Client Alert.

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SEC Publishes Long-Awaited Concept Release on Fund Use of Derivatives; Suggests Tighter Restrictions on REITs and ABS

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COMMISSION SEEKS COMMENT ON INVESTMENT COMPANY USE OF DERIVATIVES

At the August 31, 2011 open meeting, the Securities and Exchange Commission (the "Commission") unanimously approved a long-awaited Concept Release concerning investment company use of derivatives.

The Commission is soliciting public comment on a wide range of issues relevant to the use of derivatives by funds, including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration, valuation, and related matters.

The Concept Release summarizes the history of the Commission's regulation of derivatives use and identifies the challenges faced by the regulators, investment advisers and independent trustees in light of the dramatic growth in the volume and complexity of derivatives investments over the past two decades and funds' increased use of derivatives during that period.

Among other things, the Concept Release discusses possible alternative regulatory approaches, including those used by foreign regulators and those suggested by the July 6, 2010 Report of the Task Force on Investment Company Use of Derivatives and Leverage of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law.[1]

We will provide a Client Alert discussing the Commission's investment company derivatives Concept Release in greater detail.

> *Use of Derivatives by Investment Companies under the Investment Company Act of 1940,* Investment Company Act Rel. No. 29776 (August 31, 2011); available at http://www.sec.gov/rules/concept/2011/ic-29776.pdf

COMMISSION PROPOSES NEW ABS CONDITIONS; SEEKS PUBLIC COMMENT

The Commission voted to seek public comment through advance notice of proposed rulemaking on possible amendments to Rule 3a-7 under the Investment Company Act of 1940 (the "1940 Act"), the rule that excludes certain issuers of asset-backed securities (ABS) from being deemed an investment company for all purposes under the 1940 Act.

The Commission also published a companion Concept Release about interpretations of Section 3(c)(5)(C) of the 1940 Act, relied upon by some companies engaged in the business of acquiring mortgages and mortgage-related instruments, such as real estate investment trusts (REITs).

[1] *See* American Bar Association Section of Business Law, Committee on Federal Regulation of Securities, Report of the Task Force on Investment Company Use of Derivatives and Leverage (July 6, 2010) (ABA Task Force Report), available at *http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf*.

The Commission said that its proposed amendments to Rule 3a-7 could reflect market developments since 1992, when Rule 3a-7 was adopted, and recent developments affecting asset-backed issuers, including the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and the Commission's recent rulemaking regarding the asset-backed securities markets.

The Commission is considering rules that would eliminate references to credit rating agencies in Rule 3a-7, and replace them with a standard that is consistent with the investor protection goals of the 1940 Act. The Commission also proposes to address issues relating to the potential 1940 Act status of certain holders of securities of asset-backed issuers that rely on Rule 3a-7.

Background. ABS are created by buying and bundling loans or interests in loans, such as residential mortgage loans, commercial loans, or student loans, and creating securities backed by those assets. These securities are then sold to the public.

Absent an exemption, ABS issuers would fall within the definition of an "investment company," and thus would be subject to the full panoply of restrictions contained in the 1940 Act. In 1992, the Commission excluded some ABS issuers from the definition of "investment company," subject to certain conditions.

Proposed revisions to Rule 3a-7 conditions. One of the exclusionary conditions was that ABS must be rated by a nationally recognized statistical rating organization (NRSRO) or credit rating agency. The Commission has said that this condition was not primarily intended as a measure of creditworthiness of the issuer, but existed because the Commission believed that the ratings were a proxy to an assessment of the issuer's investor protection measures. The involvement of the credit rating agencies was perceived to mitigate opportunities for self-dealing by the sponsor and to assess risks related to cash flow. The rule also includes conditions addressing the safekeeping of the issuer's eligible assets and the cash flow derived from such assets.

The proposed rulemaking would consider eliminating references to credit ratings in Rule 3a-7. The Commission questions whether such references have served, as intended, as a proxy to address 1940 Act-related concerns, and whether it continues to be appropriate for Rule 3a-7 to make use of ratings in this manner.

This proposed rulemaking comes in the context of Section 939A of the Dodd-Frank Act, which generally requires the Commission to review any references to or requirements regarding credit ratings in its regulations, remove these references or requirements, and substitute other appropriate standards of creditworthiness in place of the credit ratings.

Among other things, the Commission specifically asks for public comment on whether Rule 3a-7 should continue to require credit ratings for fixed-income ABS, regardless of whether the Commission adds any other conditions to the rule. If the credit ratings requirement is perceived as a useful measure of creditworthiness, the Commission is asking whether it should adopt substitute standards for creditworthiness, as mandated by Section 939A of the Dodd-Frank Act.

The Commission also seeks comment on proposed additional conditions that would address:

- Concerns about self-dealing by insiders, misvaluation of assets, and inadequate asset coverage as they relate to the structure and operation of the asset-backed issuer;[2]

[2] In particular, the Commission is considering conditions that would discourage "dumping" and misvaluation either through specific limitations or through "principles-based" guidance.

- The benefits of an independent review of the asset-backed issuer's structure and intended operations in addressing these concerns;[3] and
- Preservation and safekeeping of the asset-backed issuer's eligible assets and cash flow.[4]

Reliance on Rule 3a-7. Rule 3a-7 excludes from the definition of "investment company" any asset-backed issuer that holds specified assets and meets the rule's conditions. A company that is excluded from the definition of an investment company does not have to comply with any of the 1940 Act's requirements. The Commission is asking whether ABS issuers that rely on Rule 3a-7 should still be considered investment companies for other purposes, such as whether an *investor* in an ABS is itself an investment company that should comply with the 1940 Act's requirements.

Availability of Section 3(c)(5) to asset-backed issuers. Section 3(c)(5) was intended to exclude from the definition of investment company certain factoring, discounting, and mortgage companies. Some ABS issuers – including issuers of securitized retail automobile installment contracts, credit card receivables, trade receivables, boat loans or equipment leases, and mortgage-backed securities – rely on Section 3(c)(5).

The Commission said that Section 3(c)(5) was not specifically intended to be used by asset-backed issuers, which generally did not exist at the time the statute was enacted.

The Commission is asking whether Congress should amend Section 3(c)(5) to limit the ability of asset-backed issuers to rely on that section, or whether the Commission should use its rulemaking authority to limit its availability to those companies to which Congress originally intended the statute to apply.

If the Commission limits the ability of certain funds to rely on the Section 3(c)(5) exception by requiring them to rely instead on Rule 3a-7, issuers of certain private placements that are not currently subject to many limitations applicable to public offerings could become subject to those limitations.

Other proposals. The Commission is also asking for comment on other issues, and "encourages all interested persons to submit their views on any issues relating to the treatment of asset-backed issuers under the Investment Company Act." The Commission said that the release is not intended in any way to limit the scope of comments, views, issues, or approaches to be considered.

> *Treatment of Asset-Backed Issuers under the Investment Company Act,*
> Investment Company Act Rel. No. 29779 (August 31, 2011); available at
> http://www.sec.gov/rules/concept/2011/ic-29779.pdf

COMMISSION SUGGESTS TIGHTER RESTRICTIONS ON REITs

The Commission published a companion Concept Release that solicits public comment on how the 1940 Act should apply to mortgage-related pools. The Concept Release asks for suggestions on the steps that the Commission should take to clarify and provide greater consistency or regulatory certainty with respect to Section 3(c)(5)(C).

[3] The Commission said that such a condition could require the asset-backed issuer to obtain 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.

[4] For example, a condition might limit the practice of servicers commingling the cash flow of ABS issuers with their own assets for periods of time prior to transferring to the cash flow to the trustee.

Section 3(c)(5)(C) of the 1940 Act generally excludes from the definition of investment company any person who is primarily engaged in, among other things, "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."

The Commission said that Section 3(c)(5)(C) was enacted to exclude from the definition of "investment company" companies that were engaged in the mortgage banking business and that were not considered to be in the investment company business. It noted that after the enactment of this provision in 1940, the mortgage markets evolved and expanded, and that the exemption expanded to other pooled vehicles that were not contemplated at the time of enactment.

The Commission also said that companies engaged in the business of acquiring mortgages and mortgage-related instruments, and that issue securities, generally hold assets that are securities under the 1940 Act and typically meet the definition of investment company under the 1940 Act.

The Section 3(c)(5)(C) exclusion is also used by some issuers of mortgage-backed securities, whose reliance on this statutory provision is discussed in the Rule 3a-7 Advance Notice of Rulemaking, summarized above.

The Commission is apparently concerned that in light of the evolution of mortgage-related pools and complex mortgage-related instruments, interpretations – largely accomplished through staff no-action letters – may have gone too far. Thus, the Commission is undertaking a comprehensive review of how the 1940 Act should apply to mortgage-related pools, and whether they should be considered investment companies.

The Commission said that many mortgage-related pools are managed in a manner that is similar to the way in which investment companies are managed, and that these pools are perceived as investment vehicles, rather than as companies engaged in the mortgage banking business, which Section 3(c)(5)(C) was originally intended to cover.

In particular, the Commission seems concerned that some mortgage-related pools may raise the potential for the same types of potential abuses addressed by the 1940 Act, such as deliberate misvaluation of the company's holdings, extensive leveraging, and overreaching by insiders.

The Concept Release summarizes the nature and market of mortgage- related pools, and requests data and comment on their management styles, corporate governance, and similarities to investment companies.

For example, the Concept Release asks whether a test should be devised to differentiate companies that are primarily engaged in real estate and mortgage banking business from companies that look like traditional investment companies, and what factors the Commission should consider in devising such a test. It is seeking this information, presumably, with the view of evaluating whether it should narrow the scope of the interpretations of the statutory exception.

> *Companies Engaged in the Business of Acquiring Mortgages and Mortgage Related Instruments*, Investment Company Act Rel. No. 29778 (August 31, 2011); available at http://www.sec.gov/rules/concept/2011/ic-29778.pdf

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