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Submitted by e-mail to rule-comments@sec.gov

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

Re: Treatment of Asset-Backed Issuers under the Investment Company Act, Release No. IC-29779, File No. S7-35-11 (the "Rule 3a-7 Proposal")

Dear Ms. Murphy:

K&L Gates appreciates the opportunity to offer comments to the Securities and Exchange Commission (the "Commission" or the "SEC") on the Rule 3a-7 Proposal. We submit this comment letter to the Rule 3a-7 Proposal on behalf of a client active in creating, holding and/or acquiring interests in securitizations relying on Rule 3a-7. The comments herein are those of the client, and do not necessarily reflect the views of K&L Gates or its other clients.

I. Introduction and Summary

K&L Gates, on behalf of our client, strongly encourages the Commission to:

1. Reaffirm that securities retained by the parent company of a majority-owned subsidiary that relies on Rule 3a-7 are not "investment securities" under the Investment Company Act of 1940, as amended (the "1940 Act") so that sponsors[1] can continue to provide financing and liquidity to the market;[2]

2. Amend Rule 3a-7 only to the extent required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") by removing references to and requirements regarding ratings organizations and substituting a sufficient alternative; and

[1] The term sponsor refers to the originator or acquirer of the loans that are then placed in a special purpose vehicle that issues the securities for purchase by investors.

[2] 1940 Act § 3(a)(2) ("As used in this section, 'investment securities' includes all securities except...(C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c)").

3. Refrain from seeking a Congressional modification to Section 3(c)(5)(C) that would prohibit mortgage-related securitizations from relying on that Section.[3]

Our client believes that these recommendations should be adhered to for the following reasons. First, the asset-backed securities industry developed rapidly and successfully following the Commission's adoption of Rule 3a-7 in 1992, and making changes to the Rule at the current time when the securities and financing markets are struggling will be detrimental to these markets and those who rely on them. Second, Rule 3a-7 was designed with sufficient investor protection and has worked well since adoption. Moreover, the investor protection regime has increased since 1992 with the adoption of a number of laws, rules and regulations that impact Rule 3a-7 entities and their sponsors. In light of such protections, additional changes to the regulation of Rule 3a-7 entities may be unnecessary and duplicative and are, at the very least, premature as the Commission studies the impacts of the existing regulatory actions. Third, Congress and the Commission have long exempted financing activities from 1940 Act registration, recognizing the distinct role of such financing activities in the United States economy. The proposed changes to Rule 3a-7 run counter to this recognition and threaten to restrict capital formation and liquidity in the marketplace. In conclusion, we believe that today's evolving regulatory landscape renders this a particularly inappropriate time for additional changes to Rule 3a-7 and that the significant amount of resources that would be required to institute such a rulemaking make unilateral regulation by the Commission impractical and unnecessary.

II. Rule 3a-7 Succeeded in Encouraging Investment in Asset-Backed Securities and Brought Liquidity to the Marketplace While Providing Significant Investor Protections and the Proposed Restrictions Are Unnecessary in Light of the Rule's Success.

A. Rule 3a-7 Worked as Intended to Promote Capital Formation and Market Liquidity and the Proposed Changes to Rule 3a-7 Will be Detrimental to an Already Struggling Market.

The Commission enacted Rule 3a-7 to broadly exempt asset-backed securities issuers from 1940 Act regulation to "remove an unnecessary and unintended barrier to the use of

[3] In response to the Commission's request for comment on whether the Commission should seek a statutory modification to Section 3(c)(5)(C) from Congress, in order to preclude asset-backed securities issuers from relying on this Section; we urge the Commission to refrain from taking such action. We believe that there is no reason to subject asset-backed securities issuers to additional regulation when: (1) such issuers are more passive companies than the actively managed companies who also rely on this Section; and (2) the use of this Section by such issuers has not raised any significant regulatory concerns. With regard to the former, if an actively managed company that primarily invests in and holds qualifying interests is excepted under Section 3(c)(5)(C), it seems unnecessary to subject a more passive company, a securitization vehicle, that holds primarily qualifying interests to additional regulation. Similarly, the Commission points to no significant regulatory concerns in the 3a-7 Proposal that would make such additional regulation necessary.

structured financing in all sectors of the economy"[4] and avoid "constrain[ing] the development of the structured finance market."[5] Further, Rule 3a-7 was intended to reduce unnecessary costs for asset-backed securities issuers and allow investors access to a greater variety of financings.[6] The Rule 3a-7 exemption has achieved all of its goals. One aspect of the Rule's success is demonstrated by the increased access to capital for the consumer and business financing industries through the securitization market. By 1995, non-mortgage asset-backed securities issuance in the United States was approximately $112.81 billion,[7] compared to only $46.60 billion in 1991 before the Commission adopted Rule 3a-7.[8] By 2006, non-mortgage asset-backed securities issuance in the United States peaked at approximately $753.86 billion,[9] emphasizing that Rule 3a-7 helped to provide "liquidity to virtually every sector of the economy."[10] However, the asset-backed securitization market is struggling in the aftermath of the 2008 financial crisis.[11] It fell to approximately $107.48 billion in 2010 and has continued to decline, with approximately $94.19 billion issued year-to-date as of October 19, 2011.[12] To help restore this struggling market, which provides investors with numerous benefits, the Commission should not change Rule 3a-7 in a way that will further restrict liquidity and surely impede this market's recovery.

Any proposed restrictions on asset-backed securities issuers, such as those proposed by the Commission, would be detrimental to the market and would further restrict liquidity and capital formation.[13] The need that was met through the adoption of Rule 3a-7 still exists in the broader economy. The Rule was successful in providing important capital to the markets, and in this time of economic upheaval, further restricting investor access to this important form of financing is unnecessary.

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[4] Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105 (November 19, 1992) ("Rule 3a-7 Adopting Release").

[5] Id.

[6] Id., at 11.

[7] SIFMA, Statistics and data pertaining to financial markets and the economy, US ABS Issuance and Outstanding as of October 19, 2011, available at http://www.sifma.org/research/statistics.aspx, accessed October 20, 2011.

[8] Division of Investment Management, Securities and Exchange Commission, Protecting Investors: A Half-Century of Investment Company Regulation ("Protecting Investors Report") at 2 and note 4.

[9] Id.

[10] Mary L. Schapiro, Speech by SEC Chairman: Opening Statement – SEC Open Meeting, January 20, 2011, available at http://www.sec.gov/news/speech/2011/spch012011mls.htm.

[11] See id.

[12] SIFMA, *supra* n.6.

[13] See infra, Section III.

B. Rule 3a-7 was Drafted with Significant Investor Protections and the Commission Should Restrict its Actions to those Amendments Required by Dodd-Frank and Should not Make Other Substantive Changes to Rule 3a-7 as they are Unnecessary in Light of the Protections Inherent in the Rule.

The amendments presented in the Rule 3a-7 Proposal are particularly unnecessary because the conditions imposed by Rule 3a-7 are intended to provide adequate protection for those individuals who invest in the asset-backed securities market. The conditions allow asset-backed securities issuers to continue to operate without the restrictions of the 1940 Act and in a manner consistent with the financing aspects of securitization. Such conditions include: (1) the issuer issues fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets; (2) securities issued by the issuer must have a certain credit rating; (3) the issuer acquires and disposes of eligible assets only under certain circumstances; and (4) the issuer must take certain steps to protect investors if it issues securities other than those exempted from the Securities Act of 1933, as amended (the "1933 Act").

The vast majority of the proposed changes are unnecessary in light of the conditions described above. The Rule 3a-7 Proposal contemplates changes to Rule 3a-7 that fall into three categories: (1) the elimination of credit ratings under Rule 3a-7;[14] (2) the addition of new conditions to Rule 3a-7; and (3) changes to the treatment of securities issued by Rule 3a-7 entities by holders of those securities.

The Rule 3a-7 Proposal suggests a number of new conditions for asset-backed securities issuers relying on Rule 3a-7. The Commission discusses three categories of investor protection concerns that prompted these potential conditions: (1) concerns about self-dealing by insiders, misvaluation of assets and inadequate asset coverage as they relate to the structure and operation of a Rule 3a-7 entity; (2) the benefits of an independent review of a Rule 3a-7 entity's structure and intended operations in addressing these concerns; and (3) preservation and safekeeping of a Rule 3a-7 entity's eligible assets and cash flow. While the Commission raises these concerns, they do not provide any specific instances of abuse in the industry. Furthermore, the concerns raised are unnecessary in light of the safeguards built in to the structure of Rule 3a-7. Concerns relating to self-dealing are unnecessary because of the transparency inherent in the process of securitization. The assets are placed in a trust or a special purpose vehicle (an "SPV") and are available for any investor to see, leaving no room for self-dealing. Similarly, concerns relating to misvaluation are misplaced here because valuation is almost irrelevant to an investment in a securitization. The determining factor for an investor is cash flow; if the underlying loans and mortgages provide sufficient cash flows to cover the investment in the securitization, then it is

[14] This action is required by Congress under Dodd-Frank and is accepted as a necessary amendment to the Rule. This proposed change is, therefore, not a focus of this letter. We acknowledge that we do not offer a proposed solution to the Commission's request for alternatives to the use of credit ratings, however, there are a number of issues raised in this letter, including the newly proposed risk retention rules, which may prove useful in the Commission's efforts.

considered a worthwhile investment regardless of the value of the underlying securities. Concerns relating to the preservation and safekeeping of eligible assets are unnecessary in light of the required trustee and trust indenture. The trustee of a Rule 3a-7 entity is required to be a bank that meets substantially the same criteria as a custodian for an investment company, so 1940 Act compliance would not add value in this regard. It is important to note that the 1940 Act does not provide protections that would solve the aforementioned concerns, as there are no provisions in the 1940 Act that determine or protect cash flows or creditworthiness. The conditions of Rule 3a-7 were intended to alleviate the investor protection concerns addressed by the 1940 Act in light of the particular structure and function of a Rule 3a-7 entity and such conditions have been successful in doing so.

Requiring Rule 3a-7 entities or their parent companies to register under the 1940 Act contradicts the protections provided by the existing regulation and is unnecessary due to the extensive protections already in place, as well as the substantial new regulatory protections afforded to asset-backed securities investors under Dodd-Frank which are discussed in Sections III.D and IV below. The proposed changes to the treatment of the securities issued by Rule 3a-7 entities would have a significant impact on the market and would likely require parent companies of such entities to register as investment companies. This idea is developed more fully below in Section III.C. Requiring registration as an investment company by the Rule 3a-7 entities or their parent companies is entirely duplicative. The conditions described above were intended "to reflect the structural and operational distinctions between registered investment companies and structured financings and incorporate investor protections imposed by the market itself. [The Commission, by proposing the rule,] also sought to accommodate future innovations in the structured finance market, consistent with investor protection."[15] These conditions and Rule 3a-7 generally have satisfied this goal without issue throughout their existence and therefore making the proposed changes unnecessary.

III. Congress and the Commission Have Long Recognized that Financing Activities Have a Unique Role in the United States Economy and the Proposed Changes to Rule 3a-7 Run Counter to this Recognition and Threaten to Restrict Capital Formation and Liquidity in the Marketplace.

A. Through the 1940 Act, Congress Made it Clear that Financing and Lending Activities are not Investment Company Activities and Should not be Subjected to 1940 Act Regulation.

Congress and the Commission have recognized that financing activity is inherently different from investment company activity and, as a result, financing entities have been and should continue to be exempted from 1940 Act regulation. For instance, Sections 3(c)(4), 3(c)(5) and 3(c)(6) of the 1940 Act exclude industrial banking entities, financing entities and the holding companies of financing entities, respectively, from the definition of investment

[15] Rule 3a-7 Adopting Release, at 3.

company. As the Commission explained, these exemptions were intended to exclude from the 1940 Act issuers engaged in commercial finance and mortgage banking activities.[16] Such exemptions demonstrate Congress' understanding that lending activities should not be regulated as investment company activities. Because Rule 3a-7 entities and the holders of their securities provide a financing function, and because Congress recognized that such financing functions should be exempted from 1940 Act registration, it would be inconsistent with Congressional intent to regulate such companies as investment companies.

B. Rule 3a-7 Entities Serve a Financing Function the Same as that of Commercial Finance and Mortgage Banking Entities which Rely on Sections 3(c)(4) and 3(c)(5) and Rule 3a-7 Properly Extended the Exemption of Financial and Lending Activities to Asset-Backed Securities in order to Ensure Investor Access to this Important Form of Financing.

By rulemaking, the Commission recognized that the special treatment given to financing activities in the 1940 Act should be extended to include the financing activities of asset-backed securities issuers. Rule 3a-7 entities clearly serve a financing function. In fact, Rule 3a-7 was adopted to ensure that all types of structured financings, as long as they comply with certain requirements, were excluded from the definition of "investment company." When the Commission issued Rule 3a-7, it explained that "[s]tructured financings are fundamentally different from investment companies in operation and purpose"[17] and are "an increasingly important form of finance."[18] When considering Rule 3a-7, the Commission considered two options: (1) to require asset-backed securitizations to register under the 1940 Act; or (2) to wholly exempt asset-backed securitizations from the Act subject to certain conditions aimed at investor protection.[19] The Commission wisely recognized that the first option was untenable, saying that "any attempt to apply even a limited array of the Act's provisions is likely to disrupt an increasingly important form of finance, depriving investors of attractive, low-risk investment and foreclosing low cost borrowing for businesses."[20] The Commission's suggestions in the Rule 3a-7 Proposal could, if implemented, threaten this important form of capital formation and market liquidity.

In addition to the Commission recognizing that structured finance serves an important financing function, market participants recognize that asset-backed securitizations play an important role in providing financing to companies and borrowers. Securitization allows sponsors to more effectively manage their loan portfolios and balance sheets[21] by permitting

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[16] Exclusion from the Definition of Investment Company for Structured Financings, 1940 Act Release No. IC 18736 (May 29, 1992) ("Rule 3a-7 Proposing Release") at 13.

[17] Rule 3a-7 Adopting Release, at note 10.

[18] Protecting Investors Report, at 83.

[19] Id.

[20] Id.

[21] Protecting Investors Report, at 16.

those who originate or acquire loans to exchange the payment streams from those loans for cash in the short term[22] rather than holding those loans on their balance sheets for long periods of time.[23] This frees up additional capital that can be used by sponsors to make or acquire additional loans or make credit available to companies seeking financing.[24] By permitting a sponsor to convert long-term financial assets into cash, a sponsor can also retire debt or acquire new receivables, which strengthens a sponsor's financial condition by increasing return on assets and return on equity and accelerating income recognition.[25] The securitization process further encourages efficient functioning of capital markets because the risks inherent in holding the financial assets are allocated among sponsors and investors based on desired risk/return characteristics.[26]

Securitization allows sponsors to gain access to less expensive funding sources.[27] Because the securitized assets are no longer assets of the sponsor, the structured financing can be rated independently of the sponsor's credit rating.[28] Perhaps most importantly, asset-backed securitizations create a secondary market for loans.[29] In addition to providing businesses with financing and ensuring market liquidity, securitized products are attractive from an investor's point of view. Investors are attracted to securitized products in large part because they are customizable: each tranche has different characteristics, such as yield, cash flow and risk. This allows investors to customize investments for their particular needs and desires for return. In sum, both the Commission and the marketplace recognize that asset-backed securitization is a financing activity and plays a vital role in providing the market with capital and liquidity. The changes discussed in the Rule 3a-7 Proposal would threaten this important form of capital formation and market liquidity, and additionally are inconsistent with Congressional intent to exempt financing activities from 1940 Act regulation.

C. Holding Companies of Rule 3a-7 Entities Should Not be Subject to Different Treatment than Any Other Holding Company of an Exempted Financing Entity.

A financing company's 1940 Act status should not change simply because the company conducts its financing activities through majority-owned subsidiaries. The exemption for

[22] Asset-Backed Securities, SEC Release Nos. 33-9117, 34-61858 (April 7, 2010)

[23] See e.g., Protecting Investors Report, Remarks of Richard C. Breeden, SEC Chairman to the Investment Company Institute (May 21,1992).

[24] Id.

[25] Protecting Investors Report, 16-17.

[26] Protecting Investors Report, at 1.

[27] Rule 3a-7 Proposal, at 39 and note 100.

[28] Protecting Investors Report, at 17.

[29] See e.g., Protecting Investors Report, 6-8 (discussing how federal promotion of a secondary market for residential mortgages provided access to capital for mortgage financing).

holding companies provided by 1940 Act Section 3(c)(6) underscores the understanding of Congress and the Commission that financing activity is inherently different from investment company activity and should not be subject to the 1940 Act, regardless of the corporate form the issuer may take. Section 3(c)(6) provides that any company "primarily engaged, directly or through majority-owned subsidiaries" in one of the financing activities exempted by Sections 3(c)(3), 3(c)(4) or 3(c)(5) should be exempted from registration as an investment company. This section demonstrates that Congress and the Commission believe that a company's 1940 Act status should not change simply because the company conducts its exempted financing activity through majority-owned subsidiaries and that access to 1940 Act exemptions should not turn on the form that a financing entity utilizes.

The Commission's proposal relating to the treatment of asset-backed issuers' securities is unprecedented and would fundamentally change the asset-backed securities market. Under the 1940 Act, a company that holds 50% or more of the outstanding voting securities of an issuer may treat that issuer as its majority-owned subsidiary.[30] Securities of majority-owned subsidiaries that are not investment companies are not "investment securities".[31] As a result, a parent company who owns 50% or more of the outstanding voting securities of a Rule 3a-7 issuer may treat the issuer as its majority-owned subsidiary and is not required to treat any of the issued securities as "investment securities" for the purpose of determining whether 40% or more of the parent company's assets are investment securities under the test in 1940 Act Section (3)(a)(1)(C) (the "40% Test") for determining investment company status. As discussed above in Section II, the Commission proposes to require that the securities issued by Rule 3a-7 entities be considered "investment securities" under the 40% Test.

There is no reason to treat the parent company of a Rule 3a-7 entity differently than another parent company of a majority-owned subsidiary that engages in financing activities, as would be the result of deeming the securities of Rule 3a-7 entities held by a parent company to be investment securities. Under the 1940 Act, there are two instances in which a non-investment company majority-owned subsidiary's securities are treated as investment securities. This exception to the general rule applies when the majority-owned subsidiary is a 3(c)(1) or 3(c)(7) entity. Both such types of entities are exempted from regulation under the Investment Company Act for reasons outside of their structure and form. 3(c)(1) and 3(c)(7) entities remain investment vehicles despite their exemption from 1940 Act registration. Entities relying on Rule 3a-7 are not investment vehicles. As discussed above and in Sections III.A and B, they have long been recognized as financing vehicles analogous to banking and commercial finance companies that rely on Sections 3(c)(4) and 3(c)(5), and therefore are not analogous to 3(c)(1) and 3(c)(7) entities. Both Section 3(c)(6), with specific regard to financing entity subsidiaries,

[30] Rule 3a-7 Proposal, at 40; 1940 Act § 2(a)(24) (defining a "majority owned subsidiary") and § 2(a)(42) (defining "voting security").

[31] 1940 Act § 3(a)(2) ("As used in this section, 'investment securities' includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c)").

and the "majority-owned subsidiary" rule demonstrate the long held contention that holding companies or parent companies of such entities should not be required to register as investment companies. There is no reason for the parent companies of Rule 3a-7 entities to be subject to such drastically different requirements than other similarly situated entities.

Additionally, the suggestion that parent companies of Rule 3a-7 entities should be considered investment companies is particularly untenable given the structure of such entities. Entities that rely on the Rule generally provide a "closed" structure where an issuer originates or otherwise obtains loans, places those loans in a special purpose vehicle and then issues debt securities backed by those loans. The issuer generally keeps all or a portion of the equity interest in the SPV. Such equity interest is a residual interest in the loans and functions as a by-product of the financings. As financing represents a unique industry and the residual interest represents a by-product of the financing, assuming the special purpose vehicle meets the requirements of Rule 3a-7, there is no reason for the residual interest to be considered an "investment security" for the purposes of the 1940 Act. Furthermore, the Commission and other federal agencies have indicated that they understand the residual interest in the special purpose vehicle to be a part of a financing activity as recently as the 2011 proposed credit risk retention rules (the "Risk Retention Proposal").[32]

D. A Brief Examination of the Risk Retention Proposal Demonstrates that such Regulation Mitigates a Number of the Commission's Concerns Raised in the Rule 3a-7 Proposal.

The Risk Retention Proposal is important, as it relates to Rule 3a-7, in two ways, it: (1) demonstrates that the Commission views the residual interest of a structured financing to be a by-product of that financing and therefore inherently a financing activity; and (2) requires the retention of the same securities that the Commission proposes to consider investment securities, therefore forcing certain entities to accrue "bad assets" on their balance sheets from an investment company perspective. We will address each concern in turn.

The Risk Retention Proposal demonstrates Congressional and Commission understanding that the residual interest in a securitization is a part of that securitization and should therefore be considered a financing by-product rather than an investment security. The Risk Retention Proposal requires asset-backed issuers to maintain a portion of the credit risk of their securitizations, which will likely be a residual equity interest in the entity. Section 941 of Dodd-Frank required, among other things, that a sponsor of an asset-backed securitization retain a percentage of the risk of securitized assets. The goal of this requirement is to assign accountability for the asset quality to parties with the ability to control the asset quality, with the hope that this will lead to more prudent lending standards. The Risk Retention Proposal provides several options that an entity might pursue in order to retain some of the credit risk of its securitization. The most relevant, based on how most sponsors will practically structure the asset-securitization, consists of what the proposed rule calls a "horizontal residual interest."[33]

[32] Credit Risk Retention, 1934 Act Release No. 64148 (March 28, 2011) ("Risk Retention Proposal").

[33] Risk Retention Proposal, at 27.

Under the Risk Retention Proposal, a securitizer or sponsor who utilizes this option must retain a first-loss position in an amount equal to at least five percent of the par value of all asset-backed interests issued in the securitization.[34] By requiring that a securitizer maintain a residual interest in the securitization, the Commission and the other federal agencies involved in the Risk Retention Proposal acknowledge that the residual equity interest in the securitization is a part of the securitization, and that it represents a by-product of the exempted financing activity. As a by-product of the exempted financing activity, there is no reason for a residual equity interest to be considered an "investment security" for 1940 Act purposes, in direct conflict with the accepted understanding that financing activities should be free from 1940 Act regulation. Furthermore, such securities are expressly excluded from the 1940 Act definition of "investment security", which excludes the securities held by a parent company issued by its majority-owned subsidiaries which are not investment companies and which are not relying on Section 3(c)(1) or 3(c)(7).[35] We also note that the Commission is asking for comment regarding alternatives to the use of credit ratings in Rule 3a-7 in an effort to ensure the creditworthiness of the assets involved in securitizations. The Risk Retention Proposal demonstrates that Congress had a similar concern regarding creditworthiness in the broader asset-backed securities market and we suggest that the Commission should consider that the Risk Retention Proposal may alleviate some of the cause for their concern.[36]

As previously noted, the Commission, through the Risk Retention Proposal and the Rule 3a-7 Proposal, would unfairly require sponsors of asset-backed securities to retain an interest in the securitization while at the same time altering the fundamental treatment of such interest under the 1940 Act. The result of the two proposals, if adopted, would be to require securitizers to retain assets that will increase the amount of investment securities that they possess and therefore put such entities closer to meeting the 40% Test. This amounts to the Commission essentially punishing those entities that securitize assets and provide liquidity to capital markets with 1940 Act registration. As noted by the Commission when adopting Rule 3a-7, asset-backed securities issuers cannot function within the restrictions of the 1940 Act,[37] so such a result could force many securitizers to exit the market which would restrict liquidity and capital formation.

IV. The Evolving Regulatory Landscape Renders this an Inappropriate Time for Additional Changes to Rule 3a-7

In the past year, the Commission has proposed and adopted significant changes to the asset-backed securities market that may have significant impacts and lead to undetermined consequences. Significant changes flowed from Dodd-Frank that will impact many aspects of the asset-backed securities market and which may address some of the investor protection concerns raised by the Rule 3a-7 Proposal. It is in the best interest of the market to allow the

[34] Id.

[35] 1940 Act §3(a)(2); Section III.C supra.

[36] See supra note 14.

[37] Rule 3a-7 Adopting Release, at 3.

new regulations and safeguards to take effect and allow the Commission, Congress and the financial industry to observe the impacts of such regulation before implementing additional broad-sweeping changes to Rule 3a-7.

The Commission adopted significant changes to Regulation AB, creating a new environment for publicly and privately offered asset-backed securities issuers, in addition to all other structured finance products.[38] These changes include: (1) the implementation of Rule 15Ga-1 which imposed new disclosure requirements on securitizers of Securities Exchange Act of 1934 (the "1934 Act" or the "Exchange Act") asset-backed securities where the underlying documents contain a covenant to repurchase or replace assets in the event of a breach of a representation or warranty; (2) amendments to Items 1104 and 1121 to require reporting of securitized assets subject to repurchase or replacement within prospectuses and reports on Form 10-D; and (3) the implementation of Rule 17g-7 under the Exchange Act requiring NRSROs to disclose: (a) representations, warranties and enforcement mechanisms available to investors; and (b) how investor rights and remedies differ from those for issuances of similar securities.

Dodd-Frank imposed several additional regulatory requirements on the asset-backed securities market that may address some or all of the Commission's investor protection concerns.[39] Section 621 of Dodd-Frank amended the 1933 Act to include Section 27B, which generally prohibits an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security from engaging in any transaction that would involve or result in any material conflict of interest with 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.[40] Section 941 of Dodd-Frank required the Commission, the Federal banking agencies, and, with respect to residential mortgages, the Secretary of Housing and Urban Development and the Federal Housing Finance Agency to prescribe rules to require that a securitizer retain an economic interest in a material portion of the credit risk for any asset that it transfers, sells, or conveys to a third party. The chairperson of the Financial Stability Oversight Council was tasked with coordinating this regulatory effort. The resulting proposed rule is discussed above in Section III.D.

Additionally, Section 942 contained disclosure and 1934 Act reporting requirements for issuers of asset-backed securities, some of which are described above in the discussion of Regulation AB. Section 943 requires the Commission to prescribe regulations on the use of representations and warranties in the market for asset-backed securities. The Commission adopted final rules under Section 943 requiring NRSROs and issuers of asset-backed securities

[38] Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, SEC Release Nos. 33-9175, 34-63741 (March 28, 2011).

[39] Rule 3a-7 Proposal, at 32 ("Asset-backed issuers are also subject to various regulations under the Securities Act and Exchange Act. We recognize that there may be existing or proposed provisions under these other federal securities laws applicable to asset-backed issuers which...may help mitigate potential Investment Company Act-related concerns").

[40] Dodd-Frank, § 621.

to provide certain disclosures on the use of representations and warranties in the market for asset-backed securities, again, as described above in the discussion of Regulation AB.[41] Section 945 required the Commission to enact Rule 193 under the 1933 Act. Rule 193 generally requires an asset-backed issuer to perform a review of the assets underlying any asset-backed securities that will be registered under the 1933 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. The Commission adopted the rules under Section 945 on January 20, 2011.[42]

The actions described above taken by Congress, through Dodd-Frank, and the Commission represent significant changes to the asset-backed securities market. Introducing any further changes before observing the impact of the recently imposed regulations and safeguards is unnecessary and may, in fact, represent ill-considered behavior on the part of the Commission. In order to determine what is effective in ensuring investor protection in the asset-backed securities market, the Commission cannot change every variable at the same time. There must be measured changes made with the appropriate attention paid to the impacts of such changes. Changing the spirit or the structure of Rule 3a-7 in addition to the multitude of changes described above could restrict capital formation and liquidity and damage the country's already fragile economy. It is in the best interest of the asset-backed securities market, the capital and liquidity that it provides, and the economy as a whole, for the Commission to study the impacts of its already extensive adjustments to the regulation of the asset-backed securities market before making sweeping and significant changes to Rule 3a-7.

V. The Commission Lacks the Mandate and the Resources to Enact Such Sweeping Regulation Unilaterally

Congress has provided no indication, through Dodd-Frank or any previous legislation, that it believes that asset-backed securities issuers or sponsors should be subject to the 1940 Act or that any changes to Rule 3a-7 should be undertaken, with the exception of the references to NRSROs. Without such Congressional intent, or any significant pressure from the financial industry, the Commission cannot and should not expand its authority on its own. The Commission does, on the other hand, have the obligation to focus on efficiency, competition and capital formation in its rulemaking.[43]

The lack of Congressional intent to alter the function of Rule 3a-7 is most obvious when Dodd-Frank is considered. Dodd-Frank required significant and wide-ranging changes to almost every aspect of the national financial markets. Specifically, and as discussed at length above, Dodd-Frank required significant review of and changes to the asset-backed securities market. Despite the extensive attention paid to the asset-backed securities market, Congress required only one change to Rule 3a-7 in Dodd-Frank. This, again, was a part of the broader requirement

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[41] See 17 CFR 229, 232, 240 and 249.

[42] 17 CFR 229 and 230.

[43] 15 U.S.C. § 80a-2(c).

under Dodd-Frank that the Commission review and revise any reference to or reliance on credit ratings by NRSROs. Aside from this one change, Congress did not require or recommend that the Commission take any action with regard to Rule 3a-7.

Furthermore, the Commission must consider the effects a rule would have on efficiency, competition and capital formation. In order to undertake a rulemaking such as that contemplated by the Rule 3a-7 Proposal, the Commission would have to undertake a significant number of economic studies to determine the impacts of such a rule. With the already strained resources at the Commission and the significant amount of rulemaking and regulation that was required by Dodd-Frank, a reexamination and imposing additional regulation through the Rule 3a-7 Propoasal does not appear to be the best use of the Commission's resources. The Investment Management Division alone has to review and provide additional regulations having to do with mutual fund derivatives, and in particular, swaps, clearing and settlement issues and disclosure issues, in addition to providing oversight to a significant number of new investment advisers, including complex private equity advisers. The Investment Management Division is also charged with studying the need for a self-regulatory organization for investment advisers. In light of the significant amount of necessary and mandated activity by the Commission, the resources that would be required to institute the studies necessary to alter the Rule 3a-7 regulations may be prohibitive.

In recent years, courts have been increasingly focused on the obligation to perform sufficient studies regarding new rulemaking and have struck down certain Commission measures for not giving this obligation significant consideration. In *Chamber of Commerce*,[44] the Commission proposed a rule requiring a fund to have a board of directors with at least 75% independent directors and an independent chairman, but despite the Commission's reasonable justification for proposing the rule the court remanded the matter to the Commission to assess the costs of the proposed rule. The court stated that the Commission has a "statutory obligation to determine as best it can the economic implications of the rule it has proposed . . . [and] uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[45]

Additionally, it is clear from *American Equity Life Insurance*[46] that the Commission has a high threshold to overcome when considering the effects of a rule on efficiency, competition and capital formation. The court in *American Equity Life Insurance* held that the Commission's reasoning, which was similar to that which the Commission has used in the Rule 3a-7 Proposal, did not satisfy the statutory requirement to conduct a detailed economic analysis. The court explained that a statement from the Commission indicating that there was confusion in the marketplace is insufficient for an economic analysis. Such a statement only indicates that "there

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[44] Chamber of Commerce v. Sec. and Exchange Comm'n, 412 F.3d 133 (D.C. Cir. 2005).

[45] Id., at 143-144.

[46] American Equity Inv. Life Ins. Co. v. Sec. and Exchange Comm'n, 613 F.3d 166 (D.C. Cir. 2010).

[is] no regulation in place" and is insufficient to justify the adoption of a new rule.[47] In *Business Roundtable*[48] the court held that "the Commission relied upon insufficient empirical data"[49] when it concluded that the proposed proxy access rule would improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees.

This recent case law indicates that the Commission must conduct significant research into the economic impacts of a proposed rule and that it must have sufficient empirical data and evidence that a contemplated rule will not have a negative impact on efficiency, competition or capital formation. The Commission does not have the resources required to conduct the economic and competitive studies and analyses that it must undertake before implementing changes to Rule 3a-7.[50] As the Rule 3a-7 Proposal indicates, the Commission requires a better understanding of the economic and market impacts of the contemplated regulation. For example, the Rule 3a-7 Proposal asks a number of questions relating to the potential economic impacts of various revisions to Rule 3a-7, as well as the possible unforeseen impacts that the changes in regulation could have to the asset-backed securities market in general, on capital formation and on investors. It is clear from the questions asked by the Rule 3a-7 Proposal that the Commission would need to do significant research into the potentially far-reaching impacts of the changes to Rule 3a-7. It is also important to note that it would be almost impossible to conduct any analysis in a meaningful way in the immediate future, in light of the significant but unknown results and implications of recent regulation of the asset-backed securities industry.

VI. Conclusion

The asset-backed securities market must be restored in order to provide market liquidity and increase the credit available to borrowers and companies seeking financing. As such, the Commission should avoid taking any action which could further constrain liquidity and the ability of asset-backed securities issuers to provide financing to borrowers. Rule 3a-7 was intended as a broad exemptive rule which permitted structured financings to offer securities domestically without registering under the 1940 Act provided that the financing met certain

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[47] Id., at 177-78.

[48] Bus. Roundtable v. Sec. & Exch. Comm'n, No. 10-1305 (D.C. Cir. 2011).

[49] Id., at *11.

[50] Mary L. Schapiro, Testimony on "Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year", Before the United States Senate Committee on Banking, Housing and Urban Affairs, July 21, 2011, available at http://www.sec.gov/news/testimony/2011/ts072111mls.htm ("The provisions of the Dodd-Frank Act expand the SEC's responsibilities and will require significant additional resources to fully implement the law. To date, the SEC has proceeded with the first stages of implementation without the necessary additional funding... If the SEC does not receive additional resources, many of the issues highlighted by the financial crisis and which the Dodd-Frank Act seeks to fix will not be adequately addressed, as the SEC will not be able to build out the technology and hire industry expertise and other staff desperately needed to oversee and police these new areas of responsibility").

conditions meant to protect investors.[51] Limiting the eligible purchasers of interests in Rule 3a-7 entities could have significant and adverse effects on the securitization market, and the broader economy.

As discussed more fully above, Rule 3a-7 has successfully allowed the asset-backed securities market to develop and to thrive. Making changes to the Rule at a time when the market is struggling will be detrimental to the United States markets. Additionally, Rule 3a-7 was designed to incorporate investor protections sufficient to alleviate 1940 Act concerns, and the amendments proposed by the Commission in the Rule 3a-7 Proposal are unnecessary and duplicative to those protections. Further, Congress and the Commission have long distinguished financing activities from investment company activities and exempted financing activities from 1940 Act registration, regardless of whether such activities are conducted directly by a company or utilize a holding company structure. The proposed changes to Rule 3a-7 run counter to this recognition and threaten to restrict capital formation and liquidity in the marketplace. In conclusion, today's evolving regulatory landscape renders this a particularly inappropriate time for additional changes to Rule 3a-7 and that the Commission lacks the mandate and the resources to enact such sweeping regulation unilaterally. As such, we respectfully request that the Commission:

1. Reaffirm that securities retained by the parent company of a majority-owned subsidiary that relies on Rule 3a-7 are not "investment securities" under the Investment Company Act so that sponsors can continue to provide financing and liquidity to the market;

2. Amend Rule 3a-7 only to the extent required by Dodd-Frank by removing references to and requirements regarding ratings organizations and substituting a sufficient alternative; and

3. Refrain from seeking a Congressional modification to Section 3(c)(5)(C) that would prohibit mortgage-related securitizations from relying on that Section.

We appreciate the Commission's consideration of our concerns and recommendations regarding the Rule 3a-7 Proposal. If we can address any questions regarding our comments, please do not hesitate to contact Michael S. Caccese at (617) 261-3133; Phillip J. Kardis at (202) 778-9401; or Robert H. Rosenblum at (202) 778-9464.

Very truly yours,

K&L Gates LLP

K&L Gates LLP

[51] Rule 3a-7 requires the asset-backed issuer to issue fixed-income securities or other securities which entitle the holders to receive payments that depend primarily on the cash flow from "eligible assets", defined in Rule3a-7(b)(1).