INVESTMENT COMPANY INSTITUTE

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February 13, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Prohibition against Conflicts of Interest in Certain Securitizations (File No. S7-38-11)

Dear Ms. Murphy:

The Investment Company Institute[1] appreciates the opportunity to comment on proposed Rule 127B ("Proposed Rule") under the Securities Act of 1933 ("Securities Act").[2] The rule would implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). Section 621, which added new Section 27B to the Securities Act, prohibits material conflicts of interest in connection with certain securitizations. As investors in the asset-backed securities ("ABS") markets, our members generally support the proposal and believe it would serve to protect ABS investors against certain conflicts of interest which may be raised by the activities of securitization participants. Registered investment companies, however, also may be affiliates of entities that structure or distribute ABS and therefore may fall within the Proposed Rule's scope. We believe that actions taken by a registered investment company in connection with investing in ABS, through its investment adviser acting in a fiduciary capacity, do not raise the conflicts of interest the Proposed Rule was intended to address. We therefore request that the Commission clarify that the Proposed Rule excludes such activities. To provide greater certainty to market participants, we also recommend that the Commission define, in the final rule, the five conditions necessary for the rule to apply, define persons subject to the Proposed Rule, and clarify that a security issued by a registered investment company would not be treated as an ABS for purposes of the rule.

We support the Commission's proposed exception for liquidity commitments. We recommend, however, that the Commission state expressly in the final rule that commitments to

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.5 trillion and serve over 90 million shareholders.

[2] *Prohibition against Conflicts of Interest in Certain Securitizations*, Exchange Act Release No. 65355 (September 19, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-65355.pdf ("Release").

provide liquidity may be provided through means other than just purchases and sales of ABS. We also have concerns about how the proposed exception for liquidity commitments would relate to the recent regulations that have been proposed to implement Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule."[3] The Commission provides examples of how the Proposed Rule's exception for liquidity commitments would apply to liquidity facilities provided by securitization participants in connection with notes issued by asset-backed commercial paper ("ABCP") programs. Certain restrictions under the Volcker Rule Proposal, however, could be interpreted to not permit such liquidity arrangements for bank-sponsored or advised programs, which would threaten the viability of such programs. Such a result would be inconsistent with Congress' intent in enacting the exception for liquidity commitments in Section 621 of the Dodd-Frank Act, and is unnecessary to address the conflict of interest concerns against which the Volcker Rule was designed to protect. It also would be inconsistent with the Commission's express intent as stated in the Release. We address this issue further in the comment letter we are submitting on the Volcker Rule Proposal.

I. Define in the Final Rule the Five Conditions Necessary for the Rule to Apply

The Commission explains in commentary in the Release that, in order for the Proposed Rule to apply, the relevant transaction must involve (1) covered persons; (2) covered products; (3) a covered timeframe; (4) covered conflicts; and (5) a "material conflict of interest." These conditions are not defined in the text of the Proposed Rule itself, but only in the commentary in the Release. We recommend strongly that the Commission define each of these terms in the text of the final rule. The Proposed Rule contains broad language that otherwise could sweep in a variety of transactions the Commission has stated it intends to exclude from the Proposed Rule's scope.[4] Explicitly defining these conditions in the final rule text would provide greater clarity and certainty to securitization participants and the ABS markets generally regarding the application and operation of the rule.

II. Define Persons Subject to the Rule and Clarify That an Investment Company Security is Not an Asset-Backed Security

Under the Proposed Rule, covered persons would include an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an ABS (collectively, "securitization participants").[5] Although some of these terms are defined in the federal securities laws for other purposes, the Commission requests comment on whether it should provide definitions for them for purposes of proposed Rule 127B. In order to provide certainty for persons to know whether

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[3] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds,* Exchange Act Release No. 65545 (October 12, 2011) ("Volcker Rule Proposal").

[4] *See, e.g.,* discussion of "covered conflicts of interest" below.

[5] These persons are specified in Section 27B(a) of the Securities Act.

they are subject to the Proposed Rule's prohibitions, we believe it is important that these terms be defined.

We recommend that the Commission define the term "initial purchaser" because this term otherwise could be incorrectly interpreted to mean an investor that initially purchases securities in an ABS transaction. Based on industry usage of the term in the context of Rule 144A transactions, we agree with the Commission that the term should be defined to mean "a broker-dealer functioning in a role equivalent to that of an underwriter or placement agent who purchases the ABS pursuant to an agreement that contemplates the resale of those securities to other purchasers in transactions that are not required to be registered under the Securities Act in reliance upon Rule 144A or that are otherwise not required to be registered because they do not involve any public offering."[6]

We also recommend that the Commission clarify in the final rule that, for purposes of the rule, a security issued by a registered investment company is not an "asset-backed security" under the broad definition of that term in the Securities Exchange Act of 1934 ("Exchange Act").[7] Although some registered investment companies invest in debt securities or other fixed-income instruments, investment companies have not been considered to issue ABS, nor have their securities been classified as ABS. Nonetheless, given the compliance implications and the potential for certain ordinary course activities to be banned altogether if investment company securities were considered ABS for purposes of the Proposed Rule, the Commission should clarify in the final rule that securities issued by registered investment companies are not intended to be treated as ABS.

III. Clarify That "Covered Conflicts of Interest" Would Exclude Registered Investment Companies Investing in ABS

The Commission states that the Proposed Rule applies only to "covered conflicts of interest." The Commission explains that this excludes, among other things, conflicts that arise exclusively between securitization participants or exclusively between investors. Specifically, the Commission

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[6] Release, *supra* note 2, at 25 (*internal citations omitted*).

[7] Section 3(a)(77) of the Exchange Act defines an "asset-backed security," in relevant part, 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, including—
> (i) a collateralized mortgage obligation;
> (ii) a collateralized debt obligation;
> (iii) a collateralized bond obligation;
> (iv) a collateralized debt obligation of asset-backed securities;
> (v) a collateralized debt obligation of collateralized debt obligations; and
> (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section . . .

states that "conflicts of interest arising solely among investors in the ABS offering (where investors could include securitization participants, provided these conflicts arise only from their interests as an investor) would also not be covered by the proposed rule."[8] We agree with this interpretation, with the additional clarification discussed below, and believe it should be included in the text of the final rule.

As mentioned above, registered investment companies technically may be considered securitization participants under the Proposed Rule if they are affiliated with a sponsor or other entity that has a role in structuring an ABS. Such investment companies, however, would have no role in structuring or distributing an ABS transaction.[9] Rather, their only interest in an ABS transaction would be as investors in the ABS. Accordingly, we believe that any conflicts that might arise between such an investment company and other ABS investors would fall within the exclusion, described above, for conflicts arising exclusively between investors. For example, in a restructuring of an ABS issuance or other significant event affecting the ABS, a registered investment company, acting through its adviser, may take an action with respect to the investment company's holdings of ABS that is in the best interests of the investment company and its shareholders, but which may conflict with the interests of other ABS investors in the transaction, such as those holding other tranches of the ABS offering.[10] This type of transaction does not raise the concern that the Proposed Rule is intended to address, which is that firms may package and sell ABS to their clients and then engage in transactions that create conflicts of interests between the firm and its clients.[11] We also note that the Investment Company Act of 1940 ("Investment Company Act") comprehensively regulates conflicts of interest that may arise from transactions between registered investment companies and their affiliates.[12] These Investment

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[8] Release, *supra* note 2, at 32.

[9] Even if the investment company's adviser, separately, had a role in structuring the ABS transaction, the adviser would be acting on behalf of the investment company solely as an investor in investing in the ABS, a role the Commission acknowledges would not raise a covered conflict of interest. *See* text accompanying *supra* note 8.

[10] Advisers to registered investment companies have a fiduciary duty to act in the best interests of the investment companies they manage. *See, e.g., Tannenbaum v. Zeller,* 552 F.2d 402 (2d Cir. 1977). The Commission states that in the Release that the Proposed Rule is not intended to prohibit the multi-tranche structures commonly used in ABS offerings, even though those structures may inherently involve conflicts of interest between the various classes of investors. Release, *supra* note 2, at 32.

[11] *See* Letter from Senators Jeffrey Merkley and Carl Levin to the Honorable Mary Schapiro, Chairman, Securities and Exchange Commission, et al., dated August 3, 2010 ("2010 Merkley Levin Letter"). *See also* Letter from Senators Jeffrey Merkley and Carl Levin to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated January 12, 2012 ("2012 Merkley Levin Letter").

[12] *See, e.g.,* Section 17(a) of the Investment Company Act (prohibits an affiliated person, promoter, or principal underwriter of a registered investment company, or an affiliated person of any such person, from engaging, as principal, in purchases and sales of securities or other property with, or borrowing money or other property from, the company); Section 17(d) of, and Rule 17d-1 under, the Investment Company Act (prohibit an affiliated person of, or principal underwriter for, a registered investment company, or an affiliated person of any such person, from engaging in joint transactions with the company

Company Act provisions would further mitigate the types of conflicts of interest the Proposed Rule is intended to address. We therefore request that the Commission clarify, in the final rule, that "covered conflicts of interest" would exclude those potential conflicts arising from actions taken by a registered investment company, through its investment adviser acting in a fiduciary capacity, in connection with investing in ABS.

IV. Information Barriers

The Commission requests comment on a variety of issues related to the use of information barriers within multi-service financial firms, and whether such barriers might address the types of conflicts of interest against which Section 27B was designed to protect. As discussed above, we believe that registered investment companies that technically may be considered securitization participants under the Proposed Rule would nonetheless be excluded from the rule because they would not engage in a "covered conflict of interest." Rather, their only interest in a securitization transaction would be as investors.

In its discussion of information barriers, however, the Commission asks several questions that raise the issue of whether registered investment companies, under certain circumstances, should be restricted in their investing activities because of their affiliation with a sponsor or other securitization participant. The Commission requests comment on whether the ordinary business functions of affiliates and subsidiaries of securitization participants are sufficiently separated from the process of creating and marketing ABS so as not to raise the material conflicts of interest that the proposed rule is designed to address.[13] We believe that in multi-service financial firms with properly constructed information barriers, they are. We note that the Volker Rule Proposal would explicitly permit the use of information barriers to address and mitigate conflicts of interest.[14] We recommend that the Commission take a similar approach under the final rule.

The Commission requests comment on the example of an affiliate of a securitization participant that manages a fund, where the fund purchases a credit default swap referencing securities issued in the ABS transaction. In this example, if the affiliate were a registered investment adviser and

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except pursuant to an order of exemption issued by the Commission); Section 17(e) of, and Rule 17e-1 under, the Investment Company Act (prohibit an affiliated person of a registered investment company, or an affiliated person of such person, acting as agent, from accepting compensation, other than regular salary or wages, for the purchase and sale of property to or for the company except in the course of such person's business as an underwriter or broker; a broker may receive a "usual and customary broker's commission" if certain conditions are satisfied); and Section 10(f) of, and Rule 10f-3 under, the Investment Company Act (prohibit registered investment companies from knowingly purchasing or otherwise acquiring a security from an affiliated underwriter except pursuant to the conditions set forth in the rule).

[13] Release, *supra* note 2, at 86.

[14] Volcker Rule Proposal, *supra* note 3, at 186-87.

the fund were a registered investment company, the adviser and investment company would be subject to information barriers that would address the types of conflicts of interest the Proposed Rule is intended to address. For instance, investment advisers are required by the Investment Advisers Act of 1940 ("Advisers Act") to establish and maintain written policies and procedures reasonably designed to prevent the misuse of material non-public information,[15] which may include information barriers. Registered broker-dealers are subject to a similar requirement under the Exchange Act.[16] Information barriers also may be established in connection with other requirements of the federal securities laws.[17]

As discussed above, registered investment companies and their affiliates also are subject to comprehensive regulation with respect to conflicts of interest, which further mitigate the types of conflicts the Proposed Rule is designed to address.[18] Furthermore, federal securities law requirements applicable to ABS issuers as well as those applicable to registered investment advisers and registered investment companies mandate clear disclosure of potential conflicts of interest.[19] Because of all of these protections, we believe a registered investment company purchasing a credit default swap under these circumstances would not raise the conflict of interest concerns that the Proposed Rule is designed to address.

Another question the Commission asks is whether, if consistent with Section 27B of the Securities Act, one unit of a firm should be able to effect (or should be restricted from effecting) a transaction that involves a directionally opposed view of the ABS or its reference portfolio if that unit is separated by information barriers from another unit in the same firm that created and distributed the ABS.[20] Investment advisers to registered investment companies are fiduciaries and must act in a

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[15] Section 204A of the Advisers Act.

[16] Section 15(g) of the Exchange Act.

[17] For example, Regulation M under the Exchange Act provides that an affiliate, which may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder, that regularly purchases securities for its own account or the account or for the account of others, or that recommends or exercises investment discretion with respect to the purchase or sale of securities will not be considered an "affiliated purchaser" for purposes of Regulation M if the distribution participant, issuer, or selling security holder maintains and enforces information barriers and certain other conditions are met. Rule 100 of Regulation M (definition of "affiliated purchaser").

[18] *See supra* note 12 and accompanying text.

[19] *See, e.g.,* Item 1119 of Regulation AB (affiliations and certain relationships and related transactions); Items 7 (financial industry affiliations and private fund reporting) and 8 (participation or interest in client transactions) of Part 1A of Form ADV; Items 8 (financial intermediary compensation), 19 (investment advisory and other services), and 21 (brokerage allocation and other practices) of Form N-1A. We note that the Volcker Rule Proposal explicitly permits a banking entity to address and mitigate material conflicts of interest through timely and effective disclosure. *See* Volcker Rule Proposal, *supra* note 3, at 183-85.

[20] Release, *supra* note 2, at 87.

manner consistent with the interests of the investment companies they manage.[21] In order to satisfy their fiduciary duty, they must be able to purchase and sell securities in a manner that is in the best interests of the investment company. This obligation may result in investment company advisers effecting transactions that take a view of an ABS or its reference portfolio that is directionally opposed to that taken by another part of the same firm. As discussed above, investment advisers that are affiliates of multi-service financial firms are subject to a variety of information barriers which address conflicts of interest, including those which otherwise could be raised by the activities of separate units within a multi-service financial firm. They and the registered investment companies they manage also are subject to disclosure requirements regarding potential conflicts of interest that further mitigate the concerns the Proposed Rule is intended to address.

V. The Proposed Exception for Liquidity Commitments

Regardless of whether registered investment companies may be deemed securitization participants as discussed above, they may invest in instruments that could be subject to the Proposed Rule, including ABCP. As we have explained in prior letters, ABCP has unique characteristics that distinguish it from typical ABS, including liquidity facilities for the benefit of investors that often are provided by the sponsoring bank or one of its affiliates.[22]

The Proposed Rule includes an exception, implementing the statutory exception from the prohibition under Section 27B of the Securities Act, for liquidity commitments by securitization participants. The Commission notes in the Release that while the statutory language refers specifically only to "purchase or sales of asset-backed securities," the Commission understands that commitments to provide liquidity may encompass a variety of activities, and includes several examples of activities that could be encompassed by the exception.[23] These examples include, among others, a securitization participant providing financing to accommodate for differences in the maturity dates between ABCP and the underlying assets, or a liquidity commitment involving an agreement by an underwriter of an ABS to purchase an ABS from its customer in a repo transaction.[24]

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[21] *See supra* note 10.

[22] *See, e.g.,* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., dated July 29, 2011 ("July 2011 Letter").

[23] Release, *supra* note 2, at 59.

[24] *Id.* at 59-60. We note that municipal tender option bond programs ("TOBs"), like ABCP programs, are characterized by liquidity facilities for the benefit of investors that often are provided by the sponsor bank or an affiliate. These liquidity facilities serve a similar purpose to those provided in connection with ABCP programs and, as with ABCP, the liquidity feature of a TOB program is of critical importance to investors. However, as discussed in our July 2011 Letter, TOBs have many features that distinguish them from typical ABS, and market participants generally do not perceive TOBs as ABS. *See* July 2011 Letter, *supra* note 22. Furthermore, we believe transactions involving TOBs would not meet the "material

The liquidity feature is a key component of an ABCP program and is of critical importance to investors. ABCP programs typically are supported by both committed liquidity facilities and credit enhancement. The liquidity support for an ABCP program typically equals the face amount of ABCP outstanding, to protect investors in case of a market interruption or any timing differences with respect to repayment.[25] For ABCP programs referred to as "fully supported," the liquidity facilities can be drawn to fund all of the receivables held by the program, even if some of those receivables are deemed to be "defaulted." For "partially supported" ABCP programs, the liquidity facilities will fund only "performing" receivables, *i.e.*, those not deemed to be in default. As a means of offsetting this potential source of risk, partially supported programs have credit enhancement facilities at both the pool level[26] (supporting individual transactions, often in the form of overcollateralization) and at the program level.[27] Because of these protections, investors generally analyze ABCP transactions primarily on the strength of the ABCP program sponsor and of these programs' credit and liquidity arrangements, and less on the receivables being financed.

In order for the liquidity commitment exception to be useful, we believe it is critical that it encompass those liquidity arrangements that are typical in the marketplace for ABCP. As the examples detailed by the Commission demonstrate, liquidity may be provided through means other than just purchases and sales of ABS. Limiting the proposed exception to cover only purchases and sales of ABS would be an overly restrictive reading of the statutory language and is unnecessary to achieve Congress' intent in enacting Section 621 of the Dodd-Frank Act, which was "not intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for [an ABS]."[28] Neither the legislative history, nor subsequent statements of Senators Merkley and Levin, the sponsors of Section 621, suggests that the exception should be limited

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conflicts of interest" condition of the Proposed Rule because the actual, anticipated or potential decline in the value of the assets in a TOB trust (*i.e.,* the municipal bonds) would negatively impact all the participants in the securitization.

[25] In the event that maturing ABCP cannot be refunded in the money markets, the administrator of the program (which is often the financial institution sponsoring the program) will draw upon the liquidity facilities in an amount sufficient to redeem all maturing ABCP.

[26] In some cases, the amount of pool-level credit enhancement for a given transaction is set dynamically, in that it increases to offset deteriorating pool performance.

[27] Program-level credit enhancement is often in the form of a letter of credit or a cash collateral account, effectively providing a five to ten percent subordinated cushion for the ABCP. The Commission states in the Release that it preliminarily agrees that providing credit enhancement through a letter of credit is among those activities it views as not prohibited by the Proposed Rule. Release, *supra* note 2, at 80. We believe a cash collateral account or similar arrangement should be analyzed in a similar manner.

[28] 156 Cong. Rec. S.5899 (daily ed. July 15, 2010) (statement of Sen. Carl Levin).

to only purchases and sales of ABS to achieve this result.[29] We recommend strongly that the Commission state explicitly in the final rule that liquidity may be provided through means other than just purchases and sales of ABS, as the Commission recognizes in the Release.

VI. Relationship to Volcker Rule

The Commission recognizes that both the Volcker Rule and Section 621 of the Dodd-Frank Act are concerned with conflicts of interest and include certain similar exceptions to their prohibitions.[30] The Commission requests comment on the potential interplay between the Volcker Rule and the Proposed Rule.

We are particularly concerned about how the Proposed Rule's exception for liquidity commitments would relate to the potential application of the Volcker Rule Proposal. As discussed above, the Proposed Rule's exception for liquidity commitments would apply to liquidity facilities provided by securitization participants in connection with ABCP programs. Certain restrictions under the Volcker Rule Proposal, however, could be interpreted to not permit such liquidity arrangements for bank-sponsored or advised programs, which would threaten the viability of such programs.[31] Such a result would be inconsistent with Congress' intent in enacting the exception for liquidity commitments in Section 621 of the Dodd-Frank Act, and is unnecessary to address the conflict of interest concerns against which the Volcker Rule was designed to protect.[32] It also would be inconsistent with the Commission's express intent as stated in the Release.[33] We address this issue further in the comment letter we are submitting on the Volcker Rule Proposal.[34]

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[29] *See* 2010 Merkley Levin Letter, *supra* note 11 ("The conflict of interest prohibition in section 621 is not intended to prevent firms from supporting an asset-backed security in the after-market. But this activity must be designed to support the value of the security, not undermine it."). While Senators Merkley and Levin recently expressed some concern with applying the liquidity commitment exception to certain "other services" in connection with an ABS offering, they stated that their concern was with "'other services' that could give rise to the conflicts of interest Congress sought to prohibit." 2012 Merkley Levin Letter, *supra* note 11. ABCP liquidity facilities do not raise these conflicts of interest.

[30] For example, market-making related activities and risk-mitigating hedging activities are permitted under both provisions.

[31] In particular, the so-called "Super 23A" restriction would prohibit banks from entering into "covered transactions" with their affiliates, which would include loans and extensions of credit, among other things. Volcker Rule Proposal, *supra* note 3, at 269-70.

[32] *See, e.g.,* 2010 Merkley Levin Letter, *supra* note 11 ("Section 619(d)(2) [the Volcker Rule provision that specifically addresses conflicts of interest] prohibits what might otherwise be permitted activities, if such activities would involve or result in material conflicts of interest with clients, customers, or counterparties. This conflicts of interest prohibition seeks to restore integrity and stability to the financial marketplace, making it safe for clients to place their investments with firms that are required to work on their behalf instead of betting against their interests. Unlike section 621, section 619(d)(2) is not limited to asset-backed securities, but applies to all types of permitted trading activities.").

[33] *See supra* notes 23-24 and accompanying text.

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815 or Sarah Bessin at (202) 326-5835.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
The Honorable Daniel M. Gallagher

Robert W. Cook, Director
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U.S. Securities and Exchange Commission

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[34] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., dated February 13, 2012