Clients&FriendsMemo

SEC Seeks Public Comment On Treatment of Asset-Backed Issuers under the Investment Company Act

September 13, 2011

The Securities and Exchange Commission (the "**SEC**") recently issued an advance notice of proposed rulemaking (the "**ANPR**")[1] requesting public comment on the treatment of asset-backed issuers[2] under Rule 3a-7 under the Investment Company Act of 1940 (the "**Investment Company Act**").

Specifically, the SEC is requesting public comment on the following, among other things:

- **Ratings requirements**: whether the credit rating requirements in Rule 3a-7 should be removed;
- **Independent review of the structure and operations of asset-backed issuers**: whether the rating condition currently contained in Rule 3a-7 should be replaced with conditions that would require: (i) an independent review of the asset-backed issuer and its intended operations prior to the sale of the fixed-income securities; and (ii) either (A) an opinion of an independent evaluator as to the sufficiency of the cash flow to service expected payments on the fixed-income securities or (B) a similar certification from the issuer rendered after considering the views of an independent evaluator;
- **New prescriptive conditions concerning the structure and operation of asset-backed issuers**: whether the SEC should add new conditions to Rule 3a-7 imposing specific requirements or limitations on the structure and operations of an asset-backed issuer or take a less prescriptive and more principles-based approach by requiring an issuer's organizational documents to set out parameters of the issuer's structure and operation;

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1 See *Treatment of Asset-Backed Issuers Under the Investment Company Act*, SEC Release No. IC-29779, File No. S7-35-11; Advance notice of proposed rulemaking; withdrawal, (August 31, 2011), 76 Fed. Reg. 55308-01 (September 7, 2011), available at http://www.sec.gov/rules/concept/2011/ic-29779.pdf.

2 The term "asset-backed issuer" is used in the ANPR and this memorandum to refer generally to any issuer of fixed-income securities the payments on which depend primarily on the cash flows generated by a specified pool of underlying financial assets.

- **New conditions concerning safekeeping of eligible assets and cash flows**: whether any changes should be made to the conditions in Rule 3a-7 designed to address the safekeeping of the asset-backed issuer's eligible assets and the cash flow derived from such assets;

- **Other SEC rules and regulations**: whether other SEC rules and regulations[3] can replace the references to ratings in Rule 3a-7 or can be used as a basis for meeting the rule's conditions;

- **Use of Section 3(c)(5) by asset-backed issuers**: whether Section 3(c)(5) under the Investment Company Act should not be available to asset-backed issuers[4]; and

- **Holders of an asset-backed issuer's securities**: whether asset-backed issuers that are exempt from the Investment Company Act under Rule 3a-7 should be treated as "investment companies" for the limited purpose of determining whether an entity investing in such issuers is itself an "investment company" under the Investment Company Act.

In the ANPR, the SEC has not proposed any specific rules; rather it is soliciting comment on concepts the SEC is considering for proposed rulemaking on these topics.

Comments should be provided to the SEC by November 6, 2011, i.e., 60 days after publication of the ANPR in the Federal Register.

This memorandum summarizes the issues relating to Rule 3a-7 and Section 3(c)(5) with respect to which the SEC is seeking public comments in the ANPR.

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[3] These include regulations adopted under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat.1376 (July 21, 2010) (the "**Dodd-Frank Act**"), the rules proposed by the SEC on April 2010 regarding the disclosure, reporting and offering process for asset-backed securities (the "**2010 ABS Proposal**") and the rules re-proposed by the SEC on July 26, 2011 regarding new shelf eligibility requirements for asset-backed securities (the "**2011 ABS Re-proposal**"). See the following memoranda prepared by our Firm: SEC Proposes Significant Enhancements to Regulations of Asset-Backed Securities (April 20, 2010), Reforms to the Asset-Backed Securitization Process and the Regulation of Credit Rating Agencies under Dodd-Frank Wall Street Reform and Consumer Protection Act (July 20, 2010), Proposed Credit Risk Retention Requirements for Asset-Backed Securities Transactions (April 6, 2011), and SEC Re-proposes Shelf Eligibility Conditions for Asset-Backed Securities (August 16, 2011).

[4] The SEC has also, on August 31, 2011, released a concept release (the "**3(c)(5)(C) Concept Release**") requesting public comment on the treatment of REITs and mortgage-related pools under Section 3(c)(5)(C) of the Investment Company Act. See *Companies in the Business of Acquiring Mortgages and Mortgage-Related Instruments*, SEC Release No. IC-29778, File No. S7-34-11; Concept Release; request for comments (August 31, 2011), 76 Fed. Reg. 55300-01 (September 7, 2011), available at http://www.sec.gov/rules/concept/2011/ic-29778.pdf.

BACKGROUND

The Investment Company Act regulates the activities of companies engaged primarily in investing and trading in securities. Although the Investment Company Act was not written with asset-backed securitizations in mind, most such securitizations raise Investment Company Act issues because most securitization vehicles own income-producing assets such as loans which, in this context, could be deemed securities. Unless exempt, an investment company must register with the SEC under the Investment Company Act and comply with the Investment Company Act's many requirements and restrictions.

Although many asset-backed securitization vehicles resemble in many respects investment companies[5] and meet the definition of investment company under the Investment Company Act, they generally cannot operate under certain of the requirements and restrictions applicable to registered investment companies.[6] Thus, the availability of a statutory exception to the definition of investment company or exemptive relief from the Investment Company Act has been critical to issuers of asset-backed securities.

Specifically, issuers of asset-backed securities have relied on one of the following exemptions:

- **Rule 3a-7**: Rule 3a-7 excludes issuers of asset-backed securities from the definition of investment company if the rule's requirements are satisfied, as further described below. Because this Rule 3a-7 exception applies regardless of the type of financial assets that an asset-backed issuer holds, many securitizations, including those relating to commercial mortgages, have relied on Rule 3a-7 since its adoption in 1992.

- **Section 3(c)(5)**: Section 3(c)(5) excludes from the definition of investment company issuers of asset-backed securities that are primarily engaged in purchasing or otherwise

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5 For example, asset-backed issuers have no employees and must rely for their operations on their sponsors, servicers and other persons, each of whom has its own separate and distinct set of financial and other interests. Furthermore, with the exception of the role typically assigned to the trustee, the sponsor, or a person affiliated with the sponsor, potentially could be responsible for most, if not all, of the operations of an asset-backed issuer. This structure presents Investment Company Act-related concerns, including (i) the possibility of a sponsor intentionally overvaluing assets or "dumping" into the asset-backed issuer assets that are insufficient to produce the cash flow needed to meet the issuer's obligations to its securities holders, contrary to representations made to investors, (ii) the possibility of a sponsor potentially substituting inferior assets for the assets transferred to the issuer at the time of securitization and (iii) the commingling by the servicer or the trustee of the assets and the cash flow with their own assets or investment by the servicer or trustee of the issuer's cash flow in a speculative manner.

6 For example, Section 17(a) of the Investment Company Act generally would prohibit the sponsor's sale of assets to the asset-backed issuer. 15 U.S.C. 80a-17(a). In addition, certain asset-backed issuers could not comply with Section 18 of the Investment Company Act, which generally limits the extent to which registered investment companies may issue senior securities, including debt. 15 U.S.C. 80a-18.

acquiring a particular type of financial asset.[7] Since Rule 3a-7 is a non-exclusive rule, certain issuers, including those that securitize retail automobile installment contracts, credit card receivables, trade receivables, boat loans or equipment leases, and issuers of residential mortgage-backed securities (but generally not issuers of commercial mortgage-backed securities) have relied on Section 3(c)(5) instead of Rule 3a-7.

- **Section 3(c)(1)**: Section 3(c)(1) excludes from the definition of investment company any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than 100 persons and that is not making and does not propose to make a public offering of its securities. This exemption has traditionally been relied upon by issuers of asset-backed securities that were unable to meet the requirements imposed by either the Rule 3a-7 or Section 3(c)(5) exemptions.

- **Section 3(c)(7)**: Section 3(c)(7) excludes from the definition of investment company any issuer that is not making and does not propose to make a public offering of its securities and whose outstanding securities are exclusively owned by "qualified purchasers". This exemption has been used by issuers of collateralized debt obligations and collateralized loan obligations.

Rule 3a-7 Existing Requirements

Rule 3a-7 states that any issuer that is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets and that does not issue redeemable securities will not be considered, and thus will not be required to be registered as, an investment company under the Investment Company Act provided the following conditions are met:

- The securities issued must be fixed-income securities or other securities with payments primarily dependent upon the cash flow from eligible assets.[8]

[7] Section 3(c)(5) excludes from the definition of investment company "[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise 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, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Section 3(c)(5) is used by certain asset-backed issuers instead of Rule 3a-7.

[8] Eligible assets are defined to mean financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or assets designed to assure the servicing or timely distribution of proceeds to security holders.

- Fixed-income securities sold by the issuer or any underwriter generally must be rated at the time of initial sale in one of the four highest rating categories by at least one nationally recognized statistical rating organization ("**NRSRO**"), subject to certain exceptions.[9]

- The issuer may acquire additional eligible assets, or dispose of eligible assets, only if:

  (a) the assets are 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;

  (b) the acquisition or disposition of the assets does not result in the downgrading in the rating of the issuer's outstanding fixed income securities; and

  (c) the assets are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

- Unless the issuer issues only commercial paper exempted from the Securities Act by Section 3(a)(3) thereof, the issuer must:

  (a) appoint a trustee that meets certain requirements of the Investment Company Act;

  (b) take reasonable steps to cause the trustee to have a valid and perfected security interest or ownership interest in the underlying eligible assets; and

  (c) take actions necessary to safeguard the cash flows derived from the underlying assets by requiring them to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the outstanding fixed-income securities.

CURRENT RATING REQUIREMENTS IN RULE 3a-7

In light of the Dodd-Frank Act, which requires the SEC to review and, where appropriate, remove references to credit ratings in its regulations, and of concerns about NRSROs' rating

[9] Any unrated fixed-income securities may be sold to institutional accredited investors ("**Institutional Accredited Investors**"), as defined in paragraphs (1), (2), (3) or (7) of Rule 501(a) under the Securities Act of 1933, as amended (the "**Securities Act**"), and any entity in which all of the equity owners are Institutional Accredited Investors. Additionally, any unrated securities (whether or not fixed-income) may be sold to "qualified institutional buyers" ("**QIBs**"), as defined in Rule 144A under the Securities Act, and any person (other than any rating organization rating the issuer's securities) involved in the organization or operation of the issuer or an affiliate of such person. In each case, the issuer or any underwriter thereof effecting such sale must exercise reasonable care to ensure that such securities are sold and will be resold only to the specified persons.

methodologies that emerged in the wake of the recent financial crisis, the SEC has requested public comment on, among other things:

- Whether the credit rating requirements in Rule 3a-7 have served to address Investment Company Act-related concerns;[10]
- Whether other mechanisms in place ensure that the NRSROs conduct the type of analysis and review of asset-backed issuers' structures and operations that address Investment Company Act-related concerns;
- Whether removing the references to credit ratings in Rule 3a-7 would have any economic impact; and
- Whether there are substitute standards or conditions that the SEC should consider adopting as a measure of credit-worthiness.

NEW CONDITIONS FOR RULE 3a-7

The SEC is asking for comments on new conditions that should be added to Rule 3a-7 to address investor protection concerns under the Investment Company Act in addition to, or in replacement of, the ratings conditions described above. These investor protection issues fall into the following areas:

- 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;
- 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.

Each of these issues is addressed in detail below.

[10] In adopting the Investment Company Act, Congress was concerned, among other things, about companies that were: (i) organized, operated, managed, or their portfolio securities selected, in the interest of company insiders; (ii) issuing excessive amounts of senior securities; (iii) when computing the asset value of their outstanding securities, employing unsound or misleading methods, or not being subjected to adequate independent scrutiny; and (iv) operating without adequate assets. There were also concerns that the assets of investment companies were not adequately protected, with controlling persons of investment companies commingling the investment company's assets with their own and then proceeding to misappropriate them.

Structural and Operational Safeguards for Asset-Backed Issuers

Among the approaches being considered by the SEC are:

- Specifying the manner in which the asset-backed issuer's assets should be selected and valued to avoid "dumping" of assets and misvaluation;
- Structuring the asset-backed issuer to guard against self-dealing and overreaching by insiders;
- Prohibiting any person involved in the operation of the asset-backed issuer from engaging in specific activities that may adversely affect payment of the fixed-income securities to be issued by such asset-backed issuer; and
- Requiring the parameters of the asset-backed issuer's organization and operations to be set forth in its organization documents.

Independent Review

To address concerns arising under the Investment Company Act about self-dealing and overreaching by insiders, the SEC is considering whether to replace the credit rating conditions currently contained in Rule 3a-7, in part, with a condition that would provide for an independent review of the asset-backed issuer and its intended operations prior to the sale of the fixed-income securities.

Questions raised by the SEC in connection with such independent review include:

- Whether the asset-backed issuer should be required to obtain an opinion from an independent evaluator with respect to the sufficiency of the cash flows to service expected payments on the fixed-income securities.[11]

> ***NOTE**: The ANPR suggests that the opinion could be rendered by "potentially any independent person, including an NRSRO" that has the requisite expertise. It is unclear what benefit would be derived from re-casting the role of the rating agencies as an*

[11] As proposed, the opinion would state 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." See ANPR, 76 Fed. Reg. at 55314.

"independent evaluator," since this is the role that investors have traditionally counted on the rating agencies to perform.

- Alternatively, whether the asset-backed issuer itself should be required to provide a similar certification in its offering documents, after considering the views of an independent evaluator that has reviewed the structure and the intended operations of the asset-backed issuer.

  ***NOTE**: In the 2011 ABS Re-proposal,*[12] *the SEC also proposed replacing the investment grade ratings criterion for shelf eligibility for asset-backed securities offerings with a similar certification requirement.*[13] *However, the certification required for shelf-registration covers only publicly offered securities that are senior in right of payment to more junior classes privately offered. Although it may be feasible for the issuer to make the required certification with respect to such senior classes, the certification or opinion suggested in the ANPR would need to cover all of the fixed-income securities. Because the term "fixed-income securities" typically covers all classes having a stated principal balance and/or a stated interest rate, not just senior classes, it may become more difficult to make the certification as classes get more junior and the risk increases.*

- What should be the scope of the independent review under Rule 3a-7?

- What should be the standard(s) for the conclusion(s) reached by the independent evaluator for purposes of Rule 3a-7?

- What types of entities should serve as independent evaluators under Rule 3a-7 and what eligibility criteria would be appropriate for purposes of Rule 3a-7?

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[12] See *Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities*, SEC Release Nos. 33-9244; 34-64968; File No. S7-08-10; Re-proposed Rule (July 26, 2011), 76 Fed. Reg. 47948 (August 5, 2011), available at http://sec.gov/rules/proposed/2011/33-9244fr.pdf.

[13] As proposed, such certification would state, among other things, that based on the officer's knowledge, "taking into account the characteristics of the securitized assets underlying the offering, the structure of the securitization, including internal credit enhancements, and any other material features of the transaction, in each instance, as described in the prospectus, the securitization is designed to produce, but is not guaranteed by this 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." See 2011 ABS Re-proposal, 76 Fed. Reg. at 47953.

- What steps should the asset-backed issuer be required to take to determine whether a prospective independent evaluator meets the qualifications to serve as an independent evaluator under Rule 3a-7?

- If an independent evaluator condition were to be included in Rule 3a-7, should the rule also require the asset-backed issuer to include the independent evaluator's opinion as an exhibit to its registration statement thereby requiring the independent evaluator to consent to being named as an "expert" in the registration statement and being subject to potential liability under Section 11 of the Securities Act?

- What would be the economic impact of including an independent evaluator condition in Rule 3a-7?

- If Rule 3a-7 were to include an independent evaluator condition, would there be circumstances in which compliance with such condition might not be necessary for investor protection?

Preservation and Safekeeping of Eligible Assets and Cash Flow

Rule 3a-7 contains several conditions designed to address the safekeeping of the asset-backed issuer's eligible assets and the cash flow derived from such assets, including perfection of security interests, segregation of the trustee's accounts, and ratings requirements for the asset-backed issuer's fixed-income securities.

The current rule, however, does not limit pre-transfer commingling of cash flows by asset-backed issuers or address the treatment of cash flow when there is a timing mismatch between receipt and distribution.

The SEC is asking for comment on whether Rule 3a-7 should be amended to strengthen the provisions relating to the preservation and safekeeping of the asset-backed issuer's assets and related cash flow. Specifically, the SEC is seeking to get additional information on the servicer's remittance practices and public comments on:

- Whether the rule should specifically require the servicer to keep the cash flows on the eligible assets in a segregated account;

- Whether the rule should be amended to prescribe a time period in which the servicer must transfer the cash flows on the eligible assets to the trustee; and

- The economic impact of such a provision.

The SEC is also interested in obtaining information about how the cash flows on the eligible assets are invested under Rule 3a-7 and who receives the returns from such investments. Specifically, the SEC is asking:

- Should the rule contain a condition that restricts the manner in which the cash flows may be invested?
- Should the rule limit who may receive the benefit of the returns of such investment?
- Should the rule include a condition specifying that the eligible assets and the cash flows generated from such assets be available to pay the fixed-income securities consistent with their terms, notwithstanding the bankruptcy or insolvency of the sponsor or depositor?
- Should any such condition also extend to the bankruptcy of the servicer?

> ***NOTE**: Most rated securitization transactions contain detailed provisions governing the segregation of cash, the accounts in which such cash must be maintained, and the quality, maturity and other characteristics of "eligible investments" in which such cash may be invested. Many of these requirements reference credit ratings. In the absence of any reliance on ratings, the SEC is seeking ideas for what other requirements should be applicable.*

Other Possible Investor Protections

Other SEC Rules

The SEC is requesting comment on whether any existing or proposed provisions under other federal securities laws applicable to asset-backed issuers may help mitigate potential Investment Company Act-related concerns and could serve, in whole or in part, as substitutes for the references to ratings in Rule 3a-7.[14] The SEC indicates that such provisions, if any, may need to be

[14] Among the provisions applicable to asset-backed issuers that were specifically mentioned by the SEC in the ANPR are: (i) Rule 193 under the Securities Act, which generally requires an asset-backed issuer to perform a review of the assets underlying any asset-backed securities that will be registered under the Securities Act; (ii) the SEC's proposal in the 2011 ABS Re-proposal to include, as part of the shelf eligibility requirements for asset-backed issuers, a requirement that the issuer's underlying transaction agreements provide for a "credit risk manager" to review the underlying assets in specified circumstances; and (iii) Section 27B of the Securities Act, which generally prohibits an underwriter, sponsor, or any affiliate or subsidiary of any such entity 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.

included as conditions in Rule 3a-7 to ensure that all asset-backed issuers relying on the rule are subject to the same conditions, regardless of their status under the other securities laws.[15]

Eligibility to Use Rule 3a-7

Currently, any issuer generally may rely on Rule 3a-7 provided that it is in the business of purchasing or otherwise acquiring and holding eligible assets, issues securities that entitle their holders to receive payments that depend primarily on the cash flows from eligible assets, and meets the other conditions of the rule. The SEC is requesting comment on any new approaches that the SEC should consider to an issuer's eligibility to use Rule 3a-7 that would address Investment Company Act-related concerns, including:

- Whether the requirements of Regulation AB or the shelf eligibility requirements may serve to address the Investment Company Act-related concerns underlying Rule 3a-7 and therefore be a basis for meeting some or all of the rule's conditions;
- Whether the conditions of Rule 3a-7 should distinguish between issuers that meet the shelf eligibility requirements and those that do not; and
- Whether there would be any economic impact if Rule 3a-7 were available to all issuers of asset-backed securities as defined in Regulation AB or included the further limitations found in the shelf eligibility requirements.

Standard for Acquisition and Disposition of Eligible Assets

Activities relating to the acquisition and disposition of an issuer's eligible assets permitted under Rule 3a-7 are limited to those activities "that do not in any sense parallel typical 'management' of registered investment company portfolios."[16] Permitted activities under the rule include: (i) selling or substituting eligible assets when documentation is defective or for nonconformity with representations or warranties, (ii) disposing of assets in default or in imminent default, and (iii) removing excess credit support.

The SEC is requesting comment on any possible changes to the rule's conditions addressing the acquisition and disposition of eligible assets and the economic impact of any such changes.

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[15] Not all asset-backed issuers that rely on Rule 3a-7 are subject to the same provisions under federal securities laws. For example, certain asset-backed issuers may offer or sell their securities under an exemption from registration under the Securities Act or may not use a shelf offering and therefore may not be subject to certain regulations under the Securities Act and/or the Securities Exchange Act of 1934, as amended.

[16] See ANPR, 76 Fed. Reg. at 55318.

ASSET-BACKED ISSUERS RELYING ON SECTION 3(c)(5)

Section 3(c)(5) was intended to exclude from the definition of investment company certain factoring, discounting and mortgage companies, and did not specifically contemplate asset-backed issuers, which did not exist at the time Congress adopted the Investment Company Act in 1940.

Certain asset-backed issuers, including issuers of residential mortgaged-backed securities, however, rely on the exclusion from the definition of investment company in Section 3(c)(5) of the Investment Company Act rather than on Rule 3a-7. Unlike the exclusion provided by Rule 3a-7, the exclusion provided by Section 3(c)(5) is not subject to any conditions specifically addressing the Investment Company Act-related concerns presented by asset-backed issuers. Accordingly, the SEC is seeking comment on whether Section 3(c)(5) should be amended, or regulations under Section 3(c)(5) should be promulgated by the SEC, to limit the ability of asset-backed issuers to rely on Section 3(c)(5). In particular, the SEC seeks comment on the following issues:

- Whether there are any structural or operational reasons that make it necessary for certain asset-backed issuers to rely on Section 3(c)(5) rather than Rule 3a-7;
- What types of asset-backed issuers rely on Section 3(c)(5);
- What the effect would be on asset-backed issuers, the securitization market and on capital formation if asset-backed issuers could no longer rely on Section 3(c)(5); and
- Whether any revisions to Rule 3a-7 could be made to better facilitate asset-backed issuers' reliance on the rule rather than on Section 3(c)(5).

TREATMENT OF HOLDERS OF AN ASSET-BACKED ISSUER'S SECURITIES

In the ANPR, the SEC expresses concern that certain companies may be operating as investment companies and avoiding registration under the Investment Company Act by investing in the residual or equity interests in Rule 3a-7 issuers. Because a Rule 3a-7 issuer is not an investment company by virtue of the exclusion provided by the rule, any company that holds 50% or more of the outstanding voting securities of a Rule 3a-7 issuer may treat the Rule 3a-7 issuer as its majority-owned subsidiary and is not required to treat any of the securities issued by the Rule 3a-7 issuer as "investment securities" for purposes of determining the company's own status under Section 3(a)(1)(C)[17] of the Investment Company Act. As a result, these companies may not meet the

[17] A company may be an investment company under Section 3(a)(1)(C) of the Investment Company Act if it owns or proposes to acquire "investment securities," which generally include, among others, securities issued by an investment company, having a value exceeding 40% of the company's total assets (exclusive of government securities and cash items) on an unconsolidated basis. Securities of majority-owned subsidiaries that are not investment companies are not "investment securities" for purposes of determining whether the parent meets the definition of investment company in Section 3(a)(1)(C). Section 2(a)(24) of the Investment Company Act states that a "majority-owned subsidiary" of a person "means a company

definition of investment company in the Investment Company Act and may not be required to be registered thereunder.

The SEC is requesting comments on the extent to which various types of holders of securities of Rule 3a-7 issuers use the exclusion provided by Rule 3a-7 to determine their own status under the Investment Company Act. Specifically, the SEC is seeking comment on:

- The potential economic impact if the exclusion from the definition of investment company provided by Rule 3a-7 were modified so that it did not extend to the definition of "investment securities" in Section 3(c)(1)(C)(i) or if a Rule 3(a)-7 issuer would be exempted from the requirements of the Investment Company Act but would nevertheless be an investment company for purposes of determining the holders' own status under the Investment Company Act;

- Whether a modification would adversely affect those sponsors that form Rule 3a-7 issuers to facilitate the operation of their non-investment company business; and

- Whether there are reasons not to modify the exclusion provided by Rule 3a-7 to address this issue.

> ***NOTE**: In the 3(c)(5)(C) Concept Release,[18] the SEC is seeking comment on whether real estate investment trusts ("**REITs**") and certain other mortgage pools should continue to be permitted to use Section 3(c)(5)(C), given that they may operate like traditional investment companies and may not be the types of companies that were intended to be excluded from regulation under the Investment Company Act.*

In addition, the SEC points out that by virtue of the exclusion from the definition of investment company provided by Rule 3a-7, a business development company (a "**BDC**") might treat a Rule 3a-7 issuer as an eligible portfolio company[19] for purposes of satisfying its investment requirements under the Investment Company Act. The SEC expressed its view that 3a-7 issuers are not the type of small, developing or financially troubled businesses in which Congress intended

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50% or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person."

[18] See *supra* note 4.

[19] The Investment Company Act generally prohibits a BDC from making any investment unless, at the time of the investment, at least 70% of the BDC's total assets (other than certain specified non-investment assets) are invested in securities of certain specified issuers, which securities include certain securities of "eligible portfolio companies," as defined by the Investment Company Act. Among other criteria, issuers qualifying as eligible portfolio companies must not meet the definition of investment company or be excluded from the definition of investment company.

BDCs primarily to invest. Accordingly, the SEC is requesting comment on whether Rule 3a-7 should be amended to provide expressly that an issuer relying on Rule 3a-7 is an investment company for purposes of the definition of eligible portfolio company under the Investment Company Act. The SEC is seeking comment on the effect on BDCs or Rule 3a-7 issuers if Rule 3a-7 were amended to expressly provide that an issuer relying on Rule 3a-7 is not an eligible portfolio company and whether BDCs that invest in Rule 3a-7 issuers typically treat such issuers as eligible portfolio companies.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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