *Securitization of Financial Assets*, (2d ed. 2009) (“Kravitt”); *Asset-Backed Securities*, Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506 (Jan. 7, 2005)] (“2004 ABS Release”); *Exclusion from the Definition of Investment Company for Certain Structured Financings*, Investment Company Act Release No. 18736 (May 29, 1992) [57 FR 23980 (June 5, 1992)] (“Proposing Release”).

An asset-backed issuer typically meets the definition of investment company under Section 3(a)(1) of the Investment Company Act because it issues securities¹⁶ and is engaged in the business of investing in, owning or holding financial assets that are securities¹⁷ under the Investment Company Act.¹⁸ With respect to investment companies generally, as set forth in Section 1(b) of the Act,¹⁹ Congress was concerned, among other things, about companies that were: (i) organized, operated, managed, or their portfolio securities selected, in the interest of company insiders;²⁰(ii) issuing excessive amounts of senior securities;²¹(iii) when computing the

¹⁶ Section 2(a)(36) of the Investment Company Act broadly defines "security" as "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

¹⁷ See, e.g., SEC, *Report on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 328 (1966) (stating that notes representing the sales price of merchandise, loans to manufacturers, wholesalers, retailers and purchasers of merchandise or insurance, and mortgages and other interests in real estate are investment securities for purposes of the Investment Company Act). See also *Protecting Investors Report*, *supra* note 4, at n. 339 and accompanying text.

¹⁸ Section 3(a)(1)(A) of the Act defines an investment company as any issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities." Section 3(a)(1)(C) defines an investment company as any issuer which "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities [as defined by Section 3(a)(2) of the Investment Company Act] having a value exceeding 40 per centum of the value of [its] total assets (exclusive of Government securities and cash items) on an unconsolidated basis" ("40% investment securities test"). Section 3(a)(2) of the Investment Company Act defines "investment securities" to include all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries that are not themselves (i) investment companies and (ii) are not relying on the private investment company exclusions of that Act. Asset-backed issuers typically meet the definition of investment company in Section 3(a)(1)(A) and/or Section 3(a)(1)(C). 15 U.S.C. 80a-3(a)(1). See also *infra* note 30 (discussing statutory exclusions from the definition of investment company that may be available to certain asset-backed issuers).

¹⁹ 15 U.S.C. 80a-1(b).

²⁰ A study conducted prior to the adoption of the Act documented numerous instances in which investment companies were managed for the benefit of their sponsors and affiliates to the detriment of investors. *Investment Trusts and Investment Companies: Hearings on S.3580 Before a Subcomm. of the Senate Comm. On Banking and Currency*, 3d Sess. 89 (1940) ("Investment Trusts Study"). Section 17 of the Investment Company Act prohibits certain transactions involving investment companies and their affiliates. 15 U.S.C. 80a-17(a). Other provisions of the Investment Company Act also effectively limit opportunities for overreaching by investment company sponsors and affiliates. See, e.g., Section 10(f) of the Investment Company, which generally prohibits a registered investment

asset value of their outstanding securities, employing unsound or misleading methods, or not being subjected to adequate independent scrutiny;²² and (iv) operating without adequate assets.²³

In addition, the Investment Company Act reflected concerns that the assets of investment companies were not adequately protected, with controlling persons of investment companies commingling the investment company's assets with their own and then proceeding to misappropriate them.²⁴

Like most investment companies, asset-backed issuers typically have no employees and must rely for their operations on their sponsors, servicers and other persons, each of whom has its own separate and distinct set of financial and other interests. Furthermore, with the exception of the role typically assigned to the trustee, the sponsor, or a person affiliated with the sponsor, potentially could be responsible for most, if not all, of the operations of an asset-backed issuer.²⁵

This structure presents significant potential for conflicts of interest. Thus, for example, one

Investment Company Act-related concern is the possibility of a sponsor intentionally

company from knowingly purchasing, during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an affiliated person of the investment company. 15 U.S.C. 80a-10(f).

²¹ Prior to 1940, some investment companies were highly leveraged through the issuance of "senior securities" in the form of debt or preferred stock, which often resulted in the companies being unable to meet their obligations to the holders of their senior securities. *See id.* Excessive leverage also greatly increased the speculative nature of the common stock of the companies. *Id.* Section 18 of the Investment Company Act limits the ability of registered investment companies to engage in borrowing and to issue senior securities. 15 U.S.C. 80a-18.

²² Prior to 1940, investment companies often valued their portfolios inaccurately, resulting in unfair and discriminatory practices in the pricing of their securities. *See* Investment Trusts Study, *supra* note 20. The Investment Company Act governs the manner in which registered investment companies value their portfolios, including defining "value" in Section 2(a)(41), with respect to securities held by a registered investment company, to be (a) market value for securities for which market quotations are readily available or (b) for other securities or assets, fair value as determined in good faith by the company's board of directors. 15 U.S.C. 80a-2(a)(41).

²³ *See* Investment Trusts Study, *supra* note 20.

²⁴ *See, e.g.,* Investment Trusts Study, *supra* note 20. Prior to 1940, investment company assets were not adequately protected from misuse by investment company insiders. *Id.* In many cases, controlling persons of investment companies commingled the investment companies' assets with the investment advisers' assets and then proceeded to misuse the assets themselves. *Id.* Section 17(f) of the Investment Company Act and the rules thereunder set forth requirements with respect to the custody of investment company assets. 15 U.S.C. 80a-17(f). *See, e.g.,* Rule 17f-2 under the Investment Company Act governing custody of investments by a registered investment company. 17 CFR 270.17f-2.

²⁵ *See, e.g.,* Proposing Release, *supra* note 15 at n.95 and accompanying text.

overvaluing assets or “dumping” into the asset-backed issuer assets that are insufficient to produce the cash flow needed to meet the issuer’s obligations to its securities holders, contrary to representations made to investors.²⁶ Another Investment Company Act-related concern is that a sponsor potentially could substitute inferior assets for the assets transferred to the issuer at the time of securitization.²⁷ Still another Investment Company Act-related concern relates to the safeguarding of the issuer’s assets and the cash flow derived from such assets from being jeopardized, among other things, by the servicer or the trustee commingling the assets and the cash flow with their own assets or by the servicer or trustee investing the issuer’s cash flow in a speculative manner.²⁸

B. Rule 3a-7

Although asset-backed issuers typically meet the definition of investment company, as a practical matter, they cannot operate under certain of the Investment Company Act’s requirements and restrictions.²⁹ As a result, asset-backed issuers often rely on Rule 3a-7 under the Investment Company Act to be excluded from regulation under the Act.³⁰ The Commission

²⁶ See, e.g., *SEC v. Patrick Quinlan, et al.*, 2008 Fed. Sec. L. Rep. (CCH) ¶95,005 (E.D. Mich. Nov.7, 2008), *aff’d*, 373 Fed. Appx. 581 (6th Cir., 2010) (the Commission brought an enforcement action against the sponsor of a mortgage-backed issuer that placed in the issuer a large number of mortgages that the sponsor itself had originated whose loan-to-value ratios exceeded the maximum loan-to-value ratios stated in the issuer's prospectus, significantly increasing the riskiness of the investment).

²⁷ See Protecting Investors Report, *supra* note 4 at text following n.281.

²⁸ See *id.* at text following n.289.

²⁹ For example, Section 17(a) of the Investment Company Act generally would prohibit the sponsor’s sale of assets to the asset-backed issuer. 15 U.S.C. 80a-17(a). In addition, certain asset-backed issuers could not comply with Section 18 of the Act, which generally limits the extent to which registered investment companies may issue senior securities, including debt. 15 U.S.C. 80a-18. See Proposing Release, *supra* note 15 at n.36; Protecting Investors Report, *supra* note 4 at n.253 and accompanying text.

³⁰ Certain asset-backed issuers alternatively may seek to rely on the exclusion from the definition of investment company set forth in Section 3(c)(5)(A), (B) or (C) of the Investment Company Act. 15 U.S.C. 80a-3(c)(5). See *infra* section III.C. The Commission today is issuing a concept release concerning companies that rely on Section 3(c)(5)(C). *Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments*, Investment Company Act Release No. 29778 (Aug. 31, 2011) (the "Section 3(c)(5)(C) Concept Release"). That release may be relevant to certain asset-backed issuers that rely on that Section. See *infra* section III.C.

adopted Rule 3a-7 in 1992 specifically to exclude from the definition of investment company certain asset-backed issuers that meet the rule's conditions.³¹ These conditions were intended to reflect the structural and operational distinctions between registered investment companies and asset-backed issuers,³² and incorporated what we believed to be then-existing practices in the asset-backed securities market that addressed investor protection under the Investment Company Act and promoted capital formation.³³ The conditions also were intended to accommodate future developments in the asset-backed securities market, consistent with investor protection.³⁴

III. DISCUSSION

A. Revisiting Rule 3a-7

To rely on Rule 3a-7, an asset-backed issuer must issue fixed-income securities or other securities which entitle the holders to receive payments that depend primarily on the cash flow

As yet another alternative, asset-backed issuers that privately offer and sell their securities may seek to rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, commonly referred to as the "private investment company exclusions." 15 U.S.C. 80a-3(c)(1); 15 U.S.C. 80a-3(c)(7). Section 3(c)(1) generally excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making and does not presently propose to make a public offering of its securities. 15 U.S.C. 80a-3(c)(1). Section 3(c)(7) of the Investment Company Act generally excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are certain sophisticated investors, called "qualified purchasers," and which is not making and does not at that time propose to make a public offering of its securities. 15 U.S.C. 80a-3(c)(7). *See* Section 2(a)(51) of the Investment Company Act (defining the term qualified purchaser). 15 U.S.C. 80a-2(a)(51). Section 3(c)(7) may be a particularly useful exclusion for asset-backed issuers that privately offer and sell their securities because, unlike Section 3(c)(1), it does not limit the number of investors that may hold the issuer's securities and many investors in asset-backed securities are large institutional investors that meet the definition of qualified purchaser under the Act. *See, e.g.,* Kravitt, *supra* note 15 at 12.03[D].

³¹ Prior to the adoption of Rule 3a-7, the Commission had issued approximately 125 orders under Section 6(c), the Investment Company's Act general exemptive provision, which provided exemptive relief to certain asset-backed issuers, primarily those holding mortgage-related assets. 15 U.S.C. 80a-6(c). *See, e.g.,* Mortgage Bankers Financial Corp. I, *et al.*, Investment Company Act Release Nos. 16458 (June 28, 1988), 53 FR 25226 (notice of application) and 16497 (July 25, 1988), 41 SEC Docket 814 (order); Shearson Lehman CMO, Inc., Investment Company Act Release Nos. 15796 (June 11, 1987), 52 FR 23246 (notice of application) and 15852 (July 2, 1987), 38 SEC Docket 1403 (order). The Commission has not issued any such orders since Rule 3a-7 was adopted in 1992.

³² For example, an issuer relying on Rule 3a-7 may not issue redeemable securities, because "investors could confuse the securities with those issued by open-end management investment companies." Proposing Release, *supra* note 15, at n. 61 and accompanying text.

³³ Adopting Release, *supra* note 4 at text following n.8.

³⁴ *Id.*

from eligible assets.³⁵ The rule provides that the issuer’s fixed-income securities generally must be rated by at least one NRSRO in one of the four highest ratings categories.³⁶ At the time the rule was adopted, the Commission understood that NRSROs, in providing credit ratings for fixed-income securities of asset-backed issuers, typically expected the issuers to have certain structural safeguards.³⁷ The Commission viewed these safeguards as addressing investor protection under the Investment Company Act.³⁸

For example, in providing a credit rating for certain asset-backed securities, the NRSROs, among other things, were understood to typically: review the specific assets to be transferred to the issuer or the method by which the assets were selected; expect an independent auditor to confirm that the asset pool was representative of the sponsor’s portfolio; and evaluate limitations placed on the substitution of the issuer’s assets and the reinvestment of the cash flow derived from the assets.³⁹ Such expected review by an NRSRO had the perceived benefit of mitigating

³⁵ Rule 3a-7(b)(1) defines eligible assets to be financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

³⁶ Rule 3a-7(a)(2). When Rule 3a-7 was adopted, almost all publicly offered fixed-income securities issued by asset-backed issuers were rated by at least one rating agency, with most issuing at least one class of fixed-income securities rated in one of the top two categories. *See* Protecting Investors Report, *supra* note 4 at nn. 187-188 and accompanying text. Rule 3a-7 contains an exception from the rating requirement that permits non-investment grade or unrated fixed-income securities to be sold to institutional accredited investors and any security, without regard to type or rating, to be sold to qualified institutional buyers or to persons involved in the organization or operation of the issuer and their affiliates, provided that the issuer and its underwriters use reasonable care to ensure that all excepted sales and resales are to such persons. *See* Rule 3a-7(a)(2). The exception reflected then-existing industry practice that subordinate tranches of fixed-income asset-backed securities issuances, which typically were not highly rated, if rated at all, and residual interests in the issuer, were placed with certain sophisticated investors. Proposing Release, *supra* note 15 at n.77 and accompanying text.

³⁷ Adopting Release, *supra* note 4, at text following n. 42. As noted above, the recent financial crisis has exposed various problems with the ratings process and the NRSROs’ procedures and methodologies. *See supra* note 14.

³⁸ Adopting Release, *supra* note 4. The Commission also explained that the rating requirement also served as a means of distinguishing asset-backed issuers from registered investment companies. The Commission, however, emphasized that, “although ratings generally reflect evaluations of credit risk, the rating requirement [was] not intended to address investment risks associated with the credit quality of a financing.” Adopting Release, *supra* note 4 at text following n.41.

³⁹ Protecting Investors Report, *supra* note 4 at nn. 208-211 and accompanying text, n. 218 and accompanying text, and text following n.292 and prior to n.293.

opportunities for self-dealing and overreaching by the sponsor or other insiders of the asset-backed issuer.⁴⁰ In addition, the NRSROs were understood to analyze the potential performance of the issuer's assets, the risks related to the issuer's cash flow and the cash flow allocation with respect to the payment of the fixed-income securities. Such analysis was viewed as addressing potential concerns relating to misvaluation of the issuer's assets and inadequate asset coverage.⁴¹ The NRSROs also were understood to review whether the asset-backed issuer's assets would be available in the event of the sponsor's insolvency, and evaluate the processes and controls regarding the custody of the issuer's assets and cash flow. Such review was viewed as addressing concerns relating to the safekeeping of the issuer's assets.⁴²

Rule 3a-7 also imposes limitations on the acquisition and disposition of the eligible assets that were intended to help ensure that any changes in the issuer's assets would not adversely affect the outstanding fixed-income securities holders and guard against self-dealing and overreaching by the issuer's sponsor or servicer.⁴³ The restrictions also were intended to prevent activities that resemble the portfolio management practices employed by registered management investment companies.⁴⁴ Under the rule, an issuer generally may acquire additional eligible assets or dispose of such assets only if that action complies with the terms and conditions set forth in the issuer's organizational documents.⁴⁵ In addition, any acquisition or disposition of eligible assets may not result in a downgrading of the rating of the issuer's fixed-income

⁴⁰ *Id.* at text following n.292.

⁴¹ *Id.* at nn.212, 220-221 and 293 and accompanying text.

⁴² *Id.* at nn.294-295 and accompanying text.

⁴³ *See* Adopting Release, *supra* note 4 at n. 66 and accompanying text.

⁴⁴ *Id.* at n.62 and accompanying text. *See also infra* section III.A.3. For example, Rule 3a-7 does not permit the acquisition or disposition of eligible assets for the primary purpose of recognizing gains or losses resulting from market changes. Rule 3a-7(a)(3)(iii).

⁴⁵ Rule 3a-7(a)(3)(i).

securities.⁴⁶ The rule also does not permit the acquisition or disposition of eligible assets for the primary purpose of recognizing gains or losses resulting from market changes.⁴⁷

Finally, the rule includes conditions addressing the safekeeping of the issuer's eligible assets and the cash flow derived from such assets. Among other things, the issuer generally must take reasonable steps to cause an independent trustee⁴⁸ to have a perfected security interest or ownership interest valid against any third parties in the eligible assets that principally generate the cash flow needed for payment on the fixed-income securities.⁴⁹ In addition, the cash flow derived from the eligible assets that is received by the servicer must be deposited periodically in a segregated account that is maintained or controlled by the independent trustee, "consistent with the rating of the outstanding fixed-income securities."⁵⁰ This reference to the rating reflected what the Commission understood to be the practice of NRSROs, in issuing the rating, to review the capability of the issuer's servicer to perform its duties, including the risk of loss from the servicer holding the cash flow derived from the eligible assets.⁵¹

⁴⁶ Rule 3a-7(a)(3)(ii). The Commission explained that tying the management of the issuer's eligible assets to the rating of the fixed-income securities addressed the danger of self-dealing, because any addition or removal of assets that adversely affected the fixed-income securities holders was understood to result in a downgrading of the issuer's outstanding fixed-income securities. *See* Adopting Release, *supra* note 4 at n.66 and accompanying text.

⁴⁷ Rule 3a-7(a)(3)(iii).

⁴⁸ Rule 3a-7(a)(4)(i) generally requires that the trustee be a bank that meets the requirements of Section 26(a)(1) of the Investment Company Act and that is not affiliated, as that term is defined in Rule 405 under the Securities Act, with the issuer or with any person involved in the organization or operation of the issuer, that does not offer or provide credit or credit enhancement to the issuer, and that executes an agreement or instrument concerning the issuer's securities containing provisions to the effect set forth in Section 26(a)(3) of the Investment Company Act, limiting when the trustee may resign. 15 U.S.C. 80a-26(a)(3).

⁴⁹ Rule 3a-7(a)(4)(ii).

⁵⁰ Rule 3a-7(a)(4)(iii).

⁵¹ *See* Proposing Release, *supra* note 15 at n.31. *See also* Adopting Release, *supra* note 4 at text following n.82; Kravitt, *supra* note 15 at 7.03[E].

1. Rating Requirements

As discussed above, Rule 3a-7 contains references to ratings in three of the rule's conditions. Specifically, an asset-backed issuer relying on Rule 3a-7 generally must have its fixed-income securities rated by at least one NRSRO in one of the four highest ratings categories.⁵² In addition, any acquisition or disposition of eligible assets may not result in a downgrading of the rating of the issuer's fixed-income securities.⁵³ Finally, the cash flow derived from the eligible assets that is received by the servicer must be deposited periodically in a segregated account that is maintained or controlled by an independent trustee, "consistent with the rating of the outstanding fixed-income securities."⁵⁴ In each case, the reference to ratings was intended to be a type of proxy for the relevant investor protections afforded by the Investment Company Act.⁵⁵ The condition that the fixed-income securities be rated also was viewed as a means of distinguishing asset-backed issuers from most registered investment companies.⁵⁶

The Commission is considering eliminating the references to ratings in Rule 3a-7. We question whether such references have served, as intended, as a proxy to address Investment Company Act-related concerns, and whether it continues to be appropriate for Rule 3a-7 to make use of ratings in this manner. Accordingly, we ask for comment on the type of analysis that rating agencies currently conduct in providing credit ratings for the fixed-income securities of asset-backed issuers, and the types of structural safeguards that rating agencies expect asset-backed issuers to have, that also address Investment Company Act-related

⁵² Rule 3a-7(a)(2).

⁵³ Rule 3a-7(a)(3)(ii).

⁵⁴ Rule 3a-7(a)(4)(iii).

⁵⁵ *See supra* note 38 and accompanying text.

⁵⁶ *Id.*

concerns.⁵⁷ Please provide a full explanation of whether, and if so how, the actions and expectations of the rating agencies today mitigate the potential for the types of abuses otherwise addressed by the Investment Company Act.

- Do ratings today serve as a proxy for addressing Investment Company Act-related concerns? If so, are there mechanisms in place that help ensure that NRSROs conduct the type of analysis and review of asset-backed issuers' structures and operations that serve to address Investment Company Act-related concerns?

- Did the revelations concerning the NRSROs' processes, policies and methodologies arising out of the recent financial crisis also suggest that ratings failed to serve as a proxy for addressing Investment Company Act-related concerns?

- Even if the actions and expectations of the rating agencies with respect to asset-backed issuers today mitigate the potential for Investment Company Act-related concerns, does it continue to be appropriate to rely on ratings as a proxy for addressing Investment Company Act-related concerns in Rule 3a-7?

- Should some or all of the references to ratings be removed from the rule? Should the references to ratings be replaced with other conditions? What would be the economic impact of removing the references to ratings in Rule 3a-7 and of any suggested new conditions?

- Should Rule 3a-7 continue to require that the fixed-income securities be rated regardless of whether any other conditions are added to the rule? To the extent that the ratings requirements in the rule are perceived to be or are useful as a measure of credit-worthiness, what

⁵⁷ See *supra* section III.A.1 (describing the types of review we believed was conducted by the rating agencies when the rule was adopted).

substitute standards should the Commission consider adopting in accordance with Section 939A of the Dodd-Frank Act?⁵⁸ We ask commenters to fully explain their views.

We note that, as discussed in greater detail below, various provisions of the Dodd-Frank Act and Commission rules thereunder, as well as the 2010 ABS Proposing Release and 2011 ABS Re-proposal, set forth requirements relating to certain asset-backed issuers and certain persons involved in the organization and operation of asset-backed issuers, that may serve to address the same Investment Company Act-related concerns as those that underlie the references to ratings in Rule 3a-7.⁵⁹ As detailed below, we ask for comment on whether any such requirements should be included as conditions to the exclusion from the definition of investment company provided by Rule 3a-7.⁶⁰

We also note that, although Rule 3a-7 generally states that fixed-income securities of an asset-backed issuer must be rated by at least one NRSRO in one of the four highest rating categories, the text of the rule does not require fixed-income securities of a Rule 3a-7 issuer to be rated, provided that the securities are sold and resold only to certain sophisticated investors.⁶¹ We request comment on whether and, if so, to what extent, any issuer has relied on Rule 3a-7 to offer fixed-income securities to the sophisticated investors specified in the rule without any tranche of the issuer's fixed-income securities being rated in the categories specified in the rule. If so, please explain whether these securities were offered publicly or privately.

⁵⁸ See *supra* note 7 and accompanying text (Section 939A of the Dodd-Frank Act generally requires the Commission to review any references to or requirements regarding credit ratings in its regulations, remove these references or requirements and substitute other appropriate standards of credit-worthiness in place of the credit ratings).

⁵⁹ See *infra* section III.A.2.d.

⁶⁰ *Id.*

⁶¹ See *supra* note 36.

2. Possible New Conditions for Rule 3a-7

We ask for comment on the conditions that should be added to Rule 3a-7 to directly address investor protection under the Investment Company Act.⁶² These investor protection issues generally can be characterized as falling into the following areas: (i) concerns about self-dealing by insiders, misvaluation of assets and inadequate asset coverage as they relate to the structure and operation of the asset-backed issuer; (ii) the benefits of an independent review of the asset-backed issuer's structure and intended operations in addressing these concerns; and (iii) preservation and safekeeping of the asset-backed issuer's eligible assets and cash flow.

Each of these investor protection issues is discussed in greater detail below. Although the Commission has identified these particular issues, the Commission requests and encourages commenters to provide both thoughts about the types of investor protection concerns under the Investment Company Act presented by asset-backed issuers and suggestions as to the types of conditions that should be included in Rule 3a-7 to address these concerns. We also ask for comment on the changes in the asset-backed securities market since 1992, whether such changes present other issues or concerns under the Investment Company Act that we have not described, and how Rule 3a-7 should address them. We ask that commenters fully explain their recommendations, including how any suggested conditions would directly address investor protection under the Investment Company Act, and well as how such suggestions might affect capital formation. We also ask commenters to provide suggested rule text.

⁶² We note that this approach was suggested by a commenter that had responded to the Commission's request for comment in the 2008 NRSRO Proposing Release. *See* comment letter from Shearman & Sterling LLP (on behalf of its client Merrill Lynch Depositor Inc.) to Florence E. Harmon, Acting Secretary (Sept. 24, 2008), File Nos. S7-18-08 and S7-19-08 ("if the Commission feels it necessary that Rule 3a-7 be amended, our client feels that the Commission's proposal that the rating requirement be replaced with alternative specific requirements regarding abuses that the Investment Company Act is designed to address, such as self-dealing and overreaching by issuers, misvaluation of assets, and inadequate asset coverage, is worth further consideration by the Commission . . .").

a. Structure and Operation of the Issuer

In many respects, the Investment Company Act is generally intended to address the structural and operational integrity of an issuer in relation to the securities being issued.⁶³ In the context of an asset-backed issuer that may use the exclusion provided by Rule 3a-7, the concern is with the possibility of abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage.⁶⁴ For example, the asset-backed issuer's sponsor, among other things, might potentially engage in intentional misvaluation of assets or in a form of “dumping” by transferring assets insufficient to produce the cash flow needed to meet the issuer’s obligations to its securities holders, contrary to representations made to investors. In addition, once the securities are issued, any person involved in the operation of the issuer potentially might engage in activities that could adversely affect payment of the outstanding fixed-income securities. Such activities might include, for example, substituting assets in the pool after the time of securitization with lower quality assets, investing the issuer’s cash flow in a speculative manner, or other activities that present potential conflicts of interest.

There are various approaches that the Commission could take to address these types of concerns in Rule 3a-7. The rule could 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 assets should be selected and valued to avoid potential "dumping" of assets and misvaluation. The rule also could specify the particular manner in which the issuer's depositor and sponsor may structure the issuer to help guard against self-dealing and overreaching by these insiders. The rule further could prohibit any person involved in the

⁶³ See *e.g.*, *supra* notes 19-24 and accompanying text.

⁶⁴ See Proposing Release, *supra* note 15, at nn. 69 and 70 and accompanying text.

operation of the issuer from engaging in specific activities that may adversely affect payment of the fixed-income securities consistent with their terms.

Alternatively, the rule could take a principles-based approach that would be less prescriptive. For example, among other things, the rule could require that the parameters of the issuer's organization and operations be set forth in its organizational documents, with the goal of mitigating potential opportunities for self-dealing and overreaching on the part of the issuer and any person involved in the organization or operation of the issuer. To this end, the rule could require that the issuer's organizational documents set forth: (i) the specific roles and responsibilities of any person involved in the organization or operation of the issuer; (ii) the specific terms and conditions pursuant to which the issuer may acquire or dispose of eligible assets; and (iii) policies and procedures that are reasonably designed to prevent insiders from engaging in activities that may adversely affect payment of the fixed-income securities after the securities are sold. We understand that the current industry practice of publicly-offered asset-backed issuers is to set forth the parameters of the issuer's organization and operations in the issuer's organizational documents,⁶⁵ with varying degrees of specificity.⁶⁶

The Commission requests comment on the types of conditions that may be appropriate for Rule 3a-7 to provide structural and operational safeguards for asset-backed issuers that seek to rely on the rule.

⁶⁵ An issuer's organizational documents must be filed as exhibits to the registration statement. *See* Item 60 of Regulation S-K [17 CFR 229.60].

⁶⁶ We note, for example, that Regulation AB generally requires asset-backed issuers to describe much of this information in their registration statements, although perhaps not with the same degree of specificity that could be required under this approach. *See, e.g.*, Item 1104(d) (requiring a description of the sponsor's material roles and responsibilities in its securitization program); Item 1107(b) (requiring a description of the permissible activities of the issuer); Item 1108(a)(1) (requiring a description of the roles, responsibilities and oversight requirements of the servicers involved in a transaction) [17 CFR 229.1104(d), 1107(b), 1108(a)(1)]. In addition, as discussed previously, under current Rule 3a-7, an issuer generally may acquire additional eligible assets or dispose of such assets only if that action complies with the terms and conditions set forth in the issuer's organizational documents. *See supra* note 45 and accompanying text.

- Is one of the possible approaches discussed above more consistent with investor protection than, or otherwise preferable to, the other? If so, which one and why? What would be the impact of such an approach on capital formation?
- What would be the potential economic impact of the approaches discussed above?
- If the rule were to impose specific requirements or limitations on the structure and operations of an asset-backed issuer relying on the rule, what should those requirements or limitations be, and what would be the likely benefits and costs of such requirements or limitations?
- Should the rule require an issuer's organizational documents to set forth the types of information suggested above? How would such a requirement change current practice?
- Rule 3a-7(a)(3)(i) currently provides that an issuer generally may acquire additional eligible assets or dispose of eligible assets only in accordance with the specific terms and conditions of the issuer's organizational documents. Should that condition be expanded to cover the initial transfer of eligible assets to the issuer at the time of securitization, in order to mitigate opportunities for dumping and other potential abuses by insiders that exist both at the time of the initial transfer of the assets to the issuer and over the course of the operation of the issuer? If the condition were so expanded, would it help mitigate such potential abuses?
- Are there other approaches that the Commission should consider that would adequately address Investment Company Act-related concerns such as self-dealing and overreaching, misvaluation, and inadequate asset coverage?⁶⁷ If so, what types of approaches, why and with what economic impact? We ask commenters to fully explain their views and, if appropriate, provide rule text and supporting data.

⁶⁷ One approach to addressing these concerns might be to include a condition in Rule 3a-7 that provides for an independent third party review of the issuer's structure and intended operations. We discuss such a condition in the next section. *See infra* section III.A.2.b.

- Are there other Investment Company Act-related concerns that Rule 3a-7 should address besides self-dealing, misvaluation and inadequate asset coverage? If so, what are those concerns and how should the rule address them? For example, one of the Investment Company Act-related concerns is the pyramiding of investment companies.⁶⁸ Should Rule 3a-7 address this concern?⁶⁹ If so, why and how should the rule address it? Should the rule restrict the ability of an issuer relying on the rule to invest in other asset-backed issuers? If so, what restrictions should the rule impose?

b. Independent Review

The concept of independent oversight or independent review is fundamental to the regulatory framework of the Investment Company Act.⁷⁰ Registered investment companies typically rely for their structure and operations on third parties that have their own financial interests separate and distinct from those of the investment companies and their shareholders, presenting potential conflicts of interest that require independent oversight. The independent oversight in the case of registered management investment companies is provided by the company's board of directors, and in particular the independent board members, as required by the Act.⁷¹

⁶⁸ See Section 1(b)(4) of the Investment Company Act. Cf. *Fund of Funds Investments*, Investment Company Act Release No. 26198 (Oct. 1, 2003) ("The complex structures that resulted from pyramiding created additional problems for shareholders. These structures permitted acquiring funds to circumvent investment restrictions and limitations, and made it impossible for shareholders to understand who really controlled the fund or the true value of their investments.").

⁶⁹ We note, for example, that the Financial Crisis Inquiry Commission found that investments by issuers of collateralized debt obligations ("CDOs) in other CDOs magnified total leverage and increased exposure to loss. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (Jan. 2011) at 132-134, 155. See also *The Report of the Counterparty Risk Management Policy Group III, Containing Systemic Risk: The Road to Reform* (Aug. 6, 2008) at 55 (discussing CDOs that invested in other CDOs).

⁷⁰ See generally Section 1(b) of the Investment Company Act.

⁷¹ See Section 10 of the Investment Company Act governing the composition of a registered investment company's board of directors.

Asset-backed issuers are similar to registered investment companies in that they also typically rely for their structure and operations on third parties that have their own financial interests separate and distinct from those of the asset-backed issuers and their fixed-income securities holders.⁷² We are considering whether to replace the rating condition currently contained in Rule 3a-7, in part, with a condition that would provide for an independent review of the asset-backed issuer and its intended operations prior to the sale of the fixed-income securities. Such a condition could require the asset-backed issuer to obtain an opinion from an independent evaluator 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. Such an opinion would not serve as a guarantee that the securitization will produce such cash flow. Alternatively, the rule could require the issuer itself to provide a similar certification in its offering documents, but to do so only after considering the views of an independent evaluator that has reviewed the structure and the intended operations of the issuer. For purposes of such a condition, potentially any independent person, including an NRSRO, that has the expertise and experience in the structuring or evaluating of asset-backed issuers and their securities, could serve as the independent evaluator.

We note that, in the 2011 ABS Re-proposal, we proposed replacing the investment grade ratings criterion for shelf eligibility for asset-backed securities offerings with a requirement that

⁷² See *supra* note 25 and accompanying text.

a certification be provided by either the chief executive officer of the depositor or the executive officer in charge of securitization of the depositor.⁷³ As we stated in the 2011 ABS Re-proposal, such a certification may cause these officials to review more carefully the disclosure and the transaction, and to participate more extensively in the oversight of the transaction. In the 2011 ABS Re-proposal, we also requested comment on whether an asset-backed issuer should have the flexibility to engage an independent evaluator to perform the review necessary to give the certification, and the type of opinion that the independent evaluator would provide.⁷⁴

If Rule 3a-7 were to be amended to include a condition requiring independent review, the amendment would be premised on the need to address concerns arising under the Investment Company Act about self-dealing and overreaching by insiders.⁷⁵ Thus, the purpose of the independent review under Rule 3a-7 would be different from that which might be performed in connection with the certification requirement proposed in the 2011 ABS Re-proposal. Nevertheless, the scope of the review under any independent review provisions in the shelf eligibility conditions and those in Rule 3a-7 could be consistent so that one review could satisfy both purposes.⁷⁶

We request comment on whether Rule 3a-7 should require an independent review of the structure and intended operations of the asset-backed issuer.

- Would such a review serve to address Investment Company Act-related concerns?

⁷³ As proposed, such certification would state, among other things, that based on the officer's knowledge, "taking into account the characteristics of the securitized assets underlying the offering, the structure of the securitization, including internal credit enhancements, and any other material features of the transaction, in each instance, as described in the prospectus, the securitization is designed to produce, but is not guaranteed by this certification to produce, cash flows at times and in amounts sufficient to service expected payments on the asset-backed securities offered and sold pursuant to the registration statement." See 2011 ABS Re-proposal, *supra* note 13 at proposed Item 601(b)(36) of Regulation AB.

⁷⁴ See 2011 ABS Re-proposal, *supra* note 13 at text following n. 58.

⁷⁵ As discussed above, within the framework of the Investment Company Act, these concerns are addressed through independent review. See *supra* note 70 and accompanying text.

⁷⁶ See also *infra* section III.A.2.d.

- What should be the scope of the independent review under Rule 3a-7? What should be the standard(s) for the conclusion(s) reached by the independent evaluator for purposes of Rule 3a-7?
- What should be the independence requirements for an entity to serve as an independent evaluator for purposes of Rule 3a-7? We note that the 2011 ABS Re-proposal requests comment on certain potential independence requirements for an independent evaluator, such as prohibitions on affiliation with the issuer or any person involved in the organization or operation of the issuer, on ownership of the issuer's securities or underlying assets, and on certain material business relationships.⁷⁷ Would similar requirements be appropriate in the context of Rule 3a-7?
- The 2011 ABS Re-proposal also requests comment on whether it would be appropriate to define an independent evaluator as a person that has the expertise and experience in the structuring or evaluating of asset-backed securities. Would this be an appropriate definition of an independent evaluator for purposes of Rule 3a-7?
- Should we impose any additional or different requirements on an independent evaluator? For example, should consideration be given to whether the independent evaluator is subject to federal regulation or how the independent evaluator is regulated?
- What steps should the asset-backed issuer be required to take to determine whether a prospective independent evaluator meets the qualifications to serve as an independent evaluator under Rule 3a-7? Should the asset-backed issuer be able to rely on a statement of the prospective independent evaluator, for example, that the prospective independent evaluator has

⁷⁷ 2011 ABS Re-proposal, *supra* note 13 at nn.60-61 and accompanying text.

the required expertise and experience? Should the asset-backed issuer perform some level of due diligence?

- What types of entities may likely serve as independent evaluators under Rule 3a-7? We are interested in particular in hearing from commenters that may meet the possible independent evaluator qualifications discussed above whether they might be interested in serving as independent evaluators if such a condition were to be included in Rule 3a-7, and if not, why not.

- Should rating agencies be allowed to serve as independent evaluators under Rule 3a-7? Why or why not?

- If an independent evaluator condition were to be included in Rule 3a-7, should the rule also require the asset-backed issuer to include the independent evaluator's opinion as an exhibit to its registration statement thereby requiring the independent evaluator to consent to being named as an "expert" in the registration statement and being subject to potential liability under Section 11 of the Securities Act?

- What would be the economic impact of including an independent evaluator condition in Rule 3a-7 and what would be the factors affecting the economic impact? Would the economic impact depend on whether the independent evaluator is subject to expert liability? If so, how? How may the risk of expert liability affect the willingness of an entity to serve as an independent evaluator and the price it may charge for its services?

- Is the alternative that the asset-backed issuer itself must provide a certification about its structure and intended operations, but only after considering the views of an independent evaluator, preferable? Why or why not?

- If Rule 3a-7 were to include an independent evaluator condition, would there be circumstances in which compliance with such condition may not be necessary for investor protection? For example, should such a condition not apply with respect to an asset-backed issuer that offers and sells its securities solely to investors that meet certain objective standards, such as being “qualified institutional buyers” within the meaning of Rule 144A under the Securities Act? If such a condition should not apply to certain asset-backed issuers, should such issuers be required to disclose in their offering documents that they are not complying with the independent evaluator condition and explain why? Should such issuers be subject to other, alternative conditions under Rule 3a-7 that would address Investment Company Act- related concerns, including self-dealing and overreaching by insiders?

- Are there other considerations that should factor into the Commission’s determinations on the appropriateness and the details of an independent review in the context of Rule 3a-7? We ask commenters to fully explain their views and provide supporting data, if appropriate.

c. Preservation and Safekeeping of Eligible Assets and Cash Flow

Like registered investment companies, asset-backed issuers are pools of financial assets that are subject to the risk of misappropriation. In addition, unless the asset-backed issuer is structured appropriately, its assets and cash flow might not be insulated in the event of the sponsor’s or depositor’s bankruptcy or insolvency. The issuer’s assets and cash flow also might be endangered if the servicer or trustee commingles them with its own assets. The availability of the issuer’s cash flow to the fixed-income securities holders also could be endangered if the cash flow is invested in a speculative manner.

Rule 3a-7 contains several conditions designed to address the safekeeping of the issuer’s eligible assets and the cash flow derived from such assets. Under the rule, the issuer must take

reasonable steps to cause an independent trustee to have a perfected security interest or ownership valid against third parties in the eligible assets.⁷⁸ The rule also provides for the cash flow from such assets to be deposited periodically in a segregated account maintained or controlled by the independent trustee “consistent with the rating of the outstanding securities.”⁷⁹ In addition, the rule’s condition that the issuer’s fixed-income securities generally receive a rating in one of the four highest rating categories also touches on concerns relating to the safekeeping of the issuer’s assets and cash flow. For example, we understand that asset-backed securities often could not achieve an investment grade rating unless the issuer was structured in such a manner that the assets and cash flow are insulated in the event of the sponsor’s or depositor’s bankruptcy or insolvency.⁸⁰

We ask for comment on whether Rule 3a-7 should be amended to strengthen the provisions relating to the preservation and safekeeping of the asset-backed issuer’s assets and cash flow. For example, the current rule does not limit the practice of servicers commingling the cash flow of asset-backed issuers with their own assets for periods of time prior to transferring it to the trustee.⁸¹ We ask for comment on whether such practice may be unnecessarily putting the cash flow at risk. The current rule also does not address the treatment of the cash flow when there is a timing mismatch between the receipt of collections from the eligible assets and the

⁷⁸ Rule 3a-7(a)(4)(ii).

⁷⁹ Rule 3a-7(a)(4)(iii).

⁸⁰ See, e.g., Proposing Release, *supra* note 15 at n.33 and accompanying text.

⁸¹ Current Rule 3a-7(a)(4) differs significantly from the condition that was initially proposed. The Commission proposed that the cash flow derived from the eligible assets be transferred to the trustee within a reasonable period from the time of receipt. See Proposing Release, *supra* note 15 at nn.90-92 and accompanying text. The Commission explained that the proposed provision was intended to prohibit a servicer from commingling the cash flow with its own assets, arguing that “investor protection concerns outweigh any benefit resulting from the commingling of a servicer’s assets with those of the issuer.” *Id.* at text following n.92. Commenters argued that transferring the cash flow “within a reasonable period of time” was inconsistent with industry practice and that whether a servicer commingled the cash flow with its own assets, and if so, for how long, depended on the type of assets being securitized and the capabilities of the servicer’s computer systems to track the cash flow. See Adopting Release, *supra* note 4 at n.77 and accompanying text.

distributions to the fixed-income securities holders. Are there other aspects of the rule we should consider amending in order to help preserve and protect the asset-backed issuer's assets and cash flow? If so, please provide specific suggestions for such amendments, including, where possible, suggested rule text.

We also note the irregularities that had recently surfaced that have caused difficulties in determining the ownership of certain mortgages that had been securitized.⁸² As discussed, under Rule 3a-7, the issuer must take reasonable steps to cause an independent trustee to have a perfected security interest or ownership valid against third parties in the eligible assets.⁸³ We ask for comment on whether and how this requirement in Rule 3a-7 should be strengthened in light of these events.

We invite commenters to provide us with information about current practices with respect to the safekeeping of eligible assets under Rule 3a-7.

- Does the current rule contain safeguards that adequately protect the eligible assets?
- Should stronger safeguards be adopted with respect to these assets? If so, what should these safeguards be?

We also invite commenters to provide us with information about current practices under Rule 3a-7 with respect to the management of the cash flow that is derived from an asset-backed issuer's eligible assets.

⁸² See, e.g., *November Oversight Report -- Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation*, Congressional Oversight Panel 19 (Nov. 16, 2010) ("Various commentators have begun to ask whether the poor recordkeeping and error-filled work exhibited in foreclosure proceedings, described above, is likely to have marked earlier stages of the process as well. If so, the effect could be that rights were not properly transferred during the securitization process such that title to the mortgage and the note might rest with another party in the process other than the trust.")

⁸³ Rule 3a-7(a)(4)(ii).

- How long do servicers typically hold the cash flow prior to transferring the cash flow to the trustee? What are the benefits, if any, to servicers from holding the cash flow? What are the benefits and risks to asset-backed issuers from servicers holding the cash flow?

- We note that the rule does not specify that the servicer must keep the cash flow in a segregated account prior to transferring the cash flow to the trustee. Should such a condition be included in the rule and what would be its economic impact if included? Is the answer dependent on the time period that the servicer has, under the asset-backed issuer's organizational documents or otherwise, in which to transfer the cash flow to the trustee?

- Should the rule be amended to prescribe a time period in which the servicer must transfer the cash flow to the trustee and what would be the economic impact of such a provision? If so, what should that time period be? Commenters suggesting specific time periods should address the costs and benefits associated with their suggestions.

- Regulation AB requires that servicers provide an annual assessment of compliance with servicing criteria enumerated in Item 1121(d) of Regulation AB, so that investors may identify those aspects of standard servicing criteria that are in material compliance in order to better evaluate servicing responsibilities and performance and reliability of the information they receive.⁸⁴ In particular, servicers must assess compliance with the servicing criterion that payments on pool assets are deposited into the appropriate custodial bank accounts and related bank clearing accounts within no more than two business days of receipt, or such other number of days as specified in the transaction agreements.⁸⁵ Consistent with this provision, should the time period set forth in Rule 3a-7 be no more than two business days of

⁸⁴ 17 CFR 229.1122(d).

⁸⁵ See Item 1122(d)(2)(i) of Regulation AB [17 CFR 229.1122(d)(2)(i)].

receipt? Why or why not? What would be the effect if the time period were greater than or less than two business days?

We are also interested in obtaining information about how the cash flow is invested under Rule 3a-7 and who receives the returns from such an investment.

- Should the rule contain a condition that restricts the manner in which the cash flow may be invested? If so, what should this condition provide?
- Should the rule limit who may receive the benefit of the returns of such investment? Why or why not? What economic benefits and costs would be associated with such a limitation?

As discussed previously, we understand that asset-backed securities often could not achieve an investment grade rating unless the issuer was structured in such a manner that the assets and cash flow are insulated in the event of the bankruptcy or insolvency of the sponsor or depositor.⁸⁶

- Does our understanding hold true?
- Should the rule include a condition specifying that the eligible assets and the cash flow generated from such assets be available to pay the fixed-income securities consistent with their terms, notwithstanding the bankruptcy or insolvency of the sponsor or depositor?
- Should any such condition also extend to the bankruptcy of the servicer? Does the answer depend on whether the servicer needs to hold the eligible assets for servicing purposes and is not required to transfer the cash flow to the independent trustee immediately upon receipt? What would be the potential economic impact of so extending the condition?

⁸⁶ See *supra* note 80.

The Commission also requests comment on any other concerns relating to the safekeeping of the issuer's assets and cash flow that we have not contemplated under Rule 3a-7.

- If there are such concerns, what are they and how should the rule address them?
- Does the asset-backed market generally impose safeguards that are intended to ensure the safety of the issuer's eligible assets and cash flow? Should the rule reflect these safeguards? If so, what are the safeguards, how should they be reflected, and what would be the economic impact of reflecting them in the rule?

d. Other Possible Investor Protections

The exclusion from the definition of investment company provided by Rule 3a-7 is one of many regulations under the federal securities laws addressing asset-backed issuers. Asset-backed issuers also are subject to various regulations under the Securities Act and the Exchange Act. We recognize that there may be existing or proposed provisions under these other federal securities laws applicable to asset-backed issuers which, although intended for different purposes, also may help mitigate potential Investment Company Act-related concerns. Such provisions could be considered for inclusion in Rule 3a-7 in lieu of the rating condition.⁸⁷

⁸⁷ We note that not all asset-backed issuers that rely on Rule 3a-7 are subject to the same provisions under the federal securities laws. For example, asset-backed issuers that rely on Rule 3a-7 may include those issuers that offer and sell their securities under an exemption from registration under the Securities Act or that are not subject to the Exchange Act reporting requirements. Therefore, if we determine that certain existing or proposed provisions under the federal securities laws help mitigate potential Investment Company Act-related concerns, such provisions may need to be included as conditions in Rule 3a-7 to ensure that all asset-backed issuers relying on the rule are subject to the same conditions, regardless of their status under the other federal securities laws.

i. Other Commission Rules

For example, Rule 193 under the Securities Act 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 that, at a minimum, provides reasonable assurance that the disclosure in the issuer's prospectus regarding the assets is accurate in all material respects.⁸⁸ Section 945 of the Dodd-Frank Act directed the Commission to enact Rule 193 so that due diligence was "re-introduced" into the offering process.⁸⁹ This provision, if included in Rule 3a-7, might help mitigate some of the concerns underlying the Investment Company Act, such as the "dumping" of assets and the potential opportunities for overreaching and self-dealing.

Similarly, as part of the 2011 ABS Re-proposal, we proposed to include, as part of the shelf eligibility requirements for asset-backed issuers, a requirement that the issuer's underlying transaction agreements provide for a "credit risk manager" to review the underlying assets in specified circumstances.⁹⁰ That proposal addresses concerns about enforceability of representations and warranties regarding the assets, but such a requirement also might serve to mitigate potential Investment Company Act abuses relating to misvaluation of assets and inadequate asset coverage for asset-backed securities and therefore could be considered for inclusion in Rule 3a-7.

As another example, we note that the Dodd-Frank Act added Section 27B to the Securities Act generally to prohibit an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security, as defined in the Exchange Act, from engaging in any transaction that would involve or result in any material

⁸⁸ 17 CFR 230.193.

⁸⁹ See Section 943 Release, *supra* note 9.

⁹⁰ See 2011 ABS Re-proposal, *supra* note 13 at section II.B.1.b.

conflict of interest with respect to any investor in a transaction arising out of such activity for a period of one year after the date of the first closing of the sale of the asset-backed security.⁹¹

This provision “prohibits firms from packaging and selling asset-backed securities to their clients and then engaging in transactions that create conflicts of interest between them and their clients.”⁹² To the extent that this provision also may help guard against certain of the Investment Company Act-related concerns, such as the potential for self-dealing and overreaching by insiders, it could be considered for incorporation into Rule 3a-7.

Yet another example of requirements under the federal securities laws concerning certain asset-backed issuers that may be considered for inclusion in Rule 3a-7 are the risk retention requirements for sponsors of asset-backed issuers, such as the requirements recently proposed by the Commission in a joint rulemaking with other federal regulators.⁹³ These requirements may be appropriate as conditions for issuers that wish to rely on Rule 3a-7, if they serve to mitigate the Investment Company Act-related concerns about self-dealing by insiders, misvaluation of assets, and the safekeeping of assets and cash flow.

We ask for comment on whether these or any other existing or proposed provisions under other federal securities laws applicable to asset-backed issuers also may help mitigate potential Investment Company Act-related concerns and could serve, in whole or in part, as substitutes for the references to ratings in Rule 3a-7. Commenters should be specific in identifying the relevant

⁹¹ Section 621 of Dodd-Frank Act. The Dodd-Frank Act also directed the Commission to issue rules for the purpose of implementing this provision, and the prohibition described above takes effect only upon the effective date of such rules. *Id.*

⁹² Letter from Senators Jeffrey Merkley and Carl Levin to Commission Chairman Mary Schapiro, et al. (Aug. 3, 2010) (“Merkley-Levin Letter”) at p. 1, available at <http://www.sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-2.pdf>.

⁹³ *Credit Risk Retention*, Securities Exchange Act Release No. 64148 (Mar. 30, 2011) [76 FR 24090 (Apr. 29, 2011)].

provision and the Investment Company Act-related concern, and explaining how the provision may help mitigate the Investment Company Act-related concern.

ii. Eligibility to Use Rule 3a-7

Currently, any issuer generally may rely on Rule 3a-7 provided that it is in the business of purchasing or otherwise acquiring and holding "eligible assets," issues securities which entitle their holders to receive payments that depend primarily on the cash flow from the eligible assets, and meets the other conditions of the rule. When the Commission adopted Rule 3a-7, the Commission stated that the definition of "eligible assets" in Rule 3a-7 -- in part, "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period" -- was based on the definition of "asset-backed security" under the Securities Act.⁹⁴ We understand that asset-backed commercial paper programs that issue securities in reliance on an exemption from registration under the Securities Act, and other asset-backed issuers that offer and sell their securities in reliance on an exemption from registration under the Securities Act, often rely on Rule 3a-7 to be excluded from regulation under the Investment Company Act. Conversely, an asset-backed issuer that cannot meet the conditions of Rule 3a-7 (and is unable to qualify for any other exclusion from regulation under the Investment Company Act, such as Section 3(c)(5), or

⁹⁴ See Adopting Release, *supra* note 4 at n.12 and accompanying text. Regulation AB generally defines "asset-backed security" as "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases." See Item 1101(c)(1) of Regulation AB. Regulation AB considers certain types of master-trusts and issuers with prefunding periods and revolving accounts to be discrete pools of assets. See Item 1101(c)(3) of Regulation AB. In the 2010 April ABS Proposal, the Commission proposed to restrict the use of Regulation AB by master trust issuers backed by non-revolving assets, limit the number of years for revolving periods of non-revolving accounts from three years to one year, and decrease the limit on the amount of prefunding permitted by the prefunding exception from 50% to 10%. See 2010 ABS Proposing Release, *supra* note 10 at section IV. The definition of "asset-backed security" in Regulation AB also contains limits on the amounts of delinquent and non-performing assets in the asset pool. See Item 1101(c)(2). The shelf eligibility requirements on Form S-3 further limits the amount of delinquent assets and certain leases that may be held in the asset pool. See Form S-3.

register under the Act) generally may not register the issuance of its securities even if the issuer and its securities meet the other offering requirements under the Securities Act.

- We request comment on whether the requirements of Regulation AB or the shelf eligibility requirements may serve, in whole or in part, to address the Investment Company Act concerns underlying Rule 3a-7 and therefore be a basis for meeting some or all of the rule's conditions, including the rating condition and any conditions that may replace it. Should the conditions of Rule 3a-7 distinguish between issuers that meet the shelf eligibility requirements and those that do not? If so, why and how should the conditions differ? We ask commenters to be specific in their responses and to provide data and statistics, if possible.

- Would certain asset-backed issuers that currently are able to publicly offer their securities no longer be able to do so if Rule 3a-7 were limited to issuers that meet the shelf eligibility requirements? If so, please explain. With respect to such issuers, commenters also should address any alternative exclusion(s) from regulation under the Investment Company Act that may be available, and the advantages and disadvantages of the issuers' using these exclusions if Rule 3a-7 were not available to them. We ask commenters to provide data in support of their responses, if possible.

- Is our understanding correct that some asset-backed issuers that privately offer their securities rely on Rule 3a-7? If so, would certain of these issuers no longer be able to rely on Rule 3a-7 if the rule was limited in this manner? If not, why not? We also ask commenters to provide similar information and data about asset-backed issuers that rely on the private investment company exclusions from regulation under the Investment Company Act, and any alternative exclusion(s) from regulation under the Investment Company Act that may be available, and the advantages and disadvantages of the issuers' using these exclusions if

Rule 3a-7 were not available to them. The Commission also requests that commenters provide any available data about the sizes and types of asset-backed issuers that privately offer their securities that rely on Rule 3a-7.

- What would be the effect 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?

- Are there alternative approaches that the Commission should consider to an issuer's eligibility to use Rule 3a-7 that would address Investment Company Act-related concerns? Commenters that offer alternative approaches should be as specific as possible in explaining their approach and the effect such an approach would have on asset-backed issuers, on the asset-backed securities market in general, on capital formation, and on investors.

3. Standard for Acquisition and Disposition of Eligible Assets

With respect to the type and amount of activity related to the acquisition and disposition of an issuer's eligible assets that may take place under Rule 3a-7, the Commission has stated that Rule 3a-7 was intended to permit only those activities "that do not in any sense parallel typical 'management' of registered investment company portfolios."⁹⁵ Thus, according to the Adopting Release, permitted activities under the rule include selling or substituting eligible assets when documentation is defective or for nonconformity with representations or warranties, disposing of assets in default or in imminent default, and removing excess credit support.⁹⁶ We request comment on the management activities of asset-backed issuers under Rule 3a-7.

⁹⁵ See *supra* note 44 and accompanying text.

⁹⁶ See Adopting Release, *supra* note 4 at n.68 and accompanying text.

- What changes, if any, should be made to the rule's conditions addressing the acquisition and disposition of eligible assets? What would be the economic impact of any such changes?
- Does the current rule adequately preclude activities “that do not in any sense parallel typical ‘management’ of registered investment company portfolios”? If not, should additional conditions be added to the rule that would limit the acquisition and disposition of the issuer’s eligible assets, and if so, what types of conditions? What would be the economic impact of such conditions?

B. The Effect of the Exclusion Provided by Rule 3a-7

Current Rule 3a-7 excludes from the definition of investment company any issuer that meets the rule's conditions. The rule does not address how a holder of securities of a Rule 3a-7 issuer should treat those securities for purposes of determining the holder's own status under the Investment Company Act. In light of certain developments in the asset-backed securities markets in recent years, detailed below, we request comment whether we should consider limiting or clarifying the manner in which the exclusion provided by Rule 3a-7 may be used by certain holders of securities issued by Rule 3a-7 issuers.

1. Holders of an Asset-Backed Issuer’s Securities

As a general matter, the status of an issuer under the Investment Company Act matters not only to the issuer itself, but also to the holders of the issuer's securities. A holder's own status under the Investment Company Act may depend on the investment company status of the issuers of securities that it owns.⁹⁷ When the Commission adopted Rule 3a-7, the Commission

⁹⁷ For example, the holder may be an investment company under Section 3(a)(1)(C) of the Investment Company Act if it owns or proposes to acquire investment securities, which generally include, among others, securities issued by an investment company, having a value exceeding 40% of the value of the holder's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. *See supra* note 30.

focused on providing an exclusion from regulation under the Act for the asset-backed issuer, and not on the manner in which such an exclusion may affect a holder of the asset-backed issuer's securities.

We are interested in better understanding the manner in which the exclusion provided by Rule 3a-7 affects the status under the Investment Company Act of various types of holders of securities issued by Rule 3a-7 issuers. For example, in the last decade, many asset-backed issuers that relied on Rule 3a-7 were established by companies that sought to capture, by holding the equity or residual interest in these issuers, the spread between the yield of the assets being securitized and the financing cost of the fixed-income securities being issued.⁹⁸ The potential for returns on such investments led to companies being established whose business focused on purchasing equity and residual interests in collateralized loan obligations (“CLOs”) and CDOs of issuers that relied on Rule 3a-7.⁹⁹ The activities of some of these companies suggest that they are in the business of investing in securities.¹⁰⁰ However, because current Rule 3a-7 excludes issuers relying on the rule from the definition of investment company, such companies that

⁹⁸ More generally, in 2007, for example, only approximately 11.5% of CDOs issued globally were issued to remove assets from the balance sheet of the originator. The rest of the CDO market consisted of arbitrage CDOs, which are CDOs that attempt to capture the difference between the yield of its assets and the financing costs of the CDO tranches. *See, e.g.*, Securities Industry and Financial Markets Association: Research at <http://archives1.sifma.org/story.asp?id=2375> (“SIFMA”).

⁹⁹ *See, e.g.*, Jody Shenn, *Bear Stearns Funds Own 67 Percent Stake in Everquest (Update3)*, BLOOMBERG, May 11, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=> (describing various investment vehicles formed to invest in residual interests of CDOs).

¹⁰⁰ In contrast, when Rule 3a-7 was adopted, most private sector sponsors of asset-backed issuers typically securitized financial assets that they themselves had originated to facilitate the financing and operation of their non-investment company businesses. For example, some sponsors securitized their financial assets in order to manage more effectively their loan portfolios and, in turn, their balance sheets. In addition, securitization allowed sponsors to gain access to alternative, usually cheaper, funding sources. Commercial banks and savings and loan associations also securitized financial assets to facilitate compliance with regulatory capital requirements. As the Commission noted when adopting Rule 3a-7, the purpose and operation of asset-backed issuers therefore were fundamentally different from investment companies. *See* Proposing Release, *supra* note 15 at n.18 and accompanying text; Protecting Investors Report, *supra* note 4 at nn.49-62 and accompanying text.

invest in Rule 3a-7 issuers may not meet the definition of investment company in the Investment Company Act.

Specifically, under the Investment Company Act, any company that holds 50% or more of the outstanding voting securities of an issuer may treat such issuer as its majority-owned subsidiary.¹⁰¹ Securities of majority-owned subsidiaries that are not investment companies, in turn, are not “investment securities”¹⁰² for purposes of determining whether the parent meets the definition of investment company in Section 3(a)(1)(C) of the Act. Since a Rule 3a-7 issuer is not an investment company by virtue of the exclusion provided by the rule,¹⁰³ any company that holds 50% or more of the outstanding voting securities of a Rule 3a-7 issuer may treat the Rule 3a-7 issuer as its majority-owned subsidiary and is not required to treat any of the securities issued by the Rule 3a-7 issuer as “investment securities” for purposes of determining the company’s own status under Section 3(a)(1)(C) of the Investment Company Act. Such a company therefore may have virtually all of its assets invested in securities of Rule 3a-7 majority-owned subsidiaries and not meet the definition of investment company under Section 3(a)(1)(C).¹⁰⁴

¹⁰¹ Section 2(a)(24) of the Investment Company Act states that a “majority-owned subsidiary” of a person “means a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person.” Section 2(a)(42) of the Act defines “voting security,” in relevant part, to mean “any security presently entitling the owner or holder thereof to vote for the election of directors of a company.”

¹⁰² See *supra* note 18.

¹⁰³ See Rule 3a-7(a) (“Notwithstanding section 3(a) of the Act, any issuer who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets (and in activities related or incidental thereto), and who does not issue redeemable securities will not be deemed to be an investment company . . .”).

¹⁰⁴ We note that, depending on the facts and circumstances, some of these companies may meet the definition of investment company in Section 3(a)(1)(A). See *supra* note 18. Companies that meet the definition of investment company in Section 3(a)(1)(A) are subject to the requirements of the Investment Company Act unless they meet an exclusion or an exemption, even if they do not meet the other definitions of investment company in Section 3(a)(1).

We also note that the idea of a company being in the business of investing in securities, even though the securities the company holds are those of its non-investment company majority-owned subsidiaries, is not novel. We have concluded, for example, that a company may be a “special situation investment company” that should be regulated under the Investment Company Act, even though the company holds securities of its majority-owned

If the exclusion provided by Rule 3a-7 specified that an issuer relying on Rule 3a-7 would be deemed an investment company for the limited purpose of the definition of “investment securities” in Section 3(a)(2)(C)(i) of the Investment Company Act, any company that holds 50% or more of the outstanding voting securities of a Rule 3a-7 issuer would be required to treat such securities, as well as any other securities of that Rule 3a-7 issuer, as “investment securities” for purposes of determining its own status under Section 3(a)(1)(C) of the Investment Company Act.¹⁰⁵ With respect to certain types of holders of securities issued by Rule 3a-7 issuers, such as companies discussed above whose business focused on establishing Rule 3a-7 subsidiaries to capture the spread between the yield of the assets being securitized and the financing cost of the fixed-income securities being issued, and which may be engaged in the business of investing in securities, such an approach may serve to more accurately reflect their status under Section 3(a)(1)(C) of the Investment Company Act and afford their investors the appropriate protections.

The Commission requests comment on the extent to which various types of holders of securities of Rule 3a-7 issuers use the exclusion to determine their own status under the Investment Company Act.

- What would be the potential economic impact if the exclusion from the definition of investment company provided by Rule 3a-7 were modified so that it did not extend to the definition of "investment securities" in Section 3(c)(1)(C)(i)?

subsidiaries that are not investment securities. *See Certain Prima Facie Investment Companies*, Investment Company Act Release No. 10937 (Nov. 13, 1979) [44 FR 66608 (Nov. 20, 1979)] at nn.18-20 and accompanying text. A special situation investment company generally is a company that secures control of other companies primarily for the purpose of making a profit in the sale of the controlled companies' securities. *Id.*

¹⁰⁵ *See supra* note 18. Under this approach, securities of a majority-owned subsidiary relying on Rule 3a-7 would be treated in the same manner as securities of a majority-owned subsidiary that is an investment company or that relies on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. *See supra* notes 18, 30.

- Would such a modification adversely affect those sponsors that form Rule 3a-7 issuers to facilitate the operation of their non-investment company business? Are such sponsors typically invested in their Rule 3a-7 majority-owned subsidiaries to such an extent that this approach would cause a sponsor to have more than 40% of its assets in investment securities and therefore fall within the definition of investment company in Section 3(a)(1)(C)?¹⁰⁶

- Rule 3a-7 alternatively could be recast such that a Rule 3a-7 issuer would be an investment company but would be exempted from the Act's requirements, provided that the issuer meets the rule's conditions. Under this approach, because the asset-backed issuer would not be excluded from the definition of investment company, but exempted from the Investment Company Act, a holder of the issuer's securities would be required to treat such securities as "investment securities" for purposes of determining the holder's own status under the Act, as under the approach discussed above. Is this approach preferable? If so, why?

- Are there reasons not to modify the exclusion provided by Rule 3a-7 to address this issue? Please explain and, if possible, provide data in support of your responses.

2. Eligible Portfolio Company

The Commission also has become aware of an interest among business development companies ("BDCs") to sponsor and invest in securities of issuers relying on Rule 3a-7.

¹⁰⁶ Sponsors that are banks, bank holding companies, broker-dealers, savings and loans and insurance companies are excluded from the definition of the Investment Company Act by Section 3(c) of the Investment Company Act and would be unaffected by a provision narrowing the effect of the exclusion provided by Rule 3a-7. In addition, other sponsors could conclude, based on an appropriate analysis of their primary business, that they are not investment companies pursuant to Section 3(b)(1) of the Investment Company Act or seek a Commission order under Section 3(b)(2) of that Act. Section 3(b)(1) of the Investment Company Act generally excludes an issuer from the definition of investment company in Section 3(a)(1)(C) of the Act if it is primarily engaged, directly or through wholly-owned subsidiaries, in a business other than investing, reinvesting, owning, holding or trading securities. Section 3(b)(2) of the Investment Company Act generally excludes from the definition of investment company in Section 3(a)(1)(C) of the Act any issuer which the Commission, upon application by the issuer, finds and by order declares to be primarily engaged in a business other than that of investing, reinvesting, owning, holding, or trading in securities either directly or through majority-owned subsidiaries or through controlled companies conducting similar type of businesses.

Congress established BDCs in 1980 as a type of closed-end investment company the primary purpose of which was to make capital more readily available to small, developing and financially troubled businesses.¹⁰⁷ To accomplish this purpose, Congress added a special set of provisions to the Investment Company Act that govern closed-end investment companies that elect BDC status.¹⁰⁸ In amending the Investment Company Act, Congress underscored that the new provisions would apply only to BDCs that are operated for the purpose of investing in the securities of certain issuers and that make available significant managerial assistance to those issuers.¹⁰⁹ Accordingly, the Investment Company Act generally prohibits a BDC from making any investment unless, at the time of the investment, at least 70% of the BDC's total assets (other than certain specified non-investment assets) are invested in securities of certain specified issuers (“70% basket”).¹¹⁰ The 70% basket includes, among other things, certain securities of “eligible portfolio companies,” as defined by the Act.¹¹¹ Among other criteria, issuers qualifying as eligible portfolio companies must be organized under the laws of, and have their principal place of business in, the United States,¹¹² and must not meet the definition of investment company in

¹⁰⁷ Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified at scattered sections of the United States Code)(“SBIIA”).

¹⁰⁸ See Sections 54-65 of the Investment Company Act.

¹⁰⁹ See H.R. Rep. No. 1341, 96th Cong., 2d Sess. 22 (1980) (“BDC House Report”).

¹¹⁰ Section 55(a) of the Investment Company Act. See BDC House Report, *supra* note 109 at 23 (“The restrictions are designed to assure that companies electing special treatment as [BDCs] are in fact those that [the SBIIA] is intended to aid – companies providing capital and assistance to small, developing or financially troubled businesses that are seeking to expand, not passive investors in large, well-established businesses.”). BDCs may invest in certain other assets that would not count toward the 70% basket, provided that such investments are consistent with the overall purpose behind the BDC provisions of the Investment Company Act. *Id.* at 39-40.

¹¹¹ Section 2(a)(46) of the Investment Company Act.

¹¹² Section 2(a)(46)(A) of the Investment Company Act.

Section 3 of the Investment Company Act or be excluded from the definition of investment company under Section 3(c) of that Act.¹¹³

By virtue of the exclusion from the definition of investment company provided by Rule 3a-7, a BDC might seek to treat a Rule 3a-7 issuer as an eligible portfolio company, provided that certain other criteria are met.¹¹⁴ As a general matter, the Commission presently does not believe that Rule 3a-7 issuers are the type of small, developing and financially troubled businesses in which Congress intended BDCs primarily to invest. Accordingly, the Commission requests comment on whether Rule 3a-7 should be amended to provide expressly that an issuer relying on Rule 3a-7 is an investment company for purposes of the definition of eligible portfolio company under the Investment Company Act.

- What would be the effect on BDCs if Rule 3a-7 were amended to expressly provide that an issuer relying on Rule 3a-7 is not an eligible portfolio company?
- What would be the effect on Rule 3a-7 issuers if Rule 3a-7 were amended to expressly provide that an issuer relying on Rule 3a-7 is not an eligible portfolio company?
- We understand that BDCs that invest in Rule 3a-7 issuers typically do not treat such issuers as eligible portfolio companies. Is our understanding correct? If not, please explain.

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

As noted above, certain asset-backed issuers rely on the exclusion from the definition of investment company in Section 3(c)(5) of the Investment Company Act rather than on Rule 3a-

¹¹³ Section 2(a)(46)(B) of the Investment Company Act. Section 2(a)(46)(B) also includes as an eligible portfolio company a small BDC which is licensed by the Small Business Administration and which is a wholly-owned subsidiary of a BDC. In addition to meeting the requirements set forth in Sections 2(a)(46)(A) and 2(a)(46)(B), a company qualifying for eligible portfolio company status must also meet one of the criteria set forth in Section 2(a)(46)(C) or in Rule 2a-46 under the Investment Company Act.

¹¹⁴ See Section 55(a) of the Investment Company Act.

7.¹¹⁵ Section 3(c)(5) was intended to exclude from the definition of investment company certain factoring, discounting and mortgage companies,¹¹⁶ and did not specifically contemplate asset-backed issuers, which generally did not exist at the time Congress adopted the Investment Company Act in 1940.¹¹⁷ Nevertheless, certain asset-backed issuers, including those that securitize retail automobile installment contracts, credit card receivables, trade receivables, boat loans or equipment leases, have sought to rely on the provisions of Section 3(c)(5).¹¹⁸ In addition, many issuers of mortgage-backed securities have sought to rely on Section 3(c)(5). These asset-backed issuers include issuers of securities backed by whole residential mortgage loans and home equity loans (two of the most commonly securitized assets),¹¹⁹ whole commercial mortgages, participated mortgage interests, and “whole pool certificates”¹²⁰ issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae.

¹¹⁵ See *supra* note 30 discussing the 3(c)(5)(C) Concept Release. Section 3(c)(5) excludes from the definition of investment company “[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.”

¹¹⁶ S. Rep. No. 1775, 76th Cong. 3d. 13 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12(1940); S. Rep. No. 184, 91st Cong., 1st Sess. 37 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970). See Proposing Release, *supra* note 15 at text following n.5 (“section 3(c)(5)] . . . originally was intended to exclude issuers engaged in the commercial finance and mortgage banking industries.”). See also Section 3(c)(5)(C) Concept Release, *supra* note 30.

¹¹⁷ See Kravitt, *supra* note 15 at 12.03[G][4] (“The exceptions stated in Section 3(c)(5) predate by many years the securitization industry. The ‘original intent’ of the drafters of Section 3(c)(5) could not possibly have anticipated financial products such as collateralized mortgage obligations and receivables-backed securities. As with many of the Section 3 exceptions, issuers that do not, or arguably do not, fall within the original intent of the provisions have attempted to rely on the . . . exception.”)

¹¹⁸ See Kravitt, *supra* note 15 at 12.03[G]; Protecting Investors Report, *supra* note 4 at n.261 and accompanying text. Note, however, that an asset-backed issuer that securitizes these types of assets may be unable to rely on these exclusions if the issuer’s structure allows for the holding of cash or similar instruments in such amounts that the issuer may not be “primarily engaged” in holding the asset being securitized. See Kravitt, *supra* note 15 at 12.03[G].

¹¹⁹ See Kravitt, *supra* note 15 at 12.03[G].

¹²⁰ A whole pool certificate is a security that represents the entire ownership interest in a particular pool of mortgage loans. See Protecting Investors Report, *supra* note 4 at n.267.

Unlike the exclusion provided by Rule 3a-7, the exclusion provided by Section 3(c)(5) is not subject to any conditions specifically addressing the Investment Company Act-related concerns presented by asset-backed issuers.¹²¹ Whether an asset-backed issuer has the option of relying on Section 3(c)(5) as an alternative to Rule 3a-7 generally depends on whether the issuer is primarily engaged in purchasing or otherwise acquiring a particular type of financial assets.¹²² Rule 3a-7, in contrast, was generally designed to encompass any asset-backed issuer that meets the rule's conditions, regardless of the type of financial assets that it holds.

When first considering Rule 3a-7 in 1992, the Commission noted that, absent a statutory amendment precluding asset-backed issuers from relying on Section 3(c)(5), asset-backed issuers that rely on that section and those that rely on Rule 3a-7 would be subject to somewhat disparate treatment based solely on the type of the financial assets that they held. Accordingly, when the Commission proposed Rule 3a-7 in 1992, it also requested comment on, among other things, whether it should seek statutory amendments to Section 3(c)(5) that would preclude asset-backed issuers from continuing to rely on the Section.¹²³ Most commenters then argued that it would be inappropriate to narrow the scope of Section 3(c)(5), at least until both the market and the Commission gained experience with Rule 3a-7.¹²⁴ In response to commenters' concerns, the Commission decided not to pursue any regulatory changes with respect to Section 3(c)(5) at that time.¹²⁵

Now that the market and the Commission have gained almost twenty years of experience with Rule 3a-7, we believe that it is appropriate to revisit this issue as part of our review of the

¹²¹ See *supra* section III.A. See also *supra* note 115.

¹²² See *supra* note 115.

¹²³ Proposing Release, *supra* note 15 at section II.B.

¹²⁴ Adopting Release, *supra* note 4 at n.88 and accompanying text.

¹²⁵ *Id.* at text following n.89.

rule. We also believe that revisiting the ability of asset-backed issuers to rely on the exclusion provided by Section 3(c)(5) is appropriate in the aftermath of the recent financial crisis and the role that issuers of mortgage-backed securities have played in that crisis.¹²⁶ Accordingly, the Commission once again is seeking comment on whether Section 3(c)(5) should be amended to limit the ability of asset-backed issuers to rely on Section 3(c)(5).¹²⁷ The Commission also requests comment on whether it should engage in any rulemaking, consistent with Section 3(c)(5), that would define terms used in that section so as to limit its availability to those companies that are intended to be encompassed by the statutory exclusion. We also seek comment on whether there are any structural or operational reasons that make it necessary for certain asset-backed issuers to rely on Section 3(c)(5) rather than Rule 3a-7.

- If there are such structural or operational reasons, what are they?
- What types of asset-backed issuers rely on Section 3(c)(5)?
- What would be the effect on asset-backed issuers, the securitization market and on capital formation if asset-backed issuers could no longer rely on Section 3(c)(5)?
- Are there revisions to Rule 3a-7 that could be made to better facilitate asset-backed issuers' reliance on the rule rather than on Section 3(c)(5) and what would be the economic impact of such revisions?

Commenters also are requested to provide any other observations, suggestions and data on the interplay between Rule 3a-7 and Section 3(c)(5) today and as the asset-backed securities markets may develop in the future.

¹²⁶ See generally 2010 ABS Proposing Release, *supra* note 10.

¹²⁷ See also Section 3(c)(5)(C) Concept Release, *supra* note 30; 2011 ABS Re-proposal, *supra* note 13 at n.110 and accompanying text (requesting comment on whether compliance with Rule 3a-7 should be one of the shelf eligibility requirements).

IV. General Request for Comment

In addition to the issues raised in this release, the Commission requests and encourages all interested persons to submit their views on any issues relating to the treatment of asset-backed issuers under the Investment Company Act. This release is not intended in any way to limit the scope of comments, views, issues or approaches to be considered. The Commission particularly welcomes statistical, empirical, and other data from commenters that may support their views and/or support or refute the views or issues raised in this release.

By the Commission.

Elizabeth M. Murphy
Secretary

August 31, 2011