SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 27, 1988

The Honorable John D. Dingell
Chairman
Committee on Energy
and Commerce
Room 2125
Rayburn House Office Building
Washington, DC 20515

Re: Section 213 of H.R. 5094

Dear Chairman Dingell:

The purpose of this letter is to express opposition to an exemption from the registration requirements of the Securities Act of 1933 contained in H.R. 5094. Section 213 of that bill would add a new Section 3(a)(12) to the Securities Act. The new Section would exempt any security guaranteed by an insurance contract and continue the similar exemption for any security guaranteed by a bank, subject to such rules and regulation as the Commission may prescribe. There is no comparable provision in the Senate version of this legislation.

For the reasons discussed below, Section 213 would not serve the public interest or the protection of investors. In its attempt to address a possible competitive disparity by allowing insurance companies to compete more effectively with banks for financial guarantee business, the Section ignores investor protection problems created by repealing the registration requirements and associated liabilities for insurance backed securities.

As the draft Section-by-Section Analysis of H.R. 5094 points out, in 1986, Congress directed the Commission to study "the use of the exemption contained in [S]ection 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) for securities guaranteed by banks, and the use of insurance policies to guarantee securities." In response, on August 28, 1987, the Commission issued the Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities. In that Report, the Commission recognized an apparent advantage for banks competing with insurance companies for financial guarantee business, but it rejected the idea of creating a new statutory exemption for securities guaranteed by insurance contracts. The

Commission instead recommended two other approaches to deal with this possible competitive disparity.

The first was to amend Section 3(a)(2) of the Securities Act to remove the exemption from registration for securities issued or guaranteed by banks. The second was to authorize the Commission to grant exemptive relief from the registration requirements of the Securities Act on a case-by-case basis in those situations that are consistent with investor protection, the public interest, and the purposes of the Securities Act.

The statutory provision included in Section 213 differs as to certain details from the one discussed in the Report. Its objective, however, is the same -- to provide an exemption from the registration requirements of the Securities Act for securities guaranteed by insurance policies where the insurer provides the Commission with information about itself similar to that required under the Securities Exchange Act of 1934. The reasons why the Commission opposed the proposed exemption to the statute remain as valid today as they were a year ago when the Report was issued.

Most fundamentally, obtaining a guarantee does not reduce the need for the disclosures required by the registration process. The basis for the exemption for securities issued or guaranteed by a bank contained in Section 3(a)(2) of the Securities Act was not the lack of a need for disclosure, but an apparent perception by Congress in 1933 that bank regulatory authorities exercised adequate supervision over the issuance of bank securities.[1] Guarantees are deemed to be separate securities under the Securities Act. As a result, registration statements relating to guaranteed securities must include information as to the guarantor as well as the issuer of the underlying security. In addition, where the guarantee runs to the holder of the security, the guarantee must be separately registered unless it is exempt under Section 3(a)(2) or is an insurance policy excluded from registration pursuant to Section 3(a)(8) of the Securities Act. Even where the insurance policy providing the guarantee is not required to be registered because of the exclusion provided by Section 3(a)(8), the insurer is required to provide information on its financial resources and full disclosure concerning the provisions of the insurance policy providing the guarantee.

Accordingly, while the presence of a guarantor is an important factor in making an investment decision, it does not replace the need for material information regarding the financial resources of both the issuer and the guarantor or insurer, the terms of the underlying security and of the insurance policy providing the guarantee, and the material terms of the proposed transaction.

Insurance currently is used as a credit enhancement for many novel and complex financial instruments and transactions. Disclosure of the terms of these instruments is a vital focus of the Securities Act registration requirements and the review process conducted by the Commission’s staff. Under the proposed statutory amendment, investors could lose the benefits

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1 The Commission has recommended repeal of the bank guarantee exemption in part because of its view that this theory of equivalent regulation should be replaced by functional regulation.

provided by mandatory disclosure concerning the terms of such instruments and by staff review undertaken to secure compliance with those requirements.

One key aspect of the disclosure presently required is the description of the terms of the guarantee, including its possible limits. Supporters of the exemption have stressed the absolute nature of the insurance guarantees, informing the Commission that the defense of fraudulent inducement of the policy of insurance is not available to a financial guarantee insurer because payments under such policies are unconditional. Reliance on the relatively low risk of an investment has not been, and should not be, the basis for an exemption from registration. Disclosure, not merit regulation, is the philosophy underlying the Securities Act. In any event, reliance on the absolute nature of a financial guarantee may well be misplaced. In a recent case involving financial guarantees issued by a mortgage insurance company, In re: Epic Mortgage Insurance Litigation, M.D.L. No. 680 (E.D. Va., July 28, 1988), the insurance company successfully raised the defense of fraudulent inducement against claims brought by investors. In that case, the payment on the policy was not unconditional. Significantly, Section 213 would not require that the insurance contract be unconditional.

A guarantee also would not justify altering the civil liabilities associated with offering securities. Under the proposed amendment, Section 11 of the Securities Act, which sets forth a comprehensive liability scheme for registered offerings (including strict liability for the issuer), would not apply to insurance-backed securities.

While the proposed Section-by-Section Analysis does not reveal the basis for the exemption, earlier proposals relied, in part, on regulation of the insurance industry.[2] Even if reliance on another regulatory scheme could support a registration exemption, financial guarantee insurance, as the Report discussed in detail, is an essentially unregulated business. Because of the rapid growth of financial guarantee insurance, the apparent risk of the industry, and the inadequacy of current regulation, the National Association of Insurance Commissioners has developed a model act to deal with these insurers. To date, however, only one state, Florida, has adopted comparable legislation. Even if the model act were adopted by all 50 states, however, it would not be a substitute for full and fair disclosure under the Securities Act. The objective of such regulation would be to provide for safe and sound operation of the insurer, but it would not replace the need for full disclosure about the issuer of the securities, the insurer, the terms of proposed distribution of the securities, and the guarantee.

One further problem with the proposed legislative approach is the continuing lack of empirical evidence with respect to results of such insurance guarantees. While insurance contracts are becoming more prevalent in corporate deals registered with the Commission, the

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2 The specific legislative proposal addressed in the Report also was conditioned on the securities receiving a triple A rating from at least one nationally recognized rating agency. While Section 213 does not include a similar condition, as the Commission stated in its Report, ratings are not adequate substitutes for Securities Act registration requirements and rating agencies' procedures are not adequate to replace the registration requirements.

experience with defaults and payments under the insurance contracts is limited. For that reason, the result in the Epic matter referred to earlier is particularly disquieting.

To further the protection of investors and the public investors, the insurance guarantee exemption should be removed from the legislation before final Congressional action. I ask that you include this letter in the report on H.R. 5094 to be filed by the House Committee on Energy and Commerce.

Sincerely,

David S. Ruder
Chairman