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By Email (rule-comments@sec.gov) and U.S. Mail

November 15, 2011

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
Attn: Ms. Elizabeth M. Murphy, Secretary

**Re: Treatment of Asset-Backed Issuers Under the Investment Company Act - Advance Notice of Proposed Rulemaking Regarding Rule 3a-7 – Release No. IC-29779; File No. S7-35-11 ("ANPR")**

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee and the Securitization and Structured Finance Committee (the "**Committees**") of the Business Law Section of the American Bar Association (the "**ABA**") in response to the request for comments by the Securities and Exchange Commission (the "**Commission**") in connection with the ANPR.

The comments expressed in this letter represent the views of the Committees only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Business Law Section.

We appreciate the opportunity to provide comments to the Commission regarding the ANPR. In our view, Rule 3a-7 has worked well over the nearly two decades since its adoption by the Commission. For the reasons discussed below, we do not believe that there is any need to modify the Rule to delete the investment-grade ratings requirement, substitute review by another independent third-party or certification by the issuer itself for the review currently conducted by rating agencies or to import concepts from other existing or pending rulemakings by the Commission pursuant to the Dodd-Frank Act.

Initially, we note (as does the Commission in the ANPR) that the Rule 3a-7 rating agency requirements were instigated not by credit-worthiness concerns but, rather, to address investor protections as a condition to this exclusion for asset-backed issuers from

the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). In adopting Rule 3a-7 in 1992[1], the Commission found that the rating agencies, when assigning a rating to securities issued by an asset-backed issuer, would evaluate whether that issuer was structured in a manner that ensured appropriate investor protections of the kind contemplated by the Investment Company Act (including protection against abusive practices, such as self-dealing, mis-valuation of assets, and inadequate asset coverage[2]).

Because the rating agency requirements in Rule 3a-7 do not relate to credit-worthiness, we believe that there is no requirement under Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") to re-consider this requirement under Rule 3a-7. Furthermore, we note that Commission has not decided to require changes to Rule 3a-7 in its prior rulemakings pursuant to Section 939A of the Dodd-Frank Act or otherwise, even though on several prior occasions[3] it has specifically considered doing so.

Moreover, although the Commission refers in the ANPR to certain concerns regarding the credit rating procedures and methodologies of the nationally recognized statistical rating agencies ("**NRSROs**"), it is not clear to our Committees that these concerns can or should cause the Commission to question the original investor protection premise of the rating agency requirements under Rule 3a-7. We are not aware of any data or other evidence that would indicate that the NRSRO-rating process fails (or has failed) to perform the same investor protection function as originally envisaged by the Commission. Absent a compelling change in the factual basis for the Rule, we do not believe that the changes to Rule 3a-7 the Commission is considering are justified.

The Commission adopted Rule 3a-7 to facilitate the growth and development of the structured finance market, which the Commission noted had been constrained to some degree by the Investment Company Act.[4] In adopting Rule 3a-7, the Commission recognized the importance of ratings to the development of the structured finance market:

> "The involvement of rating agencies represents one of the most significant attributes of the structured finance market. This is because structured financings enable issuers to generate capital by converting often illiquid, unrated assets into marketable

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[1] Final rule, *Exclusion From the Definition of Investment Company for Structured Financings* (the "**Adopting Release**"), 57 Fed. Reg. 56248 (November 27, 1992). The related proposed rule, *Exclusion From the Definition of Investment Company for Certain Structured Financings* (the "**Proposing Release**"), 57 Fed. Reg. 23980 (June 5, 1992).

[2] Adopting Release at 56252.

[3] See, for example, other proposed rules regarding references to ratings, including 76 Fed. Reg 26550 (May 6, 2011), 76 Fed. Reg 12896 (March 9, 2011), 76 Fed. Reg. 8946 (February 16, 2011 and, pre-dating the Dodd-Frank Act, 74 Fed. Reg. 52374 (October 9, 2009).

[4] Adopting Release at 56248.

> rated securities. As discussed in the related proposing release, rating agency evaluations tend to address most of the Act's concerns regarding abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage. Rating agencies have been successful in analyzing the structural integrity of financings, without impending the development of the structured finance market. Indeed, ratings appear to have been a major factor in investor acceptance of structured financings."[5]

The substantial growth of the asset-backed securities ("**ABS**") market after the adoption of Rule 3a-7 attests to the soundness of the Commission's original determination. Consumers, businesses and investors have all benefitted from the robust growth in the ABS market. While current ABS issuance is only about 15% of pre-crisis levels, it is still over $100 billion per year according to available data[6] and, most importantly, is concentrated in autos, credit cards and equipment ABS ─ that is, the very type of ABS that relies heavily on the exemption provided by Rule 3a-7. We are concerned that any attempt to replace the relatively straight-forward ratings requirement with some other review (which would require a review scope to be proposed, final rules to be developed and processes and procedures to be adopted in order to implement any final rules) will unnecessarily impair the ABS market, which provides valuable capital formation for credit to consumers and businesses, while providing no material added protection to investors.

Even if the Commission finds that its more general concerns regarding NRSROs give rise to specific concerns regarding the investor protection function served by the rating agency requirements in Rule 3a-7, the Commission has other, more direct, means to address such specific concerns, including its current rulemaking to implement the substantial credit rating agencies reforms mandated by Title IX of the Dodd-Frank Act. For example, the Commission might exercise its regulatory authority over NRSROs to strengthen the methodologies and procedures relating to this investor protection function.

Our Committees share many of the concerns evidenced by the questions posed by the Commission regarding the proposed "independent evaluator" concept. We are not able to offer any better alternative to the evaluation provided by the rating agencies under Rule 3a-7.

Although we do not believe that any of the changes to Rule 3a-7 discussed in the ANPR are necessary, there are two areas where modifications to the Rule that we believe are appropriate and should be made.

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[5] Adopting Release at 56252 (footnote omitted).

[6] *See*, for example, research of the Securities Industry and Financial Markets Association available at: http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-ABS-SIFMA.xls.

Requirement for Rating Agency Affirmation for Acquisition or Disposition of Assets Should be Removed from Rule 3a-7

We believe it would be appropriate to remove the restriction on the acquisition and disposition of assets in paragraph (a)(3)(ii) of the Rule for the following reasons:

*First*, we believe that investors are already adequately protected by the ratings-related requirement in paragraph (a)(3)(i) of the Rule to the effect that assets be acquired or disposed of in accordance with the terms and conditions set forth in the agreements, indentures or other instruments pursuant to which the issuer's securities are issued. As noted above, in adopting current Rule 3a-7, the Commission found that the NRSROs, when assigning a rating to securities issued by an asset-backed issuer, would evaluate whether that issuer was structured in a manner that ensured appropriate investor protections of the kind contemplated by the Investment Company Act.[7] The requirements for adding and removing assets are specified in the agreements governing every ABS transaction of which we are aware, and such requirements are just one of many structural aspects evaluated by both investors and rating agencies. We note that such restrictions typically address the adequacy of asset coverage and self-dealing. We recognize that a transaction may be amended to modify the requirements for acquisitions and removals of assets; however, as noted by the Commission in the adopting release for current Rule 3a-7, any such amendment would be subject to the requirements and conditions precedent in the agreements relating to amendments of the agreements, including investor and rating agency concurrence, as appropriate.[8] In addition, the conditions for amendments and modifications of the transaction documents are another structural aspect considered by the rating agencies in issuing credit ratings.

*Second*, the credit rating-related restriction in paragraph (a)(3)(iii) of the Rule only incidentally addresses the Commission's stated goal of preventing self-dealing.[9] To the extent that the primary purpose of paragraph (a)(3)(iii) is to prevent self-dealing, we believe the Commission has more direct means of addressing self-dealing behavior.[10] By tying the restriction on acquisitions and removals of assets to whether a rating downgrade would in fact

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[7] Adopting Release at 56252.

[8] Adopting Release at 56254.

[9] In the Adopting Release, 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 fixed-income securities holders was understood to result in a downgrading of the issuer's fixed-income securities. See the Adopting Release at p.56254.

[10] As noted above, we believe the requirement in paragraph (a)(3)(i) of Rule 3a-7 (to the effect that assets be acquired or disposed of in accordance with the terms and conditions set forth in the agreements, indentures or other instruments pursuant to which the issuer's securities are issued) adequately addresses concerns relating to self-dealing.

occur, the restriction becomes dependent upon an assessment by the rating agencies of the credit-worthiness of the assets being acquired or removed and the credit-worthiness of the resulting structure. For this reason, we believe that it is appropriate to consider removing such requirement in response to Section 939A of the Dodd-Frank Act.

*Third*, we note that an issuer may not know with certainty whether an acquisition or removal of assets would cause a rating downgrade to occur until after the acquisition or removal is completed. NRSROs are increasingly unwilling to deliver confirmation that an action will not cause a rating downgrade. Therefore an issuer's ability to rely on Rule 3a-7 can be jeopardized by a determination by an NRSRO that a previously completed acquisition or disposition resulted in a less credit-worthy pool of assets.[11] We believe that removing this uncertainty from Rule 3a-7 would be beneficial to both investors and issuers.

<u>The Commission Should Revise Rule 3a-7 To Facilitate the Securitization of Lease Assets and To Accommodate the Use of Intermediate Special Purpose Entities in Securitizations</u>

The foregoing discussion demonstrates that Rule 3a-7 has protected investor interests and does not require further revision for that purpose. It would be appropriate, however, to revise Rule 3a-7 in two important respects so that it can promote those investor interest while making the securitization of certain assets easier. These revisions to Rule 3a-7 would be consistent with the principles that the Commission followed in adopting Regulation AB.

***The Definition of "Eligible Assets" under Rule 3a-7 Should Be Revised So That, in the Context of a Lease Securitization, It Includes the Related Leased Property and the Cash Realized from the Liquidation of That Property***

The Commission should clarify that the entire securitized pool in a lease[12] securitization, including the underlying leased equipment and proceeds realized on that equipment, constitutes "eligible assets" in a securitization relying on Rule 3a-7. In many securitizations that include lease assets, the payments to the holders of the securities issued in connection with such securitization rely not only on cash flow from payments under the leases themselves, but also on

[11] We also note that in the event a ratings downgrade were to cause a securitization issuer to become subject to regulation as an Investment Company Act, such event would typically cause an amortization event or event of default for the securitization, which could result in further adverse consequences for investors.

[12] Leases, for this purpose, should also include balloon loans for motor vehicles or equipment which are structured to be similar to leases where at the maturity of the loan, the obligor may return the vehicle or equipment to the lender to satisfy the balloon payment. The funds received upon liquidation of that vehicle or equipment by the lender is the functional equivalent to realizations on the residual value related to a lease. *See* similar treatment in the definition of "asset backed security" in 17 CFR Parts 210, 228, et al. *Asset-Backed Securities; Final Rule* ("ABS Rule"), footnote 76.

realization on the residual value[13] of the property subject to such leases. As a result, certain lease transactions may not be able to rely on Rule 3a-7 if these realizations on residual value are not "eligible assets" under Rule 3a-7.

The current definition of "eligible assets" in Rule 3a-7 limits the ability to execute certain lease securitizations. This definition covers only financial assets that "by their terms convert into cash with a finite time period." Virtually all auto leases, and a significant portion of equipment leases, permit the lessee to return the vehicle or leased equipment upon lease termination in lieu of purchasing that property. The residual value of the auto or equipment that is realized upon liquidation of the returned auto or equipment is an important part of the securitization value of the leasing arrangement. This residual value, however, does not currently fall within the definition of "eligible asset," because such residual value is not itself a financial asset that "convert[s] into cash within a finite time period."

Including these residual values is, however, consistent with the purpose of the definition of "eligible assets" which was intended by the SEC to include "virtually all assets that can be securitized (*i.e.*, which produce cash flows of the type that may be statistically analyzed by rating agencies and investors)."[14] In the Proposing Release, the SEC explicitly included "leases" in the definition of "eligible assets."[15] The applicable discussion in the Adopting Release indicated that an illustrative list was left out of the definition of "eligible assets" in the final Rule to avoid any suggestion that it was meant as an exclusive list, but the more general language of the final definition is intended to include all of the assets provided as examples in the proposed definition.[16] Then, as now, residual values can typically be a significant asset naturally included in lease securitizations.

In 2004 the Commission addressed a similar issue when it adopted Regulation AB and its definition of "asset-backed security." At that time, the Commission formulated that definition so that it expressly recognized that most leasing transactions fell within the definition of "asset-backed security," even if a substantial portion of the value of the lease assets consisted of a residual value to be realized upon the termination of the lease. We think that the Commission should likewise revise the definition of "eligible asset" here to recognize that the presence of

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[13] The "residual value" of an item of leased property is the value that can be realized by the lessor through sale or other disposition of that item at the end of the lease term. In a typical securitization transaction, the originator of the leases (or one of its affiliates) would act as servicer on behalf of the special purpose entity formed for purposes of the securitization transaction, and one of the servicer's obligations would be to dispose of leased property upon expiration or early termination of the leases and transfer the proceeds of such dispositions (net of its expenses) to the special purpose entity.

[14] Adopting Release at 56249.

[15] Proposing Release at 23989.

[16] Adopting Release at 56249-56250.

residual values in a securitization of lease assets should not preclude that arrangement from relying on Rule 3a-7. Such an approach will promote more consistency within the regulatory structure that the Commission oversees and will reduce the current tension in which Regulation AB accommodates leasing securitization while Rule 3a-7 does not.

Regulation AB contains certain substantive ceilings on the amount of residual value that can be part of the securitized pool balance in order for the transaction to fit within the definition of "asset-backed security". Although the approach of Regulation AB should generally be followed in revising the definition of "eligible asset," the Commission should not adopt these limits or any other similar value-based limits for the purposes of Rule 3a-7. These residual values are not securities but instead are ultimately just proceeds (or expected proceeds) obtained from the sale of goods. A company that was purely in the business of selling or holding goods (including vehicles or equipment and the related residual values) would not even fall within the definition of an investment company. In the context of the policies of Rule 3a-7, these limits are both unnecessary and counterproductive. They are unnecessary for securitizations that are structured as registered offerings, because those substantive limits will exist in any event as a result of the operation of Regulation AB itself. In the context of a private offering, they are counterproductive to the investor protection goals of Rule 3a-7. Securitizers have the option of structuring their transactions to take advantage of other exemptions from the Investment Company Act, such as Section 3(c)(7). These other exemptions do not necessarily contain the investor protection features that the ANPR notes are part of the fabric of Rule 3a-7 and were not designed for the issuance of asset backed securities and other securitization transactions. By deleting those value-based ceilings in Regulation AB's definition of "asset-backed securities" from a definition of "eligible assets" that is designed to capture lease transactions, the Commission will make Rule 3a-7 overall a more attractive exemption from the Investment Company Act that will encourage securitizers to structure their transactions to fit within Rule 3a-7 as revised, thereby providing investors with the investor protection features of Rule 3a-7.

***Rule 3a-7 should be revised to facilitate the use of intermediate entities.***

Securitization transactions typically use one or more intermediate entities to hold eligible assets. or to pass those assets from the originator or sponsor to the issuing entity. In the context of lease securitizations, these intermediate entities include so-called "titling trusts." The titling trust typically holds title to leased vehicles or other lease property (frequently of the type for which ownership and lien perfection must be reflected, as a matter of state law, on a certificate of title); titling trusts often also own the leases themselves. The securitization then provides for the titling trust to issue an instrument (sometimes a note secured by the lease assets, other times a special unit of beneficial interest in the trust itself) that is transferred either directly to the issuing entity in the securitization or to another intermediate entity that in turn transfers the instrument to the issuing entity in the securitization. It should be noted, though, that titling trusts are not the only type of intermediate entity that frequently is part of a securitization structure; other intermediate entities are depositors or similar special purpose vehicles created to pass assets to the issuer of the asset-backed securities.

The use of intermediate entities satisfies various legal requirements in securitizations, such as by providing a means to comply with accounting rules, credit isolation principles or state

certificate of title statutes while providing arrangements in which investors can be confident that they have perfected security interests in all aspects of the lease assets, including the underlying vehicles themselves. These titling trusts and other intermediate entities, however, do not cleanly fit within the scope of Rule 3a-7.

In other contexts, the Commission has recognized the utility of these intermediate entities and accommodated their use. For example, Items 1100(d)(1) and 1100(d)(2) of Regulation AB contain provisions regarding disclosure and other aspects of securitizations that reflect the special characteristics of lease securitizations. Rule 190(c) of the Securities Act of 1933 likewise provides special rules about these intermediate entities. Similarly, in its rules implementing new exemptions from the Investment Advisors Act of 1940 for advisers to certain privately-offered investment funds, the Commission agreed that venture capital funds could disregard wholly owned intermediate holding companies formed solely for tax, legal or regulatory reasons to hold such funds' investments in qualifying portfolio companies.[17]These accommodations by the Commission in other contexts permit use of the intermediate entities so long as it is clear that the regulatory aims of the underlying statute or rule are otherwise being met.

We believe that, if an asset-backed issuer can satisfy all of the Rule 3a-7 requirements, it should not be precluded from relying on Rule 3a-7 because the provisions of Rule 3a-7 do not bring titling trusts or related intermediate entities within the Rule's scope. Therefore, we suggest that the Commission revise Rule 3a-7 so that it facilities the use of Rule 3a-7 by asset-backed issuers that utilize intermediate entities while preserving the protections of Rule 3a-7 for investors.

Finally, we note that under Section 2(c) of the Investment Company Act, the Commission is required, in its rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

We again refer to the substantial growth and resilience of the ABS markets since the introduction of Rule 3a-7 in 1992 and respectfully suggest that, in the absence of some demonstrable failure of the rating requirements in Rule 3a-7 to ensure investor protection as originally contemplated by the Commission in adopting Rule 3a-7, the Commission should exercise particular care that any revisions to Rule 3a-7 will not jeopardize existing efficiency, competition and capital formation in the ABS market. In considering possible changes to Rule 3a-7, the Commission will, we assume, exercise such care and ensure that any proposed change is only prospective and that appropriate arrangements to "grandfather" existing transactions that rely on the then-current Rule 3a-7 are provided such that this reliance will be respected. In this regard, we note that many ABS transactions that rely on Rule 3a-7 would likely face an event of default (in some cases triggering immediate liquidation) if Rule 3a-7 were revised in a way that failed to respect this prior reliance and exemption. The Commission's analysis under Section

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[17] Final Rule, *Exemptions for Advisers to Venture Capital Funds, Private Equity Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers*, 76 Fed. Reg. 39646 (July 6, 2011), at 39660.

2(c) of the appropriateness of its suggested change to Rule 3a-7 will necessarily need to take into consideration the costs and expenses of redressing any such defaults if grandfathering existing transactions is not part of the revised Rule.

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The Committees appreciate the opportunity to comment on the ANPR, and we respectfully request that the Commission consider the recommendations set forth above. Although we have approached the proposals with the goal of discussing them in some detail, their scope—and the many competing legislative and regulatory initiatives affecting securitization at the same time—have resulted in certain issues being left unaddressed. We are prepared to meet with the Commission and its Staff to discuss these matters with them in more detail and to respond to any questions.

Very truly yours,

/s/ Jeffrey W. Rubin
Jeffrey W. Rubin
Chair, Federal Regulation of Securities Committee

/s/ Martin Fingerhut
Martin Fingerhut
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