Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE,
Washington, DC 20549-1090

**Re: File Number S7-01-23**

Dear Secretary Countryman:

The National Association of Health and Educational Facilities Finance Authorities ("NAHEFFA")[1] submits these comments in response to the Securities and Exchange Commission's ("SEC") request for comments on its supplemental proposed rule captioned "Prohibition Against Conflicts of Interest in Certain Securitizations" (referred to herein as the "Proposed Rule").[2]

As detailed below, NAHEFFA's viewpoint is that the substantive prohibitions contained in the Proposed Rule have no application to governmental issuers of, or borrowers of the proceeds of, municipal bonds issued for the purpose of making conduit loans[3] to charitable 501(c)(3) organizations such as not-for-profit hospitals and higher education institutions. Because the procedural requirements of the Proposed Rule, when finalized, could impose administrative and financial burdens on such governmental issuers and/or charitable borrowers with no benefit justifying such regulatory burden, NAHEFFA urges that the final version of the Proposed Rule contain an exemption for governmental entities and 501(c)(3) organizations that might, absent such exemption, be deemed "securitization participants" with respect to an "asset-backed security" issued in a conduit transaction purely because of the presence of a loan or other self-liquidating financial asset payable by the conduit borrower to the governmental issuer.

## 1. The Proposed Rule.

NAHEFFA does not object to the substantive goal of the Proposed Rule, which seeks to limit material conflicts of interest in securitization transactions involving asset-backed securities

[1] NAHEFFA supports and promotes the common interests of governmental issuers with the authority to issue tax-exempt bonds and other debt to provide capital for not-for-profit healthcare and higher education institutions of varying sizes and other charities. Learn more about NAHEFFA at https://www.naheffa.com/.

[2] 17 C.F.R. § 230.192; published in the Federal Register on February 14, 2023, 88 FR 9678.

[3] So-called 'conduit bonds' of the type issued by governmental issuers that are NAHEFFA members are municipal securities designed to raise capital for certain types of revenue-generating projects that, though owned or leased by non-governmental entities, benefit the public. As further described herein, under a conduit financing structure, a governmental 'conduit' issuer loans the proceeds of conduit bonds to a qualifying borrower, and that borrower, rather than the conduit issuer, is responsible for making payments to bondholders. Governmental conduit issuers do not pledge their full faith and credit or their taxing authority, if any, to ensure the payment of principal of and interest on conduit bonds.

(ABS). The Proposed Rule, for a limited period of time following the date a "securitization participant" reaches or has taken "substantial steps to reach" an agreement to become a "securitization participant," prohibits such "securitization participant" from engaging in short sales of the relevant ABS, purchasing a credit default swap or other credit derivative producing payments upon the occurrence of "specified" credit events relating to such ABS, or purchasing or selling, subject to certain listed exceptions, any financial instrument other than the relevant ABS that would permit the "securitization participant" to benefit from certain adverse developments implicating the performance, payment or market value of the ABS. The prohibition on such transactions applies if, and only if, "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision" with respect to the relevant ABS.

Under the Proposed Rule, a "securitization participant" includes, among other parties to an ABS transaction, a "sponsor," which is defined to include "(ii) Any person: (A) with a contractual right to direct or cause the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security; or (B) that directs or causes the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security."

The SEC's release accompanying the Proposed Rule (the "Release") includes text and footnotes indicating that municipal entities can be "sponsors" (and therefore "securitization participants") if they satisfy the definition, and that a "municipal ABS" is an ABS under the Proposed Rule if it is an ABS under the Securities Exchange Act of 1934.[4] Accordingly, the Proposed Rule does not categorically exclude municipal issuers or other governmental entities, nor does it exclude municipal bonds or other municipal securities that meet the Exchange Act's definition of an ABS. As discussed below, it apparently does not even exclude a municipal bond payable from a single loan – a transaction that no market participant would deem an "asset-backed security." Similarly, conduit borrowers in a municipal bond issue appear to be swept within the Proposed Rule's broad definitions if such definitions are met for the relevant borrower and the relevant bond issue.

The Release's Request for Comment 9 asks "Should certain parties related to a municipal securitization be excluded from the scope of the re-proposed rule?" Other market participants will advocate for a general exclusion from the scope of the Proposed Rule for all municipal securitizations and/or for various categories of participants in municipal securitizations. We agree.

NAHEFFA believes that the types of conflicts the Proposed Rule is designed to address are non-existent or extremely unlikely when it comes to municipal securities, and would support

[4] See 15 U.S.C. § 78c(a) (79), defining "asset-backed security." The Securities Exchange Act of 1934, as amended, is referred to herein as the "Exchange Act."

a general exemption applicable to all governmental entities and/or all municipal securities. In the event that a more general exemption is not adopted, NAHEFFA urges, for the reasons stated below, that at a minimum the final rule include an exemption applicable to governmental entities and 501(c)(3) entities that participate in ABS transactions involving one or more loans or other self-liquidating financial assets between a governmental entity and one or more 501(c)(3) organizations.

**2. The structure of conduit municipal bond issues for 501(c)(3) borrowers.**

Section 103 of the Internal Revenue Code excludes from gross income the interest on "state or local bonds" issued by states or their political subdivisions. This tax exemption allows such governmental entities to borrow at lower interest rates than would be available otherwise, as the net return to bondholders is not diminished by federal income taxes (and in many cases is also unaffected by state income taxes.) The Internal Revenue Code has various provisions that preclude municipal bond issuers from passing along the benefit of such lower interest rates to private parties, but there are several exceptions to those restrictions, including Section 145 of the Internal Revenue Code, which permits the issuance of tax-exempt "qualified 501(c)(3) bonds" for the benefit of tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code.

Accordingly, state or local governmental issuers (including public authorities established by state or local government for such purpose) can issue tax-exempt bonds and loan the bond proceeds to 501(c)(3) organizations, thereby giving such organization the ability to borrow at lower interest rates than would be available if such organizations borrowed on a taxable basis from banks or taxable bond investors. The governmental issuers that NAHEFFA represents are established by state statute to make such so-called conduit loans to 501(c)(3) borrowers, which include hospitals and higher education institutions and may include other types of health care providers, elderly housing providers, social services providers, museums and other non-profit entities.

In the typical structure, the governmental issuer's conduit bond issue finances a single loan to a single borrower. The borrower's loan payment obligations under the loan agreement mirror the governmental issuer's payment obligations on the applicable bonds and the governmental issuer assigns the loan agreement to a bond trustee, which receives the loan payments and pays them over to the bondholders. If the borrower defaults under its loan agreement obligations, the bond trustee may seek enforcement against, and its recourse is limited to actions against, the borrower.

**3. The Proposed Rule contains no rationale for extending ABS regulation to municipal bonds payable from a single loan.**

The Exchange Act defines an "asset-backed security" as "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive

payments that depend primarily on cash flow from the asset…." [5] In prior rulemaking under the Exchange Act, the SEC has defined "asset-backed security" less broadly; see, *e.g.*, Regulation AB, which defines "asset-backed security" as "a security that is primarily serviced by the cash flows of a discrete *pool of receivables or other financial assets*, either fixed or revolving, that by *their* terms convert into cash within a finite time period…." (emphasis added).[6] This requirement of the existence of a pool of assets is consistent with the market's understanding of the term "asset-backed security" as involving the bundling of large numbers of financial assets in order to get them off the sponsor's balance sheet and free up sponsor capital.

For purposes of the Proposed Rule's prohibition of certain conflicts of interest affecting ABS, however, the SEC replaces the Regulation AB definition of "asset-backed security" with the broader statutory definition. In prior instances when the SEC has used the statutory definition instead of the Regulation AB definition of "asset-backed security," the SEC has indicated an intent to apply the applicable rule to transactions exempt from registration.[7] In the Release for the Proposed Rule, without discussion, the SEC adds another consequence of not using the Regulation AB definition: the elimination of the requirement that an "asset-backed security" include a "pool" of financial assets. According to the Release, "an ABS that is backed by a single asset or one or more obligations of a single borrower (often referred to as 'single asset, single borrower' or 'SASB' transactions) meets the definition of an Exchange Act ABS." The Release provides little, if any, support for this novel application of the Exchange Act definition, much less any attempt to suggest that the conflicts of interest with which the Proposed Rule is concerned justify such an expansive interpretation of what constitutes an "asset-backed security."

There is no discussion in the Release of why the Proposed Rule should apply to "an ABS that is backed by … one obligation[] of a single borrower." The market, whether municipal or non-municipal, does not think of a conduit bond issue backed by a single, unitary loan as an ABS.[8] The Proposed Rule should be revised to clarify that "asset-backed security" for purposes

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[5] In rulemaking, the SEC has interpreted the word "collateralized," as used in the statutory definition of "asset-backed security" broadly, to include any "rights to cash flow from" a self-liquidating financial asset. See, e.g., the definitions of "collateral" and "collateralize" as used in the Credit Risk Retention rule (Regulation RR), 17 C.F.R. § 246.2.

[6] 17 CFR § 229.1101(c)(1).

[7] Regulation AB applies only to issuers with a reporting obligation relating to securities registered under the Securities Act of 1933, as amended or under Section 12 of the Exchange Act.

[8] Indeed, when the SEC has given examples of municipal securitizations, including in the Release, such examples have been confined to multi-loan transactions. See Release footnote 30, referencing "the broader definition of Exchange Act ABS and its application to municipal securities, such as student loan bonds, housing, and mortgage bonds" (emphasis added).

of the Proposed Rule does not include such plain vanilla conduit bond transactions that neither bundle loans nor fractionate them.

**4. Governmental issuers and 501(c) (3) borrowers are not in the business of making money from bets against their borrowers or themselves.**

State and local governmental entities in general, and issuers of qualified 501(c)(3) bonds in particular, are creatures of statute that may only undertake statutorily authorized transactions. Unlike some private participants in the financial sector who may perceive a duty to maximize profits or may otherwise have an interest in doing so, governmental entities such as those that belong to NAHEFFA are not authorized by their enabling statutes to short sell, invest in credit default swaps or otherwise bet against the success of the borrowers they are created to assist or the value of the bonds that such entities issue on behalf of such borrowers. Such issuers are created for a public purpose and generally have no financial interest in the loans they make with bondholder capital, other than modest issuance and annual monitoring fees payable by the borrower. They are also public entities subject to sunshine laws and to scrutiny of any transactions in which they engage.

To observe that such entities are constitutionally unlikely to engage in the types of conflicted transactions that the Proposed Rule regulates is gross understatement. The same is true for charitable hospitals, higher education institutions and other 501(c)(3) borrowers, which are established for pro-social purposes, have limits on unrelated business income, and have investment committees populated by community members: it is beyond unlikely that such entities would seek to profit from betting against themselves and their securities.

**5. Governmental issuers and 501(c)(3) borrowers should not be subject to the potential burdens of proving that they do not engage in conflicted transactions.**

It may appear that if governmental issuers such as NAHEFFA's constituents and/or 501(c)(3) borrowers do not engage in conflicted transactions of the type described in the Proposed Rule, they should be indifferent to whether they are technically within the scope of the Proposed Rule. That is not the case.

The principal concern of NAHEFFA and its constituents is that – by intent, by ambiguity, or by subsequent interpretation – "securitization participants," including those who for the reasons discussed above pose no realistic risk of engaging in the conflicted transactions prohibited by the Proposed Rule, may be required to expend administrative and financial resources on proving a negative, thereby imposing a cost when there is no regulatory benefit. An example is presented by Request for Comment 59 in the Release:

> Should the re-proposed rule include a requirement that a securitization participant have documented policies and procedures in place that are reasonably designed to prevent the securitization participant from violating the re-proposed rule's prohibition with respect to conflicted transactions? What should the consequences be for a securitization

> participant that did not follow such procedures? Would such a requirement provide effective protection for investors? Should such a requirement be in addition to or in lieu of the proposed compliance program requirements discussed below with respect to the risk-mitigating hedging activities exception and the bona fide market-making activities exception?

For the reasons articulated above, NAHEFFA would emphatically answer '<u>no</u>' to the application of any such "documented policies and procedures" requirement to governmental entities such as NAHEFFA's constituents. The same applies to the proposed compliance program requirements for the risk-mitigating hedging activities exception.[9] Any compliance program for an empty set is an unjustifiable regulatory burden. And even if the Proposed Rule, when finalized, exempts governmental entities and/or charitable borrowers from any stated compliance program requirements, it is impossible to predict what other implicit or prudent administrative burdens a "securitization participant" may be required to undertake in order to avoid a potential foot-fault with unknown consequences under the requirements of the rule as finalized and/or subsequently interpreted. There simply is no reason for issuers of conduit bonds for 501(c)(3) borrowers, or such borrowers, to be forced to expend resources on reviewing a rule to which they are technically subject for the purpose of concluding that they are not (or perhaps are) required to take affirmative steps to establish absence of non-compliance.

**6. Additional Considerations**

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[9] The Proposed Rule includes an exception to "conflicted transaction" status for permitted risk-mitigating hedging activities as described in the Proposed Rule, but imposes conditions on qualification for such exception, including that the "securitization participant" establish, implement, maintain and enforce "an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with the requirements [for permitted risk-mitigating hedging activities], including reasonably designed written policies and procedures regarding the risk-mitigating hedging activities that provide for the specific risk and risk-mitigating hedging activity to be identified, documented, and monitored."

As discussed above, municipal issuers in general and municipal conduit bond issuers in particular, as well as municipal conduit bond borrowers, do not engage in short sales of the relevant ABS, purchasing a credit default swap or other credit derivative producing payments upon the occurrence of "specified" credit events relating to such ABS, or purchasing or selling financial instruments that would permit such issuers or borrowers to benefit from adverse developments implicating the ABS. Although some municipal issuers and/or conduit borrowers purchase credit enhancement such as bond insurance, any benefit from such insurance runs to bondholders, not to the issuer or borrower, and the "benefit" is the payment of the bonds in accordance with their terms, with the insurer retaining rights to obtain repayment from the applicable conduit borrower of the amounts advanced by the insurer. Accordingly, such risk-mitigation transactions should not fall within the affirmative prohibitions under the Proposed Rule even if there were no exception for permitted risk-mitigating hedging activities as described in the Proposed Rule. Nonetheless, inclusion of municipal issuers and/or municipal bond conduit borrowers in the "securitization participant" definition would potentially require municipal issuers and municipal bond conduit borrowers to assess whether the absence of an "internal compliance program" regarding bond insurance and similar credit enhancement instruments might somehow be deemed by the SEC to constitute a potential rule violation.

NAHEFFA's viewpoint is subsumed within the general position of a coalition of state and local municipal securities market participants that are advancing the position that all municipal securities should be exempted altogether from the scope of the Proposed Role; a position that NAHEFFA supports.

**7. Conclusion**

The Proposed Rule should be revised to exempt municipal securities from its scope or, if the SEC decides against such an exemption, should, at a minimum, exclude from the definition of "sponsor" and/or "securitization participant" any governmental entity or 501(c)(3) organization in connection with an asset-backed security issued by a governmental entity the lendable proceeds of which are used to make or acquire one or more loans or other self-liquidating financial assets payable by one or more 501(c)(3) organizations.

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