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GLOBAL FINANCE UPDATE

Securities and Exchange Commission requests comment on proposed rulemaking related to treatment of asset-backed securities transactions under the Investment Company Act

The SEC recently released an advance notice of proposed rulemaking (the "ANPR") with respect to the treatment of asset-backed issuers under Rule 3a-7 under the Investment Company Act of 1940 (the "ICA") and Section 3(c)(5) of the ICA.[1] Comments are due on the ANPR no later than November 7, 2011.

Entities that constitute "investment companies" under Section 3(a)(1) of the ICA are highly regulated under the ICA such that it would be effectively impossible to structure an asset-backed transaction to comply with its requirements. Because issuers of asset-backed securities generally meet the definition of an investment company under Section 3(a)(1), an exclusion from the ICA's requirements is necessary. Issuers of registered asset-backed securities[2] that are otherwise Section 3(a)(1) investment companies generally rely on one of two exclusions –

- Rule 3a-7, applicable to issuers of "fixed-income securities" or other securities which entitle their holders to receive payments that depend primarily on the cash flow from "eligible assets;" or
- Section 3(c)(5), applicable to issuers who are not engaged in the business of issuing redeemable securities and who are primarily engaged in the business of (a) purchasing or acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services, (b) making loans to manufacturers, wholesalers and retailers of, and to prospective purchasers of, merchandise,

[1] See Release No. IC-29779, "Treatment of Asset-Backed Issuers under the Investment Company Act," Fed. Reg., Vol. 76, No. 173 (Sept. 7, 2011), 55308, available at http://www.sec.gov/rules/concept/2011/ic-29779fr.pdf. On the same day, the SEC released a concept release on the status of entities (including real estate investment trusts) engaged in the business of acquiring mortgages and mortgage-related instruments pursuant to the exclusion from the definition of "investment company" contained in Section 3(c)(5)(C) of the ICA. See SEC Release No. IC–29778, "Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments," Fed. Reg., Vol. 76, No. 173 (Sept. 7, 2011), 55300, available at http://www.sec.gov/rules/concept/2011/ic-29778fr.pdf. In the concept release the SEC notes that certain entities that rely upon Section 3(c)(5)(C) for an exclusion from the ICA seem to be similar to traditional investment companies yet are not subject to the requirements of the ICA. The SEC solicits comment on different alternatives the SEC could pursue to address this issue. See Sidley Austin LLP, Investment Funds Update, "The SEC Seeks Comment Related to the Status Under the Investment Company Act of REITs and Other Companies Engaged in the Business of Acquiring Mortgages and Mortgage Related Instruments," dated September 13, 2011, available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4941.

[2] Issuers of private asset-backed securities may rely on these exclusions as well as the exclusions under Section 3(c)(1), applicable to issuers whose outstanding securities are beneficially owned by 100 or fewer owners of securities sold in private placements and Section 3(c)(7), applicable to issuers whose outstanding securities are beneficially owned by qualified purchasers meeting certain eligibility requirements, and that were in each case sold in private placements.

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insurance, and services, or (c) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

Under Rule 3a-7, subject to certain exceptions for securities sold to investors meeting certain eligibility requirements, an issuer's fixed-income securities must be rated, at the time of initial sale, in one of the four highest categories assigned long-term debt or an equivalent short-term rating by at least one nationally recognized statistical rating organization ("NRSRO") that is not an affiliated person of the issuer or any person involved in the organization of the issuer. Among other requirements, Rule 3a-7 also limits acquisitions and dispositions of eligible assets by issuers relying on Rule 3a-7, precluding acquisitions or dispositions for the primary purpose of recognizing gains or losses resulting from market value changes.[3]

In the ANPR, the SEC states that when it adopted Rule 3a-7 in 1992, these and the other conditions included in Rule 3a-7 were intended to reflect the structural and operational distinction between investment companies and asset-backed issuers, to accommodate future innovations in the securitization market and to address investor protection concerns. By including a requirement that the fixed-income securities receive certain ratings, the SEC believed that certain investor protection goals would be achieved by virtue of the requirements that the NRSROs imposed on issuers in order to issue those ratings.[4] Since 2008, the SEC has issued several rule proposals and concept releases removing or examining the use of credit ratings in its rules, including proposed rules in 2008 to remove the use of credit ratings in Rule 3a-7 and to limit the investors eligible to buy fixed-income securities of issuers relying on Rule 3a-7 to institutional accredited investors and qualified institutional buyers.[5] More recently, in 2010, with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[6] the SEC is required to review any regulation that requires the use of an assessment of the creditworthiness of a security and contains references to or requirements regarding credit ratings. After this review, Section 939A of the Dodd-Frank Act requires the regulators to remove these references or requirements and to substitute in such regulations an appropriate standard of creditworthiness.

In the ANPR, the SEC distinguishes the purpose of the Rule 3a-7 credit ratings requirement which it states is aimed at investor protection from the use (prohibited by Section 939A of the Dodd-Frank Act) of credit ratings as an assessment of creditworthiness. The SEC indicates that market developments since the adoption of Rule 3a-7 in 1992, in particular the role that ratings played in the recent financial crisis, has lead it to solicit feedback on potential amendments to Rule 3a-7 that would replace references to credit ratings with conditions designed to address ICA and investor protection concerns.[7] In addition, the SEC solicits comment on the treatment of securities issued by entities relying on Rule 3a-7 for purposes of analyzing whether an investor in such securities is itself an investment company under the ICA.

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[3] Rule 3a-7 also provides that the issuer

– may only acquire or dispose of assets in accordance with the transaction documents and where the acquisition or disposition would not result in a downgrade of the fixed-income securities; and

– except if it issues commercial paper exempt under Section 3(a)(3) of the Securities Act, must take reasonable steps to cause an independent trustee to have a perfected security interest or ownership interest valid against third parties in the eligible assets, and must take action necessary for the cash flow derived from the eligible assets for the benefit of the fixed-income securities to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the fixed-income securities.

[4] See pp.55311-12 of the ANPR.

[5] See SEC Release Nos. IC–28327; IA–2751, "References to Ratings of Nationally Recognized Statistical Rating Organizations," Fed. Reg., Vol. 73, No. 134 (Jul. 11, 2008), 40124, available at http://www.sec.gov/rules/proposed/2008/ic-28327fr.pdf (the "2008 Release").

[6] The Dodd-Frank Act, Public Law 111-203 (July 21, 2010).

[7] In the ANPR, the SEC withdraws its 2008 proposed amendments to Rule 3a-7.

Rule 3a-7 and Investment Company Act concerns

The SEC highlights three areas of focus with respect to asset-backed issuers –

- self-dealing by insiders, misvaluation of assets and inadequate asset coverage as they relate to the structure and operation of the asset-backed issuer;
- the benefits of an independent review of the asset-backed issuer's structure and intended operations in addressing these concerns; and
- preservation and safekeeping of the asset-backed issuer's eligible assets and cash flow.

In the ANPR, the SEC asks whether the ratings requirements in Rule 3a-7 have served their intended purpose with respect to investment company concerns and if additional conditions should be added to Rule 3a-7 to address these concerns. The SEC also poses specific questions as to each area of focus and possible methods to address ICA and investor protection concerns.

Examples of additional conditions identified by the SEC include specifying the particular manner in which the issuer's assets should be selected and valued to avoid dumping of assets and misvaluation, and precluding people involved in the operation of the issuer from certain activities that could adversely affect the payment terms of the securities. Alternatively, the SEC contemplates a more principles-based approach whereby the limits applicable to an issuer or other transaction parties would be more general in nature (i.e., policies and procedures that are reasonably designed to prevent insiders from engaging in activities that may adversely affect payment of the fixed-income securities after the securities are sold).

With respect to the independent review, the SEC contemplates a requirement similar to the officer's certificate in its re-proposed criteria for shelf registration of asset-backed securities on Form S-3 certifying that the securitization is designed to produce, but is not guaranteed by the certification to produce, cash flows at times and in amounts sufficient to service expected payments on the asset-backed securities offered and sold pursuant to the registration statement.[8] The SEC contemplates an opinion from an independent evaluator that the independent evaluator reasonably believes, based on information available at the time the fixed-income securities are first sold and taking into account the characteristics of the securitized assets underlying the offering, that the asset-backed issuer is structured and would be operated in a manner such that the expected cash flow generated from the underlying assets would likely allow the asset-backed issuer to have the cash flow at times and in amounts sufficient to service expected payments on the fixed-income securities. (Like the proposed Form S-3 certification requirement, the opinion would not serve as a guarantee that the securitization will produce such cash flow). Alternatively, the SEC is considering an issuer certification to this same effect in its offering documents (taking into account the views of an independent evaluator that has reviewed the structure and the intended operations of the issuer). The ANPR indicates that an NRSRO with expertise and experience in structuring or evaluating asset-backed issuers and their securities could serve as the independent evaluator.

The SEC requests comment on whether Rule 3a-7 should be amended to strengthen the protection of assets and cash flow, for example, by including a maximum number of days that a servicer may retain collections before transferring them to an account held by the trustee. Currently, other than transactions seeking to rely on the FDIC safe harbor for securitization transactions, remittance conditions on how long a servicer may hold collections are dictated by NRSRO and investor requirements.

The SEC also solicits comment on the extent to which existing or proposed regulations applicable to asset-backed issuers, such as the required review of underlying assets under Rule 193 under the Securities Act, proposed risk

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[8] See SEC Release Nos. 33–9244; 34–64968; "Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities," Fed. Reg., Vol. 76, No. 151 (Aug. 5, 2011), 47948, available at http://www.sec.gov/rules/proposed/2011/33-9244fr.pdf.

retention requirements or the Form S-3 eligibility requirements would serve to mitigate against ICA concerns and thus would be suitable for inclusion in Rule 3a-7.

Overall, the proposals to amend Rule 3a-7 represent another area in which the SEC has moved beyond disclosure as a means of investor protection, much the same as has been seen in the proposed amendments to the Form S-3 shelf eligibility requirements and the Dodd-Frank Act's risk retention requirements. Similarly, the nature of these proposals is in many ways reminiscent of some of the "best practices" requirements included by the FDIC in its revisions to its securitization safe harbor rule.

Section 3(c)(5) reliance by asset-backed issuers

Although the SEC adopted Rule 3a-7 specifically for use by issuers of asset-backed securities in 1992, many issuers of asset-backed securities rely on Section 3(c)(5) of the ICA as the basis for exclusion from treatment as an investment company. Because reliance on Section 3(c)(5) is not conditioned on compliance with the various investor protection measures contained in Rule 3a-7, the SEC solicits comment on whether Section 3(c)(5) should be amended by Congress to exclude reliance by asset-backed issuers or whether the SEC should use its rulemaking authority to limit the use of Section 3(c)(5) to companies that were intended to fall within the exemption.

Treatment of Rule 3a-7 issuers under the ICA

Status of a company as a Rule 3a-7 issuer is relevant for two reasons under the ICA; first, the issuer's status as an investment company under the ICA and, second, the treatment of the securities issued by that issuer for purposes of determining whether an investor investing in such securities (including a parent company of the issuer) is itself an investment company under the ICA. Under Section 3(a)(1)(c), securities of majority owned subsidiaries (other than securities issued by companies that absent Section 3(c)(1) or Section 3(c)(7) of the ICA (often referred to as "private investment companies") would be investment companies) are not treated as "investment securities" for purposes of determining if an issuer holds more than 40% of its assets in investment securities. As a result, an entity that holds a majority of the voting securities of a Rule 3a-7 issuer is not required to treat the securities as investment securities (whereas securities issued by private investment companies would count for this limitation). The SEC questions whether the disparate treatment of private investment companies and issuers relying on Rule 3a-7 is appropriate given the similarities between these issuers, and if it should consider rulemaking to specify that securities of a Rule 3a-7 issuer must be counted for purposes of measuring an entity's holdings of investment securities.

The SEC also raises concerns with respect to the permissibility of business development company ("BDC") investments in securities issued by Rule 3a-7 issuers. BDCs are limited in their ability to invest in investment companies or companies that are excluded from the definition of investment company under Section 3(c) of the ICA. (BDCs, which are required to invest primarily in small, developing and financially troubled businesses, are subject to special ICA provisions.) Because Rule 3a-7 issuers are excluded from the definition of investment companies by reason of other than Section 3(c), BDC investments in 3a-7 issuers are not subject to the same limitations. The SEC states that as a general matter it does not believe that Rule 3a-7 issuers are the type of businesses in which Congress intended BDCs primarily to invest and solicits comment on whether it should adopt rules that would limit investment by BDCs in a 3a-7 issuer.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

Global Finance

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