September 4, 2008

BY ELECTRONIC MAIL

Ms. Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Security Ratings; Release Nos. 33-8940, 34-58071; File No. S7-18-08

References to Ratings of Nationally Recognized Statistical Rating Organizations; Release No. 34-58070 (File No. S7-17-08)

References to Ratings of Nationally Recognized Statistical Rating Organizations; Release Nos. IC-28327, IA-2751; File No. S7-19-08

Dear Ms. Harmon:

Mayer Brown LLP appreciates the opportunity to comment on the referenced releases, which propose amendments to eliminate references to security ratings from many of the Commission’s forms and rules. We are commenting only on the proposed amendments that significantly affect asset-backed securities (ABS). Specifically, we are commenting on the Commission’s proposed changes to:

- General Instruction I.B.5. to Form S-3;
- Rule 415(a)(1)(vii) under the Securities Act;
- Regulation AB;
- Regulation M (but only the proposed changes relating to ABS); and
- Rules 2a-7 and 3a-7 under the Investment Company Act.

All of these changes relate directly to offerings of ABS, except for the ones relating to Rule 2a-7, which we address because of the importance of money market funds as investors in ABS. The changes listed in our first three bullets are proposed in Release Nos. 33-8940 and 34-58071 (the
“Corp Fin Release”); the changes referred to in our fourth bullet point (relating to Regulation M) are proposed in Release No. 34-58070 (the “TM Release”); and the changes listed in our final bullet are proposed in Release Nos. IC-28327 and IA-2751 (the “IM Release”). We refer to the proposals listed in our five bullets collectively as the “Subject Proposals.”

We have reviewed the American Securitization Forum’s comment letter (the “ASF Letter”) relating to the Subject Proposals, and we support the comments made in the ASF Letter. We are also writing to provide our own point of view on the Subject Proposals.

Mayer Brown has a large ABS practice, and we have been active in this area since the early days of the ABS market. Over that time, we have had the pleasure of participating in the rulemaking processes that led to the adoption of many of the forms and rules that would be affected by the Subject Proposals. In each of those rulemaking processes, we have admired the way in which the Commission has balanced the twin goals of promoting capital formation and protecting investors. In spite of the recent turmoil, we believe that the expansion of the ABS market has substantially benefited US businesses and consumers. That expansion would not have been possible without the Commission’s enlightened, pragmatic approach to the many issues that have arisen along the way.

We are concerned, however, that the Subject Proposals are an over-reaction to recent events and do not reflect the same level of pragmatism that the Commission has shown in past ABS rulemakings. The Commission has indicated that a primary motivation for the Subject Proposals is the Commission’s consideration of whether “the inclusion of requirements related to security ratings in its rules and forms has, in effect, placed an “official seal of approval” on ratings that could adversely affect the quality of due diligence and investment analysis.” While recent events clearly justify the Commission taking a fresh look at this question, we do not believe a balanced consideration of the question justifies the Subject Proposals.

Existing Rules Adequately Disclaim any “Official Seal of Approval”

Many fixed income investors view NRSRO security ratings as important, and some may have relied excessively on them in the bubble preceding the recent credit crisis. That does not mean that investors’ reliance, whether excessive or not, was induced or increased by references to security ratings in the Commission’s forms and rules. Other commenting market participants can speak more authoritatively than us on actual investor behavior and its causes, but we note three important legal safeguards that the Commission already has in place to avoid any indication of a “seal of approval”:

- Every prospectus for a public offering of ABS is required by Item 501(b)(7) of Regulation S-K (as referenced in Form S-3 or, when used, Form S-1) to include a legend

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on the outside front cover stating that neither the Commission nor any state securities commission has approved or disapproved of the offered securities.

- The Commission’s policy on disclosure of security ratings (Item 10(c) of Regulation S-K) appropriately instructs registrants that reference security ratings in their Securities Act registration statements to include cautionary disclosures, including that “a security rating is not a recommendation to buy, sell or hold securities, that it may be subject to revision or withdrawal at any time by the assigning rating organization, and that each rating should be evaluated independently of any other rating.”

- Rule 2a-7(b)(3)(i) already limits portfolio investments by money market funds to “securities that the fund’s board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO).”

We believe that these existing safeguards sufficiently distance the Commission from security ratings and avoid any need for the Subject Proposals. In the context of registered offerings, the required legend and suggested disclosure on security ratings cover all of the transactions that would be affected by the proposed changes to General Instruction I.B.5. to Form S-3, Rule 415(a)(1)(vii) under the Securities Act, Regulation AB and Regulation M (insofar as the proposed changes to Regulation M relate to ABS). Many of the securities issued by entities that rely on Rule 3a-7 to avoid registration under the Investment Company Act are also initially distributed in registered offerings, in which case the legend and Commission policy relating to security ratings again avoid the need for the proposed changes. To the extent that securities issued by entities relying on Rule 3a-7 are sold to US persons in unregistered offerings, they would generally already be sold to qualified institutional buyers (QIBs) or institutional accredited investors.  

As to Rule 2a-7, paragraph (b)(3)(i) makes it abundantly clear that the Commission does not consider a security rating to be a substitute for independent credit evaluation and due diligence by a fund’s board of directors. Currently Rule 2a-7 imposes two requirements (a board credit determination and a minimum security rating). The proposed changes would remove one of them. This seems like throwing the baby out with the bath water. While security ratings are neither perfect nor a substitute for independent investment analysis and diligence, the market seems to view them as providing some incremental benefit, both as one of the factors that a fund’s board may consider and as an additional, independent check on the board’s judgment.

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2 We use the term “institutional accredited investors” to refer to investors of the types listed in paragraph (a)(2)(i) of Rule 3a-7 (accredited investors referred to in paragraphs (1), (2), (3) and (7) of Rule 501(a) under the Securities Act).
Security Ratings are a Valuable Indicator of Credit Quality in an Imperfect World

Security ratings have found their way into so many of the Commission’s (and other regulators’) forms and rules because of the value that market participants attribute to them. The fact that the NRSROs, along with many other market participants, apparently made serious errors that contributed to the recent credit crisis does not erase the value of security ratings in most circumstances. Investors have received a resounding reminder that they cannot rely exclusively on NRSRO ratings, but they will continue to consider ratings as one important indication of credit quality, particularly as the NRSROs adjust their rating criteria and processes to correct for their previous errors.

Because NRSRO security ratings can reasonably be expected to continue to play an important role in the fixed income markets, they will also continue to provide convenient benchmarks for determining when an ABS offering should be eligible for shelf registration and when an issuer should be permitted to rely on Rule 3a-7. They will also continue to provide a valuable secondary check on investments by money market funds, assisting and supplementing the independent and primary credit determinations of a fund’s board of directors. NRSRO ratings may not be the ideal measure to use for these purposes, but the pragmatic questions are: what are the alternatives, and are they better than NRSRO ratings for these purposes?

As to eligibility for shelf registration and Rule 3a-7, the Commission has proposed an investor requirement (QIB or, in the case of Rule 3a-7, institutional accredited investor status) and a minimum offering denomination. We submit that these alternatives are greatly inferior to the current use of investment grade security rating requirements in General Instruction I.B.5., primarily because the proposed changes would essentially drive ABS issuers away from shelf registration. Since ABS issuers can already offer to QIBs relying on Rule 144A, it is hard to see why they would pay the registration fees and incur the legal and other expenses relating to shelf registration when a shelf offering would not expand the potential investor population. In fact a shelf registered offering would have a more restricted investor population than a private placement, since issuers in private placements can make direct sales to non-QIBs in reliance on Regulation D or sell into the so-called 4(1-1/2) market. As a result, ABS investors would tend to lose the benefits of registration.

As to Rule 2a-7, the Commission has not really proposed an alternative. The minimum rating requirement would be removed, and the existing requirement for credit approval by the fund’s board would remain in place. As indicated above, we believe that the minimum rating requirement provides some incremental benefits. This is not a situation where less is more.

Some Further Points on Rule 3a-7

The IM Release states:
We understand that today most asset-backed securities are issued by special purpose vehicles that do not rely on rule 3a–7 to exclude them from the application of the Investment Company Act. Instead, they rely on section 3(c)(7) . . . .

We believe this is factually incorrect. In our experience, many issuers of ABS that are sold in registered offerings rely on Rule 3a-7.

The IM Release goes on to say that:

asset-backed securities issued by financing vehicles that rely on rule 3a–7, even when highly rated, generally are not marketed to retail investors.

Although it is true, in our experience, that the ABS market is predominantly institutional, we are opposed to limiting Rule 3a-7 in the proposed manner. When the Commission adopted Rule 3a-7, it was wisely concerned with avoiding restrictions that would arbitrarily constrain the growth and evolution of the ABS market. Prohibiting sales to retail investors would impose just such a restriction. Suitability matters should be left to broker-dealer regulation.

Specific Comments on the Subject Proposals

As will be clear from the discussion above, we oppose the Subject Proposals, especially the proposals to:

- Substitute a QIB requirement and minimum denomination for the current investment grade requirement in General Instruction I.B.5. to Form S-3;
- Make corresponding changes to Rule 415(a)(1)(vii);
- Eliminate the current option for investment grade fixed income securities issued by Rule 3a-7 issuers to be held by investors other than QIBs, institutional accredited investors and other persons referenced in paragraph (a)(2)(ii) of Rule 3a-7;
- Eliminate the rating requirement from the definition of “eligible security” in Rule 2a-7.

As to each of these proposals, we strongly urge the Commission to leave the affected text as it is.

We view the other proposed changes to Rule 2a-7 and Rule 3a-7, the proposed changes to Regulation AB and the proposed changes to Regulation M that relate to ABS as generally

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3 Federal Register, Vol. 73, p. 40127 (July 11, 2008).
4 Ibid.
5 We refer to the following portion of paragraph (a)(2)(ii) of Rule 3a-7: “persons (other than any rating organization rating the issuer’s securities) involved in the organization or operation of the issuer or an affiliate, as defined in Rule 405 under the Securities Act, of such a person”.

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“house-keeping” matters meant to harmonize other provisions in these rules with the main changes that we oppose above. Consequently, we also oppose all of those changes.

If the Commission decides to move forward with the proposed changes to General Instruction I.B.5., or Rule 415(a)(1)(vii) or the investor qualification change to Rule 3a-7, we request that the Commission make some additional changes to minimize disruption to the ABS market:

- Any place that the Commission uses a QIB requirement, it should incorporate the reasonable belief and reliance safe harbor provisions from Rule 144A(d)(1). This would apply to the proposed changes to General Instruction I.B.5. and Rule 415(a)(1)(vii), if made.

- If Rule 3a-7 is amended to preclude sales to investors other than QIBs and institutional accredited investors, it will also be important for the Commission to include appropriate grandfathering provisions. Many pre-existing issuers that rely on Rule 3a-7 have not limited the initial sales or resales of their investment grade fixed income securities to any particular type of investor. Without a grandfathering provision, these issuers could technically become investment companies once the amendment took effect, notwithstanding their good faith compliance with the terms of Rule 3a-7, as in effect at the time they were formed. Few (if any) such issuers would have the ability to cure this problem by imposing new investor restrictions in reaction to the amendment.

- The Commission should also provide a transitional period for any changes to General Instruction I.B.5. and Rule 415(a)(1)(vii). Parties who paid registration fees in the anticipation of being able to make conventional public offerings of ABS should not be deprived of that ability with respect to pre-existing shelf capacity.

- In general, the Commission should harmonize investor restrictions between General Instruction I.B.5., Rule 415(a)(1)(vii) and Rule 3a-7. Under the current and proposed terms of these materials, the additional change we would suggest would be to permit sales of ABS under shelf registration statements to “persons (other than any rating organization rating the issuer’s securities) involved in the organization or operation of the issuer or an affiliate, as defined in Rule 405 under the Securities Act, of such a person”. Sales to such persons are permitted by paragraph (a)(2)(i) of Rule 3a-7. In many circumstances, sales to persons of this type would not have to be registered under the Securities Act. Nevertheless, we suggest that the Commission harmonize the referenced authorities on this point, to avoid potential technical issues that could arise in some circumstances.

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Thank you for this opportunity to comment on the Corp Fin, TM and IM Releases. Should you have any questions relating to our comments, please feel free to contact Rob Hugi (312/701-7121; rhugi@mayerbrown.com), Stu Litwin (312/701-7373; slitwin@mayerbrown.com),
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Yours truly,

*Mayer Brown LLP*