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SEC Proposals for Credit Rating Agency Reform: Potential Impact on the Asset-backed Markets

On July 1, 2008, the Securities and Exchange Commission (the "SEC") issued three rule proposals (the "Proposed Rules") aimed at responding to ongoing concerns regarding the role and importance of credit ratings issued by nationally recognized statistical rating organizations ("NRSROs"). The Proposed Rules are intended to address the SEC's concern that the inclusion of credit ratings throughout its rules and regulations may have acted as a regulatory "seal of approval" for the ratings such that market participants may have placed "undue reliance" upon them. The proposed amendments would eliminate references to these ratings in numerous SEC rules and forms.[1]

The Proposed Rules follow, and are a companion to, the issuance on June 16, 2008 of proposed rules to increase transparency of and avoid conflicts of interest in the credit rating process (the "NRSRO Proposals"[2] and, together with the Proposed Rules, the "Proposals").[3] A copy of our July 2, 2008 client alert on the NRSRO Proposals, *SEC Proposes Reforms Relating to Credit Rating Agencies,* can be found at http://www.mofo.com/news/updates/files/080702CreditAgencies.pdf.

As drafted, the Proposals would have a significant impact on how market participants use credit ratings during the new issuance process, in determining investment suitability, for computing net capital requirements and in complying with other SEC rules and regulations. They also would impact the NRSRO regulatory regime and how NRSROs interact with market participants and other credit rating agencies. Below we review more closely how the Proposals would impact the asset-backed market.

Background of the Proposals

NRSROs have been included in SEC rules and regulations since 1975 when credit ratings were added as an objective measure in the computation of net-capital. Numerous securities law provisions, federal and state regulations, private investment guidelines and commercial contracts similarly reference NRSRO credit ratings. Recently, several studies have been published evaluating the role of credit rating agencies in the marketplace[4],

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[1] Copies of the Proposed Rules can be found at http://www.sec.gov/rules/proposed/2008/34-58070.pdf, http://www.sec.gov/rules/proposed/2008/33-8940.pdf, and http://www.sec.gov/rules/proposed/2008/ic-28327.pdf.
[2] A copy of the NRSRO Proposal can be found at http://www.sec.gov/rules/proposed/2008/34-57967.pdf.
[3] Comments on the NRSRO Proposals were due July 25, 2008 and 52 comment letters have been posted by the SEC on its website at http://www.sec.gov/comments/s7-13-08/s71308.shtml. Comments on the Proposed Rules are due by September 5, 2008. Because the Proposed Rules include changes to the Investment Company Act, broker-dealer regulation and rulemaking by self-regulatory organizations, the scope of comments on the Proposed Rules may be broader.
[4] See President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (March 2008), available at www.ustreas.gov; The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience (April 2008), available at www.fsforum.org; and Technical Committee of the International Organization of Securities Commissions, Consultation Report: The Rule of Credit Rating Agencies in Structured Finance Markets (March 2008), available at www.iosco.org.

including the role they may have played in the ongoing sub-prime crisis. The Proposals are also informed by the SEC's examination of certain NRSROs, as discussed in its July 2008 report.[5]

Scope of Proposed Regulations

The Proposals include amendments addressing the specific issues identified as a result of the sub-prime crisis, as well as amendments of general applicability related to improving credit rating agency regulation.

The proposed rules aimed at addressing problems in the asset-backed markets[6] are not drafted based on the existing definition of asset-backed securities found in Item 1101(c) of Regulation AB. Instead, certain of these proposed rules apply to a new category of securities described as "any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction." We will refer to the securities captured by the proposed description as "Asset Pool Securities." The NRSRO Proposals address this departure from the existing asset-backed definition by noting that the proposed language was used to "ensure the inclusion of ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of issuers of asset backed securities (as that term is defined in [Regulation AB])."[7] The commentary does not discuss why the asset-backed definition was considered too narrow for the proposed amendments or which gaps were intended to be remedied.

As at least one comment letter has noted, there are classes of structured securities that don't have the inherent risks associated with asset-backed securities. For example, numerous structured securities that are not taken off the balance sheet of the issuer, may not receive credit ratings independent from those of their issuer.[8]

As the rule is specifically drafted to encompass more than those securities subject to Regulation AB, structured finance market participants should carefully monitor the rule proposal process and evaluate existing and contemplated structures that may be considered Asset Pool Securities. In particular, one of the proposed conflict of interest rules, discussed more fully below, would require extensive public disclosure of information shared with NRSROs rating Asset Pool Securities if the issuer pays for the rating.

Summary of the Proposals[9]

The Proposals impacting the asset-backed market include the following:

New NRSROs Conflicts of Interest would include:

- Rating Asset Pool Securities, if the rating is paid for by the issuer (must be disclosed and managed)
- Rating a security where the NRSRO has provided recommendations (prohibited)
- Rating an issuer's security where an NRSRO employee has received a gift over $25 (prohibited)

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[5] See Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies (July 2008), available at www.sec.gov/news/studies/2008/craexamination070808.pdf.

[6] These are Proposed Rule 17g-3(a)(6) requiring annual reporting of credit rating actions taken with respect to each class of securities; Proposed Rule 17g-5(b)(9) adding as a conflict of interest with enhanced disclosure obligations, issuing a rating for Asset Pool Securities; Proposed Rule 17g-7 requiring a report each time a rating is issued for Asset Pool Securities, or flagging the symbol of the rating; and Proposed Amendments to Exhibit 1 of Form NRSRO requiring reporting of statistics.

[7] See SEC Release 34-57967 at page 84.

[8] See comment letter of the Structured Products Association, dated July 25, 2008 available at http://www.sec.gov/comments/s7-13-08/s71308.shtml.

[9] The Proposals include changes that are not expected to have a significant impact on the asset-backed market and are not discussed here. These other proposals include: (1) eliminating references to ratings and NRSROs in Securities Act Rules 138, 139 and 168, in Regulation ATS and its forms for the regulation of alternative trading systems, in confirmations for non-rated securities, on Form PILOT, on Form F-9 for certain Canadian issuers and on Forms S-4, F-4 and Schedule 14A, (2) removal of GAAP reconciliation exemption for foreign issuers of investment grade securities, and (3) changes to Investment Company Act Rules 5b-3, 17a-9 and 10f-3 and Investment Advisers Act Rule 206(3)-3T.

- Participation by an NRSRO employee in both the issuer-paid ratings process and any fee discussions (prohibited)

New NRSRO Disclosure and Reporting Obligations would include:

- If the issuer pays for a rating on an Asset Pool Security, disclose third party information used in determining the rating
- Disclose procedures and methodologies for issuing and monitoring ratings
- Disclose all new and modified ratings no later than six months after issuance, by both issuer-paid NRSROs and subscriber-paid NRSROs
- Disclose information regarding asset verification for Asset Pool Securities, information regarding assessments of obligors for Asset Pool Securities, and how models are used and surveillance is conducted
- With each rating of an Asset Pool Security, a report differentiating the rating from ratings for other types of securities *or, alternatively*, issue the rating for an Asset Pool Security with a symbol modifier (e.g., AAA.sf)
- Disclose statistics regarding historical ratings and changes thereto, as well as default statistics
- Disclose historical ratings actions by class of credit rating[10] over 1-year, 3-year and 10-year periods, and disclose default and transition statistics for each class of credit rating
- Disclose annually the number of ratings actions taken in each ratings class for the prior year

New NRSRO Recordkeeping Obligations would include:

- Maintaining records of significant deviations from models when the model was a material component of determining an issuer paid asset-backed securities rating
- Maintaining records of complaints regarding ratings analysts

Elimination of Ratings Requirement or Standard in the following:

- *Form S-3:* S-3 eligibility for asset-backed issuers would replace the investment grade standard with a requirement for $250,000 minimum denominations for initial sales and resales and limit purchasers in initial sales to qualified institutional buyers (“QIBs”). Related changes in Rule 415
- *Form S-3:* S-3 eligibility for non-asset backed issuers would replace the investment grade standard with a requirement that an issuer have sold $1 billion in non-convertible debt securities in the prior three years
- *Regulation AB of the Securities Act:* Provisions requiring disclosure by asset-backed issuers related to significant obligors and credit enhancement providers would be updated to eliminate references to investment grade ratings
- *Regulation M under the Exchange Act:* Exemption from Regulation M for investment grade securities and asset-backed securities replaced with new exemptions not linked to credit ratings
- *Rule 2a-7 under the Investment Company Act:* Changes to how money market funds will select and monitor “eligible securities” under Rule 2a-7
- *Rule 15c3-1 of the Exchange Act:* Replace reliance on ratings for determining net capital haircuts with subjective determinations by broker-dealer

[10] The “classes” of credit ratings are set forth in Section 3(a)(62)(B)(iv) of the Credit Rating Agency Reform Act and are (i) financial institutions, brokers or dealers; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities as defined in Regulation AB; and (v) issuers of government securities, municipal securities, or securities issued by a foreign government.

- *Rule 3a-7 under the Investment Company Act:* Exception from the Investment Company Act provided by Rule 3a-7 would no longer be available to issuers offering investment grade debt securities, and issuers would need to rely on the remaining provisions in the exception

Regulation of Nationally Recognized Statistical Rating Organizations

Please see our client alert of July 2, 2008[11] for a more detailed discussion of the NRSRO Proposals. Below we highlight the proposed rules with the most potentially significant impact on the asset-backed markets.

Disclosure of Materials Used by NRSROs

The proposed rules would establish that the rating of an Asset Pool Security by an NRSRO, where the NRSRO is paid by the issuer, would constitute a conflict of interest. The NRSRO would be required to disclose that the conflict of interest exists and also to disclose all third-party[12] information used by the NRSRO in issuing the credit rating and conducting surveillance on the Asset Pool Security.

For registered transactions, the proposal requires public disclosure of the information upon pricing. For private placements, the disclosure would initially be made only to investors and credit rating agencies not rating the transaction upon pricing. One day following the closing of the private placement, the disclosure must be made publicly. Information used for surveillance purposes would be required to be disclosed upon receipt by the NRSRO. These proposals raise numerous questions of interpretation and securities law liability, some of which are discussed below.

- *Who will be responsible for the disclosures?* The proposed rules appear as part of the NRSRO regulations and impose upon the NRSROs the disclosure obligation. However, the related issuer bears the risk of securities law liability. Comment letters include requests that the NRSRO be the disclosing party, to provide a central repository for investors, and requests that the issuer be the disclosing party, as the issuer drives the transaction and is the party with the most significant securities law liability. Whether the NRSROs disclose or the issuers disclose, transaction documents and the relationships between the parties would be modified to reflect the allocation of new risks and liabilities in the issuance process.

- *What materials are required to be disclosed?* The scope of the material to be disclosed is described as "information." Whether or not this includes oral communications is unclear, but as the information would be subject to Securities Act liability, it would be consistent with past SEC interpretation to include at least some oral communications. If so interpreted, the new requirements could chill or prolong the interaction between issuers and NRSROs during the ratings process. The information must be disclosed if it is 'used by' the NRSRO in determining the rating. Accordingly, the issuer would be dependent on the NRSRO to identify the information that satisfies the standard. The proposed rule does not currently require disclosure of information provided by a servicer or master servicer. Comment letters have requested the inclusion of these parties, and we expect that they would be captured in any final rule.

- *How will the disclosures be made in registered deals?* The proposal discusses three alternative means to disclose: free writing prospectus, ABS informational and computational materials and amendments to registration statements. In many cases, we expect that the information provided to the NRSROs may require that all three options are used for one transaction. Issuers will also need to consider, in light of the securities law liability that attaches, whether any explanatory information or cautionary language would be needed to be filed with these materials.

[11] http://www.mofo.com/news/updates/files/08072CreditAgencies.pdf
[12] Information provided by any of the "issuer, underwriter, sponsor, depositor or trustee" would be subject to the proposed rule.

- We note that a discussion of these alternatives implies that the issuer will be taking the primary role in providing the disclosure, but as the proposed rule establishes disclosure as an obligation of the NRSRO, the question remains open.

- *Why disclose to 'credit rating agencies' rather than to registered NRSROs?* Disclosure for private transactions must be made upon pricing, through password protected sites, to investors and credit rating agencies. The proposal requires disclosure, not to the finite universe of registered NRSROs, but to all 'credit rating agencies.'[13] It isn't clear who will determine if an entity is a credit rating agency or how often that determination will need to be made. One potential alternative is that credit rating agencies submit requests to NRSROs to be included on their distribution lists. It may then be incumbent upon the NRSRO to confirm that the applicant satisfies the definition of 'credit rating agency.' As securities law liability attaches to the issuer, issuers will need to be part of the decision making process or have contractual comfort from the NRSROs.

- *What about proprietary or confidential information?* Asset-backed securities may be backed by assets about which detailed loan level information is confidential. Particularly, the information regarding the individual loans, obligors and lessees in commercial mortgage-backed securities is often not public and disclosure would put obligors on the underlying leases at a competitive disadvantage, if disclosure would even be contractually permissible. In addition, in the asset-backed commercial paper market, details regarding the underlying assets are frequently confidential. Absent changes in the final rules to reflect these market realities, market participants may need to find alternative paths to market, including foregoing issuer-pay ratings, to permit these financing transactions to continue. We note that one traditional alternative, offering securities privately, would not be available if the final rules retain the disclosure obligation for all private transactions. Longer term, modifications to underlying contracts to facilitate the flow of necessary information under the securities laws may develop. Absent any such contractual changes, an inability to share confidential information with rating agencies may result in lower ratings and more costly transactions.

- *How will the requirements be interpreted for 'shadow' or private ratings?* Not all issuer paid ratings are used directly in the offer and sale of securities. For example, an issuer may obtain a rating for a tranche that will be retained. In those circumstances, the information provided to the rating agencies may be proprietary or confidential. Although the proposal addresses private placements, it isn't clear that the drafters contemplated retained or privately warehoused transactions. In these limited cases, there shouldn't be the same interest in generating credit rating agency competition or public dissemination of information for investor protection.

- *Why are the provisions being applied to both public and private transactions?* As drafted, the difference between disclosure of information in publicly registered transactions and private transactions relates to the timing of the release of information to the public. Traditionally, offerings have been exempt from the registration requirements based on the sophistication of the investors and their ability to request such information as is needed to make investment decisions. Achieving the goal of increased competition between NRSROs using the issuer pay model and those using the subscriber pay model would indicate disclosure only to NRSROs, rather than to the broader public. Underwriters and dealers may need to consider what enhanced procedures would be appropriate to prevent sales to unqualified individuals given the unrestricted flow of information. Parties will also need to consider the implications for the distribution of privately placed securities after the transaction has "closed."

- *Why are the ongoing reporting obligations of asset-backed issuers being extended?* The current reporting regime for asset-backed issuers under the Exchange Act requires periodic reports and at least one annual report, with many asset-backed issuers suspending their reporting obligations after one year based on the limited number of securityholders. Traditionally, the reporting rules have balanced the need to provide information to investors with the cost to the issuer of making information publicly available.

[13] As defined in Section 3(a)(61) of the Exchange Act.

The requirement that all information used for surveillance purposes be publicly disclosed would impose a new ongoing reporting requirement on issuers of Asset Pool Securities.

- *Will investors be able to use the additional information?* One of the SEC's stated goals in proposing the broad-based disclosure of information used by issuer-paid rating agencies is to provide the more independent subscriber-pay rating agencies a meaningful opportunity to issue credit ratings. The proposed rule, however, requires full public disclosure, rather than requiring disclosure to credit rating agencies or NRSROs. While investors requested additional disclosure through the Regulation AB process, Regulation AB was intended to provide that information, and it isn't clear that the level or volume of information provided to rating agencies will be helpful or useable by investors. Additionally, as noted above, issuers will need to consider whether, absent clarifying disclosure or cautionary language, the information could be misleading.
- *Are the proposals consistent with the Regulation FD protections of the issuer/rating agency relationship?* Regulation FD contains an exception from that regulation's simultaneous disclosure requirement when a disclosure has been made to a rating agency for the sole purpose of developing a credit rating. The NRSRO proposed rule, on the other hand, would require any information used in connection with surveillance be disclosed by the NRSRO when received, *i.e.*, simultaneously. If unchanged in the final rule, this could have a chilling affect on issuer communications with NRSROs.

Proposals for New Issuance

A number of the proposals impact the issuance process, as described in more detail below.

Ability to Register on Form S-3[14]

The Proposals set forth new eligibility criteria under Form S-3 for issuers of both asset-backed securities and non-asset-backed securities. In both cases the transaction eligibility provision for investment grade rated securities would be eliminated and replaced with an alternative provision.

Asset Backed Issuers

Form S-3 would be amended to replace the requirement that the registration relates to an offering of investment grade securities with the requirements that (1) initial and subsequent sales would be required to be in minimum denominations of $250,000, and (2) all initial sales would be limited to QIBs. These would be in addition to the two existing requirements related to pool composition.[15]

As the SEC notes in the Proposals, some types of asset-backed offerings would be excluded from Form S-3 eligibility under the proposal: unit repackagings, securitizations of insurance funding agreements and many repackagings of bonds and structured notes. Any asset-backed offerings with an investor group of non-QIBs would be excluded as well. We expect market participants will identify other existing and planned structures that would no longer be eligible for Form S-3 but would otherwise satisfy the principle of using Form S-3 for "high quality" securities.

Additionally, as currently drafted, the ongoing minimum denomination requirement would preclude asset-backed transactions with amortizing securities from being issued on Form S-3. The rule could be modified, for example,

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[14] Where applicable, the changes are also proposed for Form F-3.

[15] The two other requirements found in General Instruction I.B.5 are that "delinquent assets do not constitute 20% or more, as measured by dollar volume, of the asset pool as of the measurement date" and "with respect to securities that are backed by leases other than motor vehicle leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases, as determined in accordance with the transaction agreements for the securities, does not constitute 20% or more, as measured by dollar volume, of the securitized pool balance as of the measurement date."

by requiring initial sales with a minimum denomination of $250,000 and resales with a minimum denomination of $250,000 initial principal or notional balance. Nothing in the Proposals or the SEC commentary would indicate that this gap is anything other than an oversight, and we would expect changes in the final rules in response to industry comments. Repeat issuers would also need to consider whether they would lose Form S-3 eligibility if the resale restrictions were breached. Such a result would put the eligibility of the issuer into the control of remote market participants.

Finally, a limitation of sales to QIBs creates a new and unprecedented restriction on registered transactions. As a result, no asset-backed transaction registered on Form S-3 or taken off a shelf registration statement could be sold to retail or sophisticated non-QIB investors. While the proposing commentary notes that the goal of the changes was to limit eligibility to sophisticated and experienced investors, the SEC elected not to include accredited investors. They did request comment on whether "qualified investors," as defined in the Exchange Act, would be more appropriate than QIBs. The investment and asset tests for qualified investors are lower than for QIBs, and natural persons may be qualified investors. Market participants should consider carefully the limitations on the pool of available investors the proposal would impose. Transaction documentation would change, importing many provisions from 144A transactions, should the final rule include a QIB limitation.

Issuers seeking inclusion of a limited number of accredited investors may reassess whether a registered offering will achieve all of their issuance goals, given a potentially reduced investor base. And any asset-backed issuance that does not qualify for registration on Form S-3 would need to be registered on Form S-1, eliminating the ability to offer on a delayed or continuous basis.

Non-Asset Backed Issuers

For other issuers, the existing transaction requirement of Form S-3 that the registration relate to investment grade securities would be replaced with a requirement that the issuer had sold more than $1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years.

The existing standard was established based on an understanding that investment grade debt purchasers did not require expanded disclosure, as investment decisions are determined by interest rate and credit rating. In crafting the new standard, the SEC noted that issuers of $1 billion of debt securities over a three-year period are likely to be widely followed in the marketplace, with readily available information. As proposed, the rule is a transition from a standard based on the quality of the security being issued to the quantity of information available in the marketplace. Structured product issuers whose registrant is neither a well-known seasoned issuer, nor a registrant that qualifies for Form S-3 as an asset-backed issuer, would not be able to use Form S-3 or be eligible for shelf registration.

Mortgage Related Securities and Rule 415

Asset-backed securities that don't meet the eligibility requirements of Form S-3 may nevertheless be registered for issuance on delayed or continuing basis under Rule 415 if they meet the definition of "mortgage related security." By definition, a mortgage related security is required to be rated in one of the two highest rating categories by an NRSRO. The Proposals seek to amend Rule 415 to add the requirements that any mortgage related security to be offered on a delayed or continuous basis may only be sold initially and in resales in minimum denominations of $250,000 and may be sold initially only to QIBs. These new requirements in Rule 415 would mirror the requirements for an asset-backed issuer to use Form S-3. The SEC noted that absent such a change, one type of asset-backed security would be able to utilize shelf registration without complying with the requirements of Form S-3. Again, we note that the rule proposal does not take into consideration the amortizing nature of mortgage-backed securities. We would expect comments in this area and remediation in the final rules.

Changes to Disclosure Requirement of Regulation AB

The Proposals delete references to ratings in three provisions of Regulation AB: Item 1100(c), Item 1112 and Item 1114, each as described below.

Item 1100(c)(2) of Regulation AB: Presentation of Certain Third Party Financial Information; Reference Information for Significant Obligors

Financial information for significant obligors (third party information) that is otherwise required to be filed by an asset-backed issuer, instead may be incorporated by reference when the requirements of Item 1100(c)(2) are satisfied. One of those requirements is that the relevant third party is eligible to use Form S-3 to register investment grade debt. The proposal would require instead that the third-party meets the registration requirements of Form S-3 and the pool assets relating to the third party were issued in a registered primary offering. As a result, incorporation by reference of financial statements of a significant obligor would not be permitted if the assets included in the pool were privately placed.

However, we would note that the provisions of Item 1100(c)(2) for incorporating by reference are offered in the alternative and if the significant obligor or pool assets satisfy any other condition, the financial statements can be incorporated by reference. Unchanged is the provision that if the pool asset relating to the significant obligor is itself an asset-backed security for which Exchange Act reports are being filed, the related third-party financial information can be incorporated by reference.

Items 1112 and 1114 of Regulation AB:

Financial information regarding significant obligors and significant credit enhancement providers required under Items 1112 and 1114, respectively, is not currently required if the related obligations or enhancement provider is backed by the full faith and credit of a foreign government and the related obligations, or the obligations of the enhancement provider, are rated investment grade. The Proposals would remove the investment grade exemption, and would require that the financial information required by Item (5) of Schedule B be provided.

Commentary in the Proposals notes that Item 5 information should be readily available. Issuers and market participants will need to assess whether such information is readily available in all cases.

Changes to Regulation M

Regulation M, designed to prevent manipulation by offering participants during the offering process, prohibits certain activities during a restricted period around the time of an offering. Currently, offerings of investment grade non-convertible securities (Rule 101(c)(2)), and asset-backed securities (Rule 102(d)(2)) are not subject to the rule. The Proposals would replace the exemption from Regulation M for “investment grade securities” with an exemption for well-known seasoned issuers that have issued at least $1 billion of non-convertible securities other than common equity within the prior three years, and would replace the exemption from Regulation M for “asset-backed securities” with an exemption available for asset-backed securities that are registered on Form S-3.

We expect transaction documentation will be updated to reflect the new requirements, and participants in the distributions of securities will need to assess which offerings will now be subject to the restrictions of Regulation M. In addition, determining applicability of the new rule will require a different level of review of issuers and the securities being offered. Appropriate changes to training and compliance procedures will follow the final rules. Asset-backed issuers filing on Form S-1, including any sales to retail investors, would be subject to Regulation M.

Investment Company Exemptions and Exceptions

Most asset-backed securities are structured such that their issuer would be characterized as an investment company under the Investment Company Act, absent an available exception. Private placements of structured securities look to the exemptions provided in Sections 3(c)(1) or Section 3(c)(7) and registered public offerings look to the exemptions provided in Section 3(c)(5) or the exceptions of Rule 3a-5 or Rule 3a-7.

Currently, Rule 3a-7 provides that an issuer would not have to register as an investment company if, among other factors, the securities offered publicly are asset-backed[16] and are rated investment grade. The proposed amendment would delete the investment grade provision. The remaining provisions would provide that an issuer of asset-backed securities would not have to register as an investment company if it publicly issued securities to accredited investors and QIBs. Although the proposed changes are similar to the proposed changes to Form S-3, an issuer that can no longer file on Form S-3 has as an alternative filing on Form S-1. With respect to the Rule 3a-7 proposed change, if Rule 3a-7 is not available, the alternatives are narrower in scope. Both Rule 3a-5 and Section 3(c)(5), available for registered public offerings, have significant limitations. Prior to the availability of the current exceptions to the Investment Company Act, an issuer would often need to meet with the staff of the SEC or pursue no-action relief to be confident that it was not an investment company. These options were time consuming and often delayed issuance. Alternatively, issuers could elect to offer securities through one of the private issuance exceptions. Private placements, however, may not be a practical alternative depending on the securities and potential investors.

In the supporting analysis, the Proposals state that "today most asset-backed securities are issued by special purpose vehicles that do not rely on rule 3a-7"; "instead, they rely on section 3(c)(7)." As Section 3(c)(7) provides relief only for non-public issuances, which would exclude all issuers subject to Regulation AB, it would appear that further conversation with the SEC is needed to clarify the intention of the proposed change.

We expect market participants to review current and proposed structures and their potential investors to evaluate investment company alternatives. Any removal of the bright line investment grade standard will impact transaction documents and the marketing and sales process, particularly where the determination as to whether or not an issuer is an investment company would no longer be based on the nature of the securities being sold, but would be based on the purchasers of those securities. We expect alternatives to the proposed removal of the investment grade standard will be presented during the comment process.

Additional Proposed Changes to Rule 3a-7

Rule 3a-7 requires that any addition or disposition of an issuer's asset be undertaken only where such addition or disposition would not result in a change in the ratings of the outstanding fixed income securities. Issuers comply with this requirement by either establishing guidelines for additions and dispositions with an NRSRO or obtaining a ratings confirmation letter from the NRSRO at the time of additions or dispositions of assets. The proposed change would require that the issuer establish procedures to ensure that any addition or disposition would not adversely affect the full and timely payment of outstanding fixed income securities, and would eliminate the ratings component. We expect that market forces will determine if, notwithstanding the removal of the regulatory requirement, investors and NRSROs will still require confirmation or similar certainty from the NRSRO rating the transaction.

Finally, Rule 3a-7 currently requires that cash flows be deposited into a segregated account consistent with the rating of the outstanding fixed income securities. The Proposals would replace this with a requirement that the issuer deposit cash flows into a segregated account consistent with the full and timely payment of the outstanding fixed income securities. We don't anticipate this change will have much effect as investors and rating agencies will likely continue to look to the rating of the institution holding the issuer's cash.

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[16] Rule 3a-7(a)(1). The issuer issues fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets. The Rule defines "eligible assets" to mean "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders."

Money Market Funds Will Evaluate Investments Using a New Standard

Classes of asset-backed securities have been structured by issuers with maturity and other characteristics to be eligible for purchase by money market funds. In part because these short-term instruments are often repaid before other classes of securities, they are rated in the highest ratings categories. The provisions of Rule 2a-7 include, among other things, a requirement that investments by money market funds be rated in one of the two highest short-term rating categories by an NRSRO or that they be unrated securities of comparable quality and that the fund's board of directors determine that the investment presents minimal credit risk based on factors in addition to any rating. The Proposals would eliminate any reference to an investment being rated in one of the two highest short-term rating categories and instead would require the money market fund boards of directors determine that any investment presents "minimal credit risks" to be considered eligible for purchase. In its commentary, the SEC indicates that they believe boards would still be able to use NRSRO ratings that they conclude are credible.

Additionally, the requirement that the board of directors reassess an investment upon negative action from a rating agency would be replaced with a requirement that the board of directors exercise reasonable diligence regarding their investments. While we expect monitoring credit ratings would continue to be a significant component of the monitoring process, boards of directors may reassess carefully the level and adequacy of information available given the reduced confidence of regulators in NRSROs. The Proposals would also codify standards regarding the board's obligations to make determinations regarding the liquidity of investments.

While the Proposals support continued reference to NRSRO credit ratings by boards of directors, money market funds may need to update procedures and policies for the selection and monitoring of eligible securities based on the Proposals. Market participants should be aware of the new requirements for these purchasers of asset-backed securities, particularly given the reviews being undertaken by money managers following recent market illiquidity and concerns regarding the adequacy of information in the marketplace.

Proposed Net Capital Rules De-Codify References to Ratings

As proposed, the net capital rules would be amended by removing bright-line ratings based tests for computing minimum required net capital. In place of having a prescribed rating determine the treatment of securities, the broker-dealer must make a determination that any commercial paper instrument has minimal credit risk and is sufficiently liquid to provide for sale at or near carrying value almost immediately, and must find that certain other debt instruments have moderate credit risk and be sufficiently liquid to provide for sale at or near carrying value within a reasonably short period of time.

The Proposals clarify that any final release would include specific interpretive language that the new requirements could be satisfied by reference to the rating of an NRSRO. This language should alleviate concerns that the SEC no longer considers credit ratings a reliable measure of risk, particularly with respect to the asset-backed securities at the center of the current market disruption. However, in light of the extensive write-offs and charges experienced by financial institutions, we expect they will consider carefully liquidity concerns and other recent events when developing updated policies for the computation of net capital.

Transition

The proposed rules did not include provisions for a transition process or period. Elimination of form eligibility for asset-backed issuers would require a transition process to Form S-1, whether or not the issuers would have the ability to use their existing shelves for some period. We would hope for some level of expedited review of registrants transitioning from Form S-3 to Form S-1.

Conclusion

The SEC has proposed far reaching changes to remove the imprimatur of the rating agencies from its own rules and regulations. As proposed, however, the rules would dramatically change the marketplace for securities, and in many cases impose limitations on issuance beyond anything implicated by the current sub-prime crisis.

The timing and substance of the final rules will be influenced by the SEC's concern that its actions may have inadvertently failed to help protect against the current sub-prime crisis. As a result, and despite the scope of the Proposals, we expect to see final rules from the SEC later this year.

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