November 7, 2011

Ms. 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; Advance Notice of Proposed Rulemaking; File Number S7-36-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned advance notice of proposed rulemaking ("Notice") of the Securities and Exchange Commission ("Commission"), which seeks comment on possible amendments to Rule 3a-7. That rule provides certain asset-backed issuers with a conditional exclusion from the definition of an investment company set forth in the Investment Company Act of 1940.

INTRODUCTION AND SUMMARY

The costs and consequences of the Wall Street meltdown of 2008 and the following financial and economic crises are extraordinary because they have been so profound, so widespread, and so enduring. The terrible impact on American families and the public treasury can be seen in the persistently high unemployment figures, the unprecedented home foreclosure numbers, the strained local, state, and federal budgets, and, frankly, in almost all walks of life. As retirement savings, college funds, homes, jobs, and dreams have disappeared, the damage of the crisis has seeped into every corner of our nation.

Asset-backed securities, including residential mortgage-backed securities in particular, played a major role in triggering the crisis. It is therefore especially critical that the Commission's rules be adequately strengthened with respect to asset-backed issuers, as mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

The Notice seeks comment on two major issues: First, the removal of references to credit ratings in Rule 3a-7, and second, other possible enhancements to Rule 3a-7 that would strengthen investor protections. The Notice explores a number of potential approaches to these issues. To maximize investor protection, and to fulfill the mandates of

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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the Dodd-Frank Act, the Commission should be guided by the following principles as it formulates proposed rule amendments in this area:

- The references to credit ratings in Rule 3a-7 must be removed and replaced with standards that directly address the risks to investors posed by issuers of asset-backed securities.

- The new standards should be clearly prescribed, not imposed through a principles-based approach that places excessive reliance on an issuer's organizational documents.

- The rule should impose a variety of substantive conditions on issuers to increase investor protections and reduce the likelihood of abuses, including limits regarding the structure and operation of the issuer, review by an independent evaluator, and safekeeping of eligible assets and cash flow.

- The Commission should incorporate other requirements relating to asset-backed securities that have been implemented under the Dodd-Frank Act, including—

    - Requiring an asset-backed issuer to perform an initial review of the assets underlying any asset-backed security;

    - Requiring a credit risk manager to review the assets upon certain triggering events;

    - Prohibiting 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; and

    - Imposing risk retention requirements.

BACKGROUND

Issuers of asset-backed securities typically meet the definition of an investment company under the Investment Company Act ("ICA") because they issue securities and are engaged in the business of investing, owning, or holding financial assets that are securities under the ICA.[2] However, as a practical matter, they cannot operate under the requirements imposed by the ICA, including, for example, restrictions on a sponsor's sale of assets to an asset-backed issuer, and restrictions on the issuance of senior securities by an asset-backed issuer.[3]

[2] Section 3(a)(1) of the ICA.
[3] Notice at 55311.

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As a result, the Commission promulgated Rule 3a-7 in 1992 to create an exemption for asset-backed issuers from the definition of an investment company. It conditioned that exemption on a series of requirements intended to protect investors from a variety of potential abuses associated with the investment company form.

The Rule currently relies upon three references to credit ratings to help establish the conditions that must be met before the exemption may be invoked.

- First, an asset-backed issuer must have its fixed-income securities rated by at least one nationally recognized statistical rating organization ("NRSRO") in one of the four highest rating categories;

- Second, any acquisition or disposition of eligible assets may not result in a downgrading of the rating of the issuer's fixed-income securities; and

- Third, the cash flow derived from the eligible assets that is received by the servicer must be deposited periodically in a segregated account that is maintained or controlled by an independent trustee, "consistent with the rating of the outstanding fixed-income securities."

The Notice states that these credit rating references were not intended "principally" as standards of creditworthiness, but instead as a kind of proxy for investor protections aimed at curbing specific types of abuses.[4] Those abuses included self-dealing and overreaching, misvaluation of assets, misappropriation of assets, and changes in underlying assets to the detriment of the issuer's existing security-holders.[5] The theory underlying this reliance on credit ratings was that in providing a credit rating, an NRSRO would expect issuers to have certain structural safeguards in place and would take certain due diligence steps that would provide assurances against the likelihood of abuse.[6]

In light of Section 939A of the Dodd-Frank Act, which requires federal agencies to review their rules and replace references to credit ratings with alternative standards, the Notice seeks comment on whether the Commission should remove these references to credit ratings from Rule 3a-7, and if so, what alternative standards should be adopted in their place. In addition, the Notice seeks broad comment on additional protections that would be appropriate to add to Rule 3a-7.

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[4] Notice at 55308-09; 55312.
[5] Notice at 55311.
[6] *Id.*

COMMENTS

The references to credit ratings in Rule 3a-7 must be removed and replaced with standards that directly address the risks to investors posed by issuers of asset-backed securities.

The Commission should unquestionably replace the references to credit ratings in Rule 3a-7 with alternative investor protection standards. The Dodd-Frank requires it; the credit ratings are not reliable proxies for investor protection; and specific, carefully tailored investor protection standards will be a clearer and more effective means of curbing abuses by asset-backed issuers exempted from the ICA.

Section 939A of the Dodd-Frank Act is clear. It requires each Federal agency to review its regulations "that require the use of an assessment of the credit-worthiness of a security" and to "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations."

This provision applies even though the references to credit ratings in Rule 3a-7 may have been largely or even principally intended as a surrogate or proxy for certain investor protections, as opposed to strictly a measure of creditworthiness. Section 939A of the Dodd-Frank Act does not differentiate between ratings that are were intended to serve entirely as measures of creditworthiness and those that were intended to serve multiple purposes. Moreover, the statutory language provides that the standards agencies adopt to replace credit ratings must take into account the "purposes for which [the entities regulated by the Commission] rely on such standards of creditworthiness."[7] This is an implicit acknowledgement that ratings may serve different purposes but are still subject to removal and replacement in accordance with the statutory provision.

Beyond the language of Section 939A, the rationale for removing references to credit ratings in Rule 3a-7 is compelling. Simply put, if credit ratings should no longer be relied upon as a measure of creditworthiness in rules and regulations, then there is no reason to continue relying on them as a measure of anything else, including investor protection. History proves the point. Credit ratings were unreliable due to conflicts of interest, poor methodologies, inadequate controls, and incomplete or false underlying data. These same profound flaws in the credit rating process make it unreasonable to rely on ratings as a measure of investor protection. There is no reason to trust that the ratings agencies have actually engaged in the type of due diligence necessary to ensure that asset-backed issuers have appropriate structures in place to guard against the abuses inherent in the investment company model of doing business. Thus, replacing credit ratings with explicit requirements should significantly enhance investor protections for those who invest in asset-backed securities.

Replacing credit ratings with clear and direct requirements that asset-backed issuers must follow also better serves the purposes of transparency and accountability. By

[7] Section 939A(b) of the Dodd-Frank Act.

explicitly formulating investor protection requirements and applying them directly to a market participant, transparency is increased. Market participants, investors, and regulators all benefit when standards are clear and accessible. In addition, asset-backed issuers will be more accountable for their own conduct, and as a result, are likely to apply greater diligence and care in structuring, issuing, and managing their securities.

The new standards should be clearly prescribed, not imposed through a principles-based approach that places excessive reliance on an issuer's organizational documents.

The Notice seeks comment on the type of new conditions that should be added to Rule 3a-7 to replace credit ratings for purposes of protecting investors. First and foremost, the Rule should impose specific requirements and limitations, rather than relying on a more "principles based" approach that would, as suggested in the Notice, require an issuer's organizational documents to set forth the structural and operational parameters that are necessary to protect investors.[8] Even with Commission oversight, this approach to regulation leaves far too much discretion and room for evasion to the issuers.

The rule should impose a variety of substantive conditions on issuers to increase investor protections and reduce the likelihood of abuses.

Structure and operation of the issuer.

As suggested in the Notice,[9] the new conditions for exemption under the ICA should specify the manner in which assets must be selected and valued to avoid potential "dumping" of assets and misvaluations. In addition, the rule should specify the manner in which the depositor and sponsor may structure the issuer to guard against self-dealing and overreaching by insiders.

The rule should also expand the current limitations on the acquisition and disposition of assets. Rule 3a-7 currently provides that an issuer may acquire *additional* assets or *dispose* of eligible assets only in accordance with the terms and conditions set forth in the issuer's organizational documents. First, that limitation should be applied as well to the initial transfer of eligible assets to the issuer at the time of securitization. Second, the rule should stipulate the specific requirements on acquisition and disposition of assets that must be followed. These provisions will help prevent dumping of assets and other abuses by insiders over the life of the securities issued.

Independent review.

The potential for abuse with respect to investment companies in general arises from the prominent role of third parties in their structure and operation, where those third parties have their own financial interests that are separate and distinct from the investment companies themselves and their shareholders. The same principle applies to

[8] Notice at 55313.
[9] *Id.*

asset-backed issuers. It is therefore critically important that Rule 3a-7 adopt additional protections to address these structural issues.

One vitally important safeguard is the review of the asset-backed issuer and its intended operations by an independent evaluator prior to the sale of any fixed-income securities. This requirement should be added to the rule. In addition, the review should be followed by a certification to the effect that the issuer is structured and would be operated in a manner such that expected cash flows would likely allow the issuer to service expected payments on the securities. The optimal approach would be to require the issuer itself to provide that certification, following the independent evaluator's review, rather than to simply require the evaluator to make the certification. Only in this way will the issuer's incentives to comply with the applicable standards be sufficiently strong. The rule should further establish criteria relating to the qualifications and experience that an independent evaluator must have.

Finally, the independent review requirement should apply regardless of the nature of the investors who purchase the asset-backed issuer's securities, including accredited investors and qualified institutional buyers. If the Commission proposes such an exemption, then it should at a minimum require issuers to disclose that they are not arranging for an independent evaluator review and to explain the reasons for their decision to forego this process.

Preservation and safekeeping of eligible assets and cash flow.

The rule should also incorporate a number of provisions that are necessary to strengthen safeguards against the loss of assets through misappropriation, commingling, or imprudent investing. Most importantly, the rule should prohibit the commingling of assets by servicers for any time period, and should require all assets to be maintained in a segregated account prior to transfer to the trustee who must be appointed under existing Rule 3a-7. In addition, the rule should specify the types of investments in which the issuer may invest the cash flow. Putting the cash flows at risk through speculative investments is a potentially serious threat to the investors' interests.

The Commission should incorporate other requirements relating to asset-backed securities that have been implemented under the Dodd-Frank Act.

According to the Notice, the Commission is considering the incorporation of additional safeguards into Rule 3a-7, to address the specific concerns that arise from the investment company model.[10] The Commission has developed and adopted those additional protections in accordance with a variety of Dodd-Frank Act provisions relating to asset-backed securities.

[10] Notice at 55317.

We strongly support the adoption of those safeguards into Rule 3a-7. They would include:

- Requiring an asset-backed issuer to perform an initial review of the assets underlying any asset-backed security;

- Requiring a credit risk manager to review the assets upon certain triggering events;

- Prohibiting 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; and

- Imposing risk retention requirements.

All of these enhancements would increase investor protection in an area historically fraught with abuses, and they should be incorporated into Rule 3a-7.

CONCLUSION

We hope these comments are helpful as you consider ways to improve Rule 3a-7 for the benefit of investors and in accordance with the Dodd-Frank Act.

Sincerely,

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