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November 7, 2011

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

*Re: Treatment of Asset-Backed Issuers under the Investment Company Act (File No. S7-35-11)*

Dear Ms. Murphy:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's ("Commission") advance notice of proposed rulemaking with respect to Rule 3a-7 under the Investment Company Act of 1940 (the "Investment Company Act").<sup>2</sup> ICI members agree with Rule 3a-7's primary goal of distinguishing certain issuers of asset-backed securities ("ABS") from registered investment companies. In addition, as investors in ABS, ICI members have an interest in ensuring that ABS issuers that rely on Rule 3a-7 operate in a manner that is consistent with the investor protection concerns underlying the Investment Company Act.

In considering any potential new conditions under Rule 3a-7, we recommend that the Commission bear in mind the following principles:

- Any new conditions, in addition to addressing investor protection concerns under the Investment Company Act, should be related closely to Rule 3a-7's purpose of distinguishing those ABS issuers that rely on the rule from registered investment companies.

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.8 trillion and serve over 90 million shareholders.

<sup>2</sup> See *Treatment of Asset-Backed Issuers under the Investment Company Act*, Investment Company Act Release No. 29779 (Aug. 31, 2011), available at <http://www.sec.gov/rules/concept/2011/ic-29779.pdf> ("ANPR").

- If the Commission is considering adding new conditions that are drawn from rules already applicable to ABS issuers, it should ensure that those conditions would not be duplicative of, and are consistent with, requirements that already are applicable to ABS. It also should ensure that applying those conditions would not result in unintended consequences in the ABS markets. These consequences could include costs that exceed the benefits of any new conditions, such that they would impair supply and capital formation, or potential regulatory arbitrage.
- The Commission should take a holistic view of the potential implications for the ABS markets and investors of any new or revised conditions it may consider. It should consider the potential implications not just under Rule 3a-7, but also in combination with any potential changes to Section 3(c)(5)(C) of the Investment Company Act, as well as the rule that recently has been proposed to implement the “Volker Rule.”

In addition, we raise a concern about the implications for registered investment companies if the Commission were to adopt an interpretation in which it deems a Rule 3a-7 issuer to be an “investment company” as defined in the Investment Company Act, as such an interpretation could unintentionally and unnecessarily limit registered investment companies’ investments in ABS.

## **I. Potential New Conditions Under Rule 3a-7**

The Commission is considering whether to eliminate the conditions in Rule 3a-7 that refer to credit ratings by nationally recognized statistical rating organizations and, if so, what types of conditions might replace the credit rating conditions.<sup>3</sup> The types of conditions the Commission is considering include those intended to directly address investor protection concerns under the Investment Company Act,<sup>4</sup> as well as those that are drawn from existing or proposed rules that are applicable to ABS issuers under the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”).

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<sup>3</sup> The Commission states it is considering eliminating references to credit ratings in Rule 3a-7 in response to the requirement of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) (which generally requires the Commission to review any references to or requirements regarding credit ratings in its rules, remove those references or requirements and substitute other appropriate standards of creditworthiness in place of the credit ratings), as well as concerns that were raised during the financial crisis regarding NRSROs’ credit rating procedures and methodologies.

<sup>4</sup> For example, to address concerns about abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage, the Commission suggests imposing specific requirements or limitations on the structure and operations of an ABS issuer relying on the rule. Alternatively, the Commission suggests a principle-based approach, for example, requiring that the parameters of the issuer’s organization and operations be set out in its organizational documents. The ANPR also requests comment on the concept of an independent review of the ABS issuer’s structure and operations, as well as whether the rule should be amended to strengthen the provisions relating to the preservation and safekeeping of the ABS issuer’s assets and cash flow.

To the extent the Commission believes it is necessary to replace the credit rating conditions,<sup>5</sup> we recommend that the Commission bear in mind several principles as it considers possible replacements. First, we believe that any new conditions, in addition to addressing investor protection concerns under the Investment Company Act, should be related closely to Rule 3a-7's purpose of distinguishing those ABS issuers that rely on the rule from registered investment companies. Second, if the Commission is considering adding new conditions that are drawn from rules already applicable to ABS issuers, it should ensure that those conditions would not be duplicative of, and are consistent with, requirements that already are applicable to ABS. For example, the ANPR mentions the credit risk retention requirements required by Section 941 of the Dodd-Frank Act and the prohibition against material conflicts of interest in connection with certain securitizations under Section 621 of the Dodd-Frank Act. Both of these requirements already would apply to both registered and privately-issued ABS, so it is unclear why it would be necessary to have a separate condition under the Investment Company Act incorporating either of these requirements. In addition, the Commission is considering a principle-based disclosure approach to addressing concerns about potential abusive practices by ABS issuers,<sup>6</sup> and notes that Regulation AB under the Securities Act generally requires asset-backed issuers to describe much of the information the Commission contemplates "although perhaps not with the same degree of specificity that could be required under this approach."<sup>7</sup> It is critical that the Commission coordinate regulation of ABS issuers to ensure efficient regulation of these important markets and consistent protection of ABS investors.

Third, the Commission should ensure that applying such conditions under the Investment Company Act would not result in unintended consequences in the ABS markets. These consequences could include costs that exceed the benefits of any new conditions, such that they would impair supply and capital formation, or potential regulatory arbitrage. For example, the Commission requests comment in the ANPR on whether it should further limit eligibility for reliance on Rule 3a-7 to issuers that also meet the requirements of Regulation AB under the Securities Act or the shelf eligibility requirements. We have supported the Commission's disclosure initiatives under its proposals to

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<sup>5</sup> While the Commission explains that the references to credit ratings in these conditions were not intended principally as standards of creditworthiness, it is unclear whether Section 939A of the Dodd-Frank Act would require that they be removed. *See ANPR, supra* note 2, at pp. 6-7.

<sup>6</sup> For example, self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage. *See supra* note 4.

<sup>7</sup> ANPR, *supra* note 2, at n.66. Similarly, the Commission proposes an independent review requirement that is similar to a concept upon which it requested comment in its recent re-proposal of shelf-eligibility conditions for ABS, but not what was proposed in that release. *See Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment*, Securities Act Release No. 9244 (July 26, 2011) ("ABS Shelf Re-Proposal") (proposed certification by either the chief executive officer of the depositor or the executive officer in charge of securitization of the depositor; as an alternative, requested comment on an opinion by an "independent evaluator").

strengthen Regulation AB and the shelf eligibility criteria, including improving disclosure for privately-issued ABS.<sup>8</sup> In considering whether to apply these requirements as a condition of Rule 3a-7 eligibility, we believe that the Commission should consider whether certain issuers would be unable to comply with the rule.<sup>9</sup> Applying these requirements under Rule 3a-7 also could have the anomalous result that certain ABS issuers would be subject to a different disclosure regime based solely on the Investment Company Act exclusion on which they rely.<sup>10</sup> The Commission currently is addressing under the Securities Act the issue of how broadly Regulation AB should apply, including the extent to which it should apply to privately-issued ABS. We believe these regulatory considerations should be coordinated.

Finally, we encourage the Commission to take a holistic view of the potential implications for the ABS markets and investors of any new or revised conditions it may consider. It should consider the potential implications not just under Rule 3a-7, but also in combination with any potential changes to Section 3(c)(5)(C) of the Investment Company Act,<sup>11</sup> as well as the rule that recently has been proposed to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, known as the “Volker Rule.”<sup>12</sup> For example, depending how Rule 3a-7 or Section 3(c)(5)(C) may be revised, certain ABS issuers, because of their structure and operations, may be unable to rely on one

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<sup>8</sup> See Letters from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated October 4, 2011 (“October Letter”); November 15, 2010; and August 2, 2010. In the October Letter, we explained that we support the Commission’s revised shelf eligibility criteria. The letter further explained that we generally support increased disclosure for ABS, including specific disclosure requirements for private offerings of structured finance products (such as those offered in reliance on Rule 144A and Regulation D under the Securities Act). The October Letter expressed our concern, however, with the potential treatment under the Commission’s proposed disclosure rules of notes issued by asset-backed commercial paper (“ABCP”) programs and securities issued pursuant to municipal tender option bond (“TOB”) programs, both of which are typically sold in Section 4(2) private offerings and resold in reliance upon Rule 144A. We recommended in the October Letter that the Commission: (1) provide an exemption for ABCP from the proposed rules; and (2) confirm that TOBs are not within the scope of the proposed rules or provide an exemption for TOBs.

<sup>9</sup> The Commission recently acknowledged, in the ABS Shelf Re-Proposal, that some privately-issued ABS may have difficulty or be unable to meet the asset-level data disclosure requirements of Regulation AB. See ABS Shelf Re-Proposal, *supra* note 7, at 84-87.

<sup>10</sup> Other ABS issuers may rely on Section 3(c)(5)(C), Section 3(c)(1), or Section 3(c)(7).

<sup>11</sup> The Commission has requested comment in the ANPR on whether it should take action to limit the ability of ABS issuers to rely on Section 3(c)(5)(C). The Commission also has issued an interpretive release requesting comment on mortgage-related pools that rely on Section 3(c)(5)(C). See *Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments*, Investment Company Act Release No. 29778 (August 31, 2011).

<sup>12</sup> See *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, Exchange Act Release No. 65545 (October 12, 2011) at 34-35, available at <http://www.sec.gov/rules/proposed/2011/34-65545.pdf> (“Volker Rule Release”).

or both exclusions, which could have negative implications for investors and the markets. In addition, the rule that has been proposed to implement the Volker Rule also may have significant implications for ABS issuers and the ABS markets. In the release proposing that rule, the regulators explained that those ABS issuers that rely on the exclusions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act may be included within the proposed rule's definition of "covered fund," significantly restricting the ability of a banking entity from purchasing or retaining an interest in such an issuer.<sup>13</sup> In addition, an ABS issuer that is an affiliate or subsidiary of a "banking entity," and relies on Rule 3a-7 or Section 3(c)(5)(C), would be subject to the requirements of Section 13 of the Bank Holding Company Act of 1956 and the proposed rule, including prohibitions on proprietary trading.<sup>14</sup> We believe it is essential that the Commission consider the possible interaction of these potential changes and the effects they could have on ABS issuers and the ABS markets.

## II. Holders of Rule 3a-7 Issuers' Securities

The Commission expresses concern that certain companies that purchase equity and residual interests in collateralized loan obligations and collateralized debt obligations issued by Rule 3a-7 issuers may, in fact, be in the business of investing in securities. Such a company, however, may not meet the definition of "investment company" in the Investment Company Act.<sup>15</sup> The Commission requests comment on whether Rule 3a-7 should be amended to specify that a Rule 3a-7 issuer would be deemed to be an investment company for the limited purpose of determining the status of a company investing in that issuer pursuant to Section 3(a)(1)(C) of the Investment Company Act. Amending Rule 3a-7 in this manner would require an investing company that holds a majority interest in a Rule 3a-7 issuer to treat securities of the Rule 3a-7 issuer as investment securities in determining its status under the Investment Company Act. The Commission also requests comment on whether it should, alternatively, take the approach of deeming a Rule 3a-7 issuer to be an investment company, but exempting it from the requirements of the Investment Company Act, provided the issuer meets Rule 3a-7's conditions.

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<sup>13</sup> *Id.* at 34.

<sup>14</sup> *Id.*

<sup>15</sup> For example, if the company is a majority holder of a Rule 3a-7 issuer, it would not be deemed to be holding "investment securities" of that issuer for purposes of Section 3(a)(1)(C) of the Investment Company Act, and therefore may not trigger the threshold for owning or holding investment securities that would cause it to be an "investment company" under the Investment Company Act. Section 3(a)(1)(C) of the Investment Company Act defines an "investment company" as an issuer that engages or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of the issuer's assets (excluding Government securities and cash items) on an unconsolidated basis. "Investment securities" are defined in Section 3(a)(2) of the Investment Company Act to include all securities except, as relevant, securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the private investment company exclusions of the Investment Company Act.

We strongly recommend that, if the Commission determines that it is necessary to modify Rule 3a-7 to address this issue, it not adopt the approach of deeming a Rule 3a-7 issuer to be an investment company, but exempting it from the requirements of the Investment Company Act. By deeming the issuer to be an investment company generally, this approach could have significant consequences for registered investment companies that invest in ABS, including subjecting them to the limitations of Section 12(d)(1) of the Investment Company Act, which restricts the ability of registered investment companies to purchase or otherwise acquire securities issued by other investment companies.<sup>16</sup> This would unintentionally and unnecessarily limit registered investment companies' investments in ABS based solely on the Investment Company Act exclusion on which they rely, a result that would accomplish no regulatory purpose.

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<sup>16</sup> As relevant, Section 12(d)(1) provides that: (A) It shall be unlawful for any registered investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the "acquired company"), and for any investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the "acquired company"), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate—

- (i) more than 3 per centum of the total outstanding voting stock of the acquired company;
- (ii) securities issued by the acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or
- (iii) securities issued by the acquired company and all other investment companies (other than treasury stock of the acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of the acquiring company.

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815 or Sarah Bessin at (202) 326-5835.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan  
General Counsel

cc: The Honorable Mary L. Schapiro  
The Honorable Elisse B. Walter  
The Honorable Luis A. Aguilar  
The Honorable Troy A. Paredes

Eileen Rominger, Director  
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