companies commingled the investment company's assets with the investment adviser's, and then proceeded to take the assets on loan.[288] Accordingly, the Act requires that investment company assets be held by qualified custodians.[289]

The assets of a structured financing also may be subject to risk, absent the imposition of adequate safeguards. For example, the servicer could commingle collections with its own funds and then use them in such a manner as to jeopardize their availability to pay investors. The insolvency of the servicer also could affect payment to investors.

B. The Lack of Abuse in Structured Financings

Although structured financings present opportunities for abuses analogous to those that led to the enactment of the Investment Company Act, the Division is aware of only one case of abuse, despite the large volume of securitized transactions in the last decade.[290] The relative lack of abuse appears to result from the interplay of three factors.

The first factor is that most issues have been sold to institutional investors with a high degree of financial sophistication. Such investors often conduct their own due diligence reviews prior to investing and are involved in the structuring of the financing.[291]

The second factor is that most structured financings, and virtually all that have been offered publicly, have contained at least one class of highly rated securities.[292] In order for a financing to obtain a high rating, the rating agencies have required that it be structured to minimize the chance that investors in the rated securities will receive less than full and timely payment. Although the rating agencies' requirements are intended to reduce the credit risk of a structured financing, many of them have the added effect of protecting investors from the types of abuses discussed above.

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[288] *See, e.g., 1940 Senate Hearings, supra* note 252, at 89 (statement of Carl S. Stern, Attorney, SEC).

[289] *See* Investment Company Act § 17(f) (15 U.S.C. § 80a-17(f)), and rules 17f-1, 17f-2, 17f-3, 17f-4, and 17f-5 (17 C.F.R. §§ 270.17f-1, .17f-2, .17f-3, .17f-4, and .17f-5).

[290] *See supra* notes 241-249 and accompanying text for a discussion of the EPIC defaults.

[291] *See supra* note 74 and accompanying text.

[292] *See supra* note 188 and accompanying text.

For example, the rating agencies require that the sponsor of a financing sell to the issuer assets of sufficient amount and credit quality to produce adequate cash flows to pay principal and interest on the fixed-income securities being rated. Thus, they either review the specific assets to be deposited, or the method by which they will be selected, and typically require safeguards such as independent auditor confirmation that the selection is random. In addition, the rating agencies impose limitations on the substitution of assets in the pool, the reinvestment of cash flows, and servicing decisions. These requirements protect investors from self-dealing and overreaching by sponsors.

The rating agencies also address concerns related to the valuation of assets. In order to determine whether the pooled assets will produce the necessary cash flows, the rating agencies, among other things, use an actuarial or statistical analysis to make generalized assumptions about the pool's performance, as it relates to the scheduled rincipal and interest payment on the rated securities and any other debt issued?' This analysis is fundamentally an assessment of the degree of leverage of the issuer.

Finally, the rating agencies impose requirements that are intended to ensure the safety of a financing's assets. They have developed criteria to address concerns that the assets would be jeopardized in the event of the sponsor's insolvency.[294] In addition, the rating agencies generally prohibit the servicer from commingling the underlying cash flows with its own funds unless the servicer is rated as high as the fixed-income securities. They also may require that a trustee hold the assets in an account in trust for the benefit of the investors in the transaction.[295]

The third factor that appears to have prevented abuses is that most sponsors of structured financings have been large, well-known companies. These entities have an interest in ensuring that their financings are structured and operated properly, in part because any problems associated with an offering will affect their ability to offer other financings in the future. For the sponsors, the financings are a critical means to address their capital needs. In addition, sponsoring a financing that defaults could adversely affect a sponsor's public

[293] *See supra* notes 212,220-221 and accompanying text.

[294] *See supra* notes 196-206 and accompanying text.

[295] *See* S&P'S STRUCTURED FINANCE CRITERIA, supra note 108, at 23-24. The involvement of the rating agencies also alleviates to a large extent any concerns regarding the complex capital structures of structured financings. Investor confusion resulting from complex capital structures was one of the concerns that led to the enactment of section 18 of the Act.

image.[296] We note, however, that this third factor appears to be much less important than the other two, since many structured financings have been sponsored by depository institutions that subsequently were declared insolvent. None of these financings has suffered a default.[297]

C. Recommendation -- An Exemptive Rule

Reforming the treatment of structured finance under the Investment Company Act initially presents two choices. Structured financings could be considered investment companies and required to register and comply with a set of provisions specially tailored for the structured finance industry. Alternatively, structured financings could be exempted under conditions that serve both to draw lines of demarcation between traditional investment companies and structured financings and to ensure that structured financings continue to be free of abuse.

Because the structured finance industry has been virtually free of abuse, we recommend against attempting to bring all structured financings under the Investment Company Act. It is difficult and probably futile to attempt to address any investor protection concerns that have not yet arisen. The drafters of the Investment Company Act had as their inspiration the problems that plagued the investment company industry in the 1920's and 1930's. Fortunately, the structured finance industry has not presented such problems.

Just as important, any attempt to apply even a limited array of the Act's provisions is likely to disrupt an increasingly important form of finance, depriving investors of attractive, low risk investments and foreclosing low cost borrowing for businesses. For example, the Investment Company Institute ("ICI") has submitted a proposal to regulate structured financings as essentially unit investment trusts that issue only unredeemable securities (including debt).[298] While the proposal addresses some of the problems structured financings would face in attempting to comply with the Act, such as the Act's limits on leverage,

[296]Sponsors also often retain some form of economic interest in the financing after issuance, either by providing recourse, acting as servicer (whose fee is typically a percentage of cash flow), or retaining the residual interest or subordinate securities. Thus, any losses from overreaching or other abuses typically will affect the sponsors, providers of external credit enhancements, or sophisticated investors first.

[297]*See supra* note 206 and accompanying text.

[298]*See* Memorandum from the Investment Company Institute on the Regulation of Asset-Backed Arrangements under the Investment Company Act (undated), File S7-11-90 [hereinafter ICI Memorandum].

it nevertheless would prohibit a number of practices that have not, to date, harmed investors.

For example, the proposal would limit reinvestment of cash proceeds to short-term government securities and cash items. While this would prevent possible abuses, it would also reduce returns to investors by prohibiting short-term reinvestment in highly rated commercial paper and similar, relatively low risk investments.

The proposal also would subject structured financings to the Act's restrictions on joint transactions with affiliates. Some of the mechanisms that have been created to strengthen structured financings likely would be prohibited by those restrictions. For example, spread accounts in which excess cash flow is used as a credit support might be prohibited, since both the issuer and the sponsor have an interest in the cash flow from that account.[299]

In addition, the proposal would subject structured financings to the Act's restrictions on distributions of long-term capital gains.[300] While these restrictions are appropriate for registered investment companies, since they reduce the possibility that equity investors may be led to believe that capital gain income will be regular, they are not needed to protect investors in fixed-income securities and actually could prevent timely payment of principal and interest.

Finally, the proposal would require that a pool be entirely fixed at inception, with only limited exceptions. Thus, it would prohibit some of the newer generation of structured financings, such as credit card master trusts and asset-backed commercial paper programs which, although they are not truly "managed" in the sense that management investment companies are, undergo some degree of change in the composition of their assets. It would also prohibit CBOs, since most of these structures provide for limited discretionary management of the pool.[301] While we agree that structured financings should not engage in asset management to the same degree as a typical open-end or

[299]The proposal also would subject structured financings to section 17(a) of the Act, which prohibits principal transactions with affiliates, except for the initial deposit of assets and limited substitutions. *Id.* Thus, it would prohibit short-term reinvestment in a sponsor's commercial paper or in reverse repurchase agreements with the sponsor. Rating agencies have not objected to such transactions, if sufficient safeguards are present (*e.g.*, commercial paper investments are permitted where the sponsor is rated as highly as the financing).

[300]Investment Company Act § 19(b), 15 U.S.C. § 80a-19(b).

[301]*See supra* note 163 and accompanying text.

closed-end investment company, we do not believe that the strict limits of the ICI proposal are necessary.

Moreover, regulation under the Investment Company Act is likely to stifle innovation in structured finance. In just the last few years, the market has gone through a number of evolutionary changes that have benefited investors. Originally, most financings used a simple pass-through payment structure, but investors expressed concern over uncertain maturities and prepayment risk. Sponsors, underwriters, and rating agencies have designed a number of mechanisms to respond to these concerns, including multi-class structures, retention by the sponsor of an interest that absorbs the prepayment risk, short-term reinvestment of proceeds, the addition of new assets during the life of a financing, and master trusts. Designing a regulatory approach that does not inadvertently prevent or interfere with future development of the market would be extremely difficult.

For these reasons, we believe that the Commission should exempt all structured financings from the definition of investment company, subject to a number of conditions that would properly delineate the operational distinctions between investment companies and structured financings, address the investor protection concerns that could arise in this market, and accommodate future innovation. The Division recommends that the Commission promulgate a rule under the Investment Company Act to exempt all structured financings that meet the following conditions:

> **(1)** the issuer holds only "eligible assets," which would be defined to include assets that require regularly scheduled cash payments, such as notes, bonds, debentures, evidences of indebtedness, certificates of deposit, leases, installment contracts, interest rate swaps, repurchase agreements, guaranteed investment agreements, accounts receivable, chattel paper, cumulative preferred stock, guarantees, annuities, and participations or beneficial ownership interests in any of the foregoing;
>
> (2) the issuer primarily holds the assets to maturity or for the life of the issuer and does not acquire assets for the purpose of generating income from the trading or resale thereof or from the appreciation in value thereof;
>
> **(3)** the issuer does not issue any redeemable securities;
>
> **(4)** all securities offered and sold to the issuer to persons other than affiliates of the issuer or qualified institutional buyers, as defined in rule

144A under the Securities Act:[302]

(a) entitle the holder to receive:

(i) a stated principal amount and either (A) interest based on such principal amount calculated by reference to a fixed rate, a floating rate determined periodically by reference to an index that is generally recognized in financial markets as a reference rate of interest, or a rate or rates determined through periodic auctions among holders and prospective holders or through periodic remarketing of the security, or (B) an amount equal to specified portions of the interest received on the assets held by the issuer;

(ii) a stated principal amount at maturity and no interest payments; or

(iii) interest payments only, based on a notional or stated principal amount and determined in the manner described in clauses (i)(A) or (B);

(b) at the time of issuance are rated in one of the two highest grade debt rating categories by at least one nationally recognized statistical rating organization that is not affiliated with the issuer; and

(c) entitle the holder to receive payments that depend on the cash flow from the assets in paragraph (1) and that do not depend on the market value of those assets; and

(5) the issuer's assets are held by a trustee that meets the requirements of section 26(a)(1) of the Act, that is not affiliated with the issuer, and that executes an agreement concerning the securities described in paragraph **(4)** containing provisions to the effect set forth in sections 26(a)(3) and 26(a)(4) of the Act.

We believe that the conditions of the proposed rule would draw a clear dividing line between structured financings and investment companies that are required to register under the Act. At the same time, by codifying existing practices, the proposed rule would minimize the potential for the types of abuses

[302] **17 C.F.R. § 230.144A.**

addressed by the Investment Company Act, without limiting existing practices that have not harmed investors. It also should permit the continued evolution of structured financings. For example, it would permit the establishment of continuous structures and structures with differing underlying assets. All structured financings, regardless of their assets, should be able to rely on this exemption.[303]

We now discuss each of the major requirements of the proposed rule. Many of the details of the rule would be refined in the notice and comment process.

1. Eligible Assets

The definition of eligible assets is intended to encompass all financial assets that produce regular cash flow and thus could be used in a structured financing. In other words, the only limitation is that the assets have a regularly scheduled cash flow of the type that may be statistically analyzed by rating agencies and investors. Common stock and similar equity instruments would not be eligible assets.

Obviously, this would be a substantial departure from the current practice under the Investment Company Act. Today, the Act exempts structured financings based on the type of assets held and not on their structure. The rule would recognize that the ability to use an asset successfully in a structured financing turns on whether it has a relatively predictable cash flow.

2. Holding Assets to Maturity

This condition is intended to limit the amount of "management" permitted in a structured financing, while allowing enough flexibility to accommodate some of the recent innovations in the market. We have considered a number of different ways to articulate the limits on the adjustment of a financing's portfolio.

For example, one commenter responding to the Study Release[304] suggested requiring that an exempt financing have a fixed portfolio, with assets being removed and new assets being added only where assets are in default or in imminent danger of default, where assets do not conform to the representations

[303] Most commenters advocated an exemptive rule similar to the one we recommend. See, *e.g.*, Cleary, Gottlieb Study Comment, *supra* note 262, at App. A.

[304] Study Release, *supra* note 12.

and warranties made in good faith by the sponsor, or where necessary to wind up the affairs of the issuer.[305] Another commenter suggested simply limiting substitutions of assets by requiring that the substituted assets be of the same general type as the original assets and not aggregate more than forty percent of the amount of assets deposited.[306] A third suggested allowing a greater degree of substitution, limiting it only by the requirement that the issuer not acquire assets for the purpose of generating profits from the trading or resale thereof or appreciation in the value thereof.[307] All of these alternatives attempt to draw a line between structured financings and typical management investment companies with regard to the degree of "management" of assets.

Drawing this line is complicated somewhat by the increase in the number of financings that do not have a fixed pool. Today, most structured financings, regardless of the nature of their assets, have some limited degree of "management" with respect to substitution of assets, reinvestment of proceeds, and, of course, servicing, but the amount of discretion in the servicer or manager varies greatly among financings depending on the terms of the transaction and on the assets being securitized.[308] It is apparent that the structured finance market is developing structures that have ever more flexibility in the selection of assets, such as the master trust format for credit card receivables and asset-backed commercial paper programs. Both involve issuers that continuously purchase assets and issue securities. These structures have advantages over more traditional structured financings in that, among other things, they permit sponsors

[305] *See id.* Merrill Lynch suggested that if new assets are substituted for assets originally held by the issuer, the new assets must be of the same type as the assets originally held, including the same maturity and coupon, of at least the same quality as such original assets held, and insured or guaranteed to the same extent as the original assets. Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC IX-16 (Oct. 18, 1990), File No. S7-11-90 [hereinafter Merrill Lynch Study Comment].

[306] *See* Letter from the American Bar Association, Section of Business Law, 1940 Act Structured Finance Task Force to Jonathan G. Katz, Secretary, SEC 14-15 (Oct. 16, 1990), File No. S7-11-90 [hereinafter Structured Finance Task Force Study Comment].

[307] *See* Letter from Citicorp to Jonathan G. Katz, Secretary, SEC 11 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Citicorp Study Comment].

[308] For example, because the balance of pooled credit card receivables will fluctuate over time, financings backed by these assets often are structured to permit the sponsor to assign receivables from other accounts to the pool if the originally designated accounts do not generate enough receivables to support the securities. Similarly, because of the volatility and low credit quality of high yield bonds, financings using these assets are structured so that the bonds may be traded to prevent the deterioration of the pool, although typically the anticipated degree of management and trading is much less than that of a high yield bond fund.

to securitize assets without the cost of establishing new structures for each offering. They also reduce prepayment risk.[309] Accordingly, it is foreseeable that more of these types of financings will be used in the future.

Nevertheless, structured financings do not involve management to the same degree or for the same purpose as do management investment companies. Even in a CBO offering, where the manager may have some discretion to sell bonds of issuers that may soon default or bonds that have appreciated greatly and buy new bonds, investors choose to invest based primarily on the expected cash flows from the assets initially deposited, not on the trading expertise of the manager?[310]

We believe that the increase in financings involving changing pools of assets necessitates imposing a condition that permits additions to the assets in the pool, but ensures that an exempt financing is not in fact managed in the same manner as a typical investment company. Preliminarily, we recommend requiring that the issuer primarily hold its assets until their maturity or for the life of the issuer and not acquire them for the purpose of trading them for profit. This will provide a standard that accommodates a limited degree of discretion as is common presently in structured financings, but ensures that exempted issuers are not in fact truly management investment companies.[311] Given the importance of this condition and wide range of suggestions made by commenters responding to the Study Release,[312] however, we recommend that the Commission specifically request comment on this point.

[309] *See* supra text following note **176.**

[310] *See* Letter from Edward F. Greene to Thomas S. Harman, SEC **14** (Dec. **16, 1991)**, Equitable Capital Management Corp. (pub. avail. Jan **6, 1992)** ("Who the collateral manager is does not influence investors' perceptions of the risk/return characteristics of an investment in a particular CBO nearly to as great **an** extent as with actively managed pooled investment vehicles, because investors are not relying predominantly on the investment adviser's ability and expertise to trade the securities in the portfolio.").

[311] As discussed in Section V.C.4. below, we also recommend including a condition to the exemption requiring that the securities sold to the general public be rated in at least one of the top two investment grades. We expect that rating agencies will evaluate closely the degree of discretion given to the manager or servicer of the issuer's assets.

[312] Study Release, supra note **12.**

3. Prohibition on the Issuance of Redeemable Securities

Like most of the other conditions, this condition would codify industry practice. In addition, it would ensure that no exempted issuer behaves like an open-end investment company, which could lead to investor confusion. It would also prevent junior security holders from redeeming their interests, thereby endangering payment to public investors.

4. The Securities Issued to the Public

The fourth condition relates to the nature of the securities issued in the financings. It has three related requirements: all of the issuer's securities sold to public investors must be fixed-income securities; all of these securities must be rated in one of the two highest investment grade categories; and payment on the securities must be derived from the cash flow on the assets in the pool.

The first requirement would codify present practice by recognizing that structured financings almost invariably issue debt or debt-like securities. Such securities are very different from the equity interests sold by most registered investment companies.[313] The rule is intended to give issuers a great deal of flexibility in choosing the type of fixed-income security to be issued. For example, it would allow the issuance of principal-only or interest-only securities.

We recommend that the Commission specifically request comment on whether the rule should permit the ublic sale of IO and PO certificates, because of their volatility and complexity? While we do not wish to impose, in effect, investor suitability requirements, one of the Act's concerns is complex capital structures. At least arguably, IO and PO certificates raise similar concerns.[315]

[313]UITs may not issue debt or senior equity securities. See 15 U.S.C. § 4(2). Open-end management investment companies may not issue senior securities, except that they may borrow from banks as long as they have 300% asset coverage. Investment Company Act § 18(f)(1), 15 U.S.C. § 80a-18(f)(1). Closed-end management investment companies may issue debt and senior equity, but must have 300% asset coverage for debt and 200% asset coverage for senior equity. Investment Company Act § 18(a), 15 U.S.C. § 80a-18(a). While face-amount certificate companies primarily issue debt securities, there are only two such issuers registered with the Commission.

[314]Two commenters suggested that sales of IO certificates should be restricted because of their extreme volatility. See Cleary, Gottlieb Study Comment, *supra* note 262, at 73; Merrill Lynch Study Comment, *supra* note 305, at 9-13. PO certificates also are volatile.

[315]We note that the ICI's proposal would not restrict the capital structure of structured financings, since it would permit a registered financing to offer any combination of debt and equity securities. ICI Memorandum, *supra* note 298, at 2.

The second requirement, that all publicly offered fixed-income securities be rated in one of the two highest investment grades by a rating agency, also generally codifies present practice.[316] Virtually all structured financings have sold only rated securities publicly; most publicly offered securities have been rated in one of the top two categories. Securities that are not so rated or are unrated at all (*e.g.*, residual interests) could be sold only to qualified institutional buyers, as defined in rule 144A, or affiliates of the issuer. We believe it would be appropriate to request comment on whether the rule should require restrictions on resale of residual interests and similar securities.

This requirement would ensure that every structured financing sold to the public is subject to the scrutiny of at least one rating agency. It would rely on the agencies to continue to impose requirements that prevent self-dealing and overreaching, misvaluation of assets, and inadequate asset coverage. We believe it is appropriate to rely on the rating agencies in light of the outstanding record of rated financings. We appreciate the concerns expressed by the ICI that relying on rating agencies is inappropriate because they are private organizations whose sole function is to give opinions as to the credit quality of certain securities,[317] but believe that the benefits, particularly in light of the agencies' past performance in rating structured financings, are obvious, while the concerns are theoretical at best.

For example, today virtually all publicly-offered financings are rated in one of the top two investment grade ratings. Thus, the rule simply would take advantage of the role played today by the agencies and is not likely to distort the agencies' decision-making processes.

We believe also that the process of analyzing the sufficiency of the cash flow from particular assets is uniquely suited for the statistical methodology used by rating agencies to evaluate structured financings. We do not suggest that the agencies are infallible and that in the future every highly rated financing will be completely free of abuse. Nevertheless, to the Division's knowledge, no rated structured financing has defaulted on payments and relatively few have been downgraded?'' We conclude that relying on the agencies will provide a very

[316]We recommend using the term "nationally recognized statistical rating organization," which is used in a number of other instances in the federal securities laws. See *infra* note 319.

[317]*See* ICI Memorandum, *supra* note 298, at 2 ("The Institute does not believe that it is the function of the federal securities laws to regulate the public distribution of securities based on 'quality standards', whether determined by the SEC or private rating agencies.").

[318]*See supra* notes 236-237 and accompanying text.

high degree of protection against abuses. Of course, even if the Commission were to attempt to regulate structured financings under the Investment Company Act, not all abuses would be prevented.

Further, reliance on the rating agencies as an element of the regulation of the securities markets is far from novel. Ratings first were used in 1975 in rule 15c3-1 under the Exchange Act. Today, ratings play a role in at least eleven separate provisions in the federal securities laws and rules.[319] In addition, ratings are used in a number of instances in federal banking law and in the securities laws of other nations.[320] In fact, France requires ratings for all structured financings.[321] Moreover, the Commission has already issued more than 100 orders exempting mortgage-related asset-backed securities financings and government loan sales from the Act, conditioned on, among other things, ratings in one of the top two investment grades.[322] We are not aware of any abuses in those financings or any indication that the orders somehow have interfered with the rating process.

Finally, while adoption of another rule relying on rating agencies may heighten concern over their unregulated status, we do not believe it should delay adoption of an exemptive rule for structured financings.

Although under this second requirement publicly offered securities would need to be rated in one of the top two investment grades, the Commission ultimately may decide to require only investment grade ratings. Many commenters suggested that the securities receive a rating in one of the top two

[319]Section 3(a)(41) of the Exchange Act, 15 U.S.C. § 78c(a)(41); Securities Act rules 415, 436, 17 C.F.R. §§ 230.415, 436; General Instructions to Forms S-3, F-2, and F-3/17 C.F.R. §§ 239.13, 31, and 32; Exchange Act rules lob-6 and 15c3-1, 17 C.F.R. §§ 240.10b-6 and 15c3-1; Investment Company Act rules 2a-7, 10f-3, and 12d3-1; 17 C.F.R. §§ 270.2a-7, 10f-3, and 12d3-1.

[320]*See* Neil D. Baron, Statutory and Regulatory Uses of Ratings in the United States and other Jurisdictions (Jan. 30, 1989).

[321]*See French Asset-Backed Criteria*, STANDARD & POOR'S CREDITREVIEW: STRUCTURED FINANCE, June 1990, at 26.

[322]*See supra* notes 275 & 279 and accompanying text.

categories, thereby in effect codifying the present market requirement.[323] Some commenters, however, favored requiring only investment grade ratings.[324]

The third requirement of this condition would limit the availability' of the exemption to those financings that issue securities whose payment depends on the cash flows generated by the income-producing assets in the underlying pool. This criteria is intended to limit the scope of the rule to the predominate types of structured financings that are currently being offered, rather than the few "market value" financings that have been offered. Thus, financings using a market value structure, where payment of the securities is derived from the aggregate market value, would not be exempted from the rule. Such transactions raise issues that differ from those financings utilizing the cash flow structure. Although this structure has been used in the past, primarily to securitize high yield bonds, its popularity has diminished significantly, and accordingly, we do not believe this limitation will significantly affect the structured finance market. Of course, financings wishing to use the market value structure could still be sold in private placements or overseas, or seek exemptive relief.

5. Independent Trustee

The rule would require, in part, that all of the issuer's assets not needed for servicing be held in a segregated account by a qualified trustee or custodian for the benefit of the investors. Accordingly, all property of the pool at the time of issuance would be deposited with the trustee. This provision is intended to mitigate the concerns relating to the protection of assets. It also would require that the trustee execute an agreement providing that it shall not resign until the financing has been completely liquidated or until a successor trustee has been designated, and providing that records be kept of the security holders of the issuers. These requirements generally would codify industry practice.

This condition would not specify the other duties of the trustee. Thus, it would not address the other aspect of the role of the trustee in a structured financing: monitoring the issuer's obligation to investors and acting to protect the

[323] *See, e.g.,* **Letter from Financial Security Assurance Inc. to Jonathan G. Katz, Secretary, SEC 4 (Oct. 9, 1990), File No. S7-11-90; Merrill Lynch Study Comment, *supra* note 305, at IX-13.**

[324] *See* **Cleary, Gottlieb Study Comment, *supra* note 262, at 50; Structured Finance Task Force Study Comment, *supra* note 306, at 20-21. The rating agencies have told the Division that a financing whose securities are rated investment grade is structured in such a way as to address Investment Company Act concerns. A related issue is whether requiring a rating from more than one agency would be appropriate. While we believe that the vast majority of financings are rated by at least two agencies, we do not wish to impose unnecessary costs.**

interests of investors if the financing defaults.[325] The specific obligations of the trustee invariably are set forth in the P&S agreement, indentures, or similar documents. Of course, financings that publicly offer debt obligations are subject to the Trust Indenture Act,[326] and, accordingly, the trustees of these financings would generally be subject to those duties and responsibilities required by that Act. Similarly, this condition would not prevent issuers from continuing the industry practice of contractually agreeing to comply with the requirements of the Trust Indenture Act, even if they are exempt from that Act. We believe, however, that the Commission should request comment on whether other duties should be specified.[327]

The proposed rule would require that the trustee be a bank that is qualified to serve as a trustee of a UIT. Accordingly, the trustee of a securitized asset pool would be required to be a bank whose aggregate capital, surplus, and undivided profits is not less than $500,000.[328] The definition of qualified trustee would be consistent with industry practice.

The trustee also could not be affiliated with the issuer. Accordingly, a sponsor, servicer, or credit enhancer of a structured financing could not act as trustee.[329] This limitation is necessary because the sponsor, which also may act as servicer, often is a bank that would otherwise be a qualified trustee. Absent this prohibition, the sponsor could act in all capacities of the pool, without any independent party monitoring the issuer's obligations to investors. The trustee in a publicly offered structured financing usually is a commercial bank that is not affiliated with any parties to the transaction. In addition, the requirement that the trustee not be affiliated with the issuer is similar to a requirement in the Trust Indenture Act.[330]

* * * *

[325]*See supra* **notes 114-121 and accompanying text.**

[326]*See supra* **notes 114-117 and accompanying text.**

[327]**We considered but rejected proposing that the requirement found in section 26(a)(2) also should apply, because that provision's limits on fees are not compatible with the fee structure typically used in structured financings.**

[328]*See* **Investment Company Act § 26(a)(1); 15 U.S.C. § 26(a)(1).**

[329]**This requirement would not preclude the trustee from owning securities issued by the structured financing.**

[330]*See supra* **note 117.**

We believe that these conditions effectively will codify the protections imposed by the marketplace, thus addressing Investment Company Act investor protection concerns. At the same time, we believe that the rule is sufficiently flexible to allow for continued innovation in the structured finance market.

We also believe that the rule would meet the standards of section 6(c). That is, it would be appropriate in the public interest and consistent with the protection of investors and the purposes intended by the policy and provisions of the Act. The rule would be in the public interest since it would facilitate the continued development of the structured finance market, a vitally important financing technique. More importantly, we believe that the track record of structured finance and the conditions of the proposed rule clearly would enable the Commission to find that the rule would be consistent with the protection **of** investors and the purposes fairly intended by the provisions of the Investment Company Act.

The legislative history of the Act indicates that, at a minimum, section 6(c) enables the Commission to address situations that Congress either could not have considered because they did not exist in 1940, or had not considered because they were overlooked.[331] Congress did not consider structured finance in 1940 or 1970. Moreover, to the extent that Congress later considered the development of the structured finance industry and the Commission's exemptive authority, it indicated that the Commission should use its exemptive authority flexibly to accommodate the industry's development, where consistent with investor protection.[332]

D. Other Options Considered

As an alternative, the Division considered, but rejected, recommending that structured financings be conditionally exempted from the Act through a statutory amendment, rather than by rule. We believe that rulemaking is preferable, since it gives the Commission the opportunity to craft the specific terms through the notice and comment process. It also is likely the quickest means to address the

[331] *See, e.g., 1940 Senate Hearings, supra* **note 252, at 872 (Commissioner Healy stated that "it seemed possible and even quite probable that there might be companies – which none of us have been able to think of – that ought to be exempted.")** *See also* **In re J.D. Gillespie, 13 S.E.C. 470, 477 (1943) ("Section 6(c) was included in the Act to give us authority to deal with the situations that could not be foreseen at the time of its passage, to exempt persons, securities or transactions falling within the literal language of the Act but not fairly intended to be governed by its policy or provisions.").**

[332] *See supra* **note 273.**

problems caused by the Act today. Rulemaking also gives the Commission the flexibility to amend the requirements for exemption, if later market developments indicate that the rule is impeding the market or that additional safeguards are needed.

We also rejected another option for the reform of the treatment of structured finance under the Investment Company Act. A few commenters argued that the definition of "security" under the Investment Company Act, like the definition of security under the Securities Act and the Exchange Act, should be interpreted to exclude "commercial" instruments.[333] Under this approach, structured financings backed by these instruments, as well as other types of pooled vehicles that invest in these assets, would not be considered investment companies. This proposal is based on the fact that many investment companies primarily invest in liquid, readily marketable instruments, while structured financings generally are used to convert illiquid debt instruments into liquid capital market instruments. In our view, this approach neither reflects the true nature of the structured finance market nor addresses potential investor protection concerns.

Many of the illiquid debt instruments are assets that are generated in a commercial context, such as mortgages and consumer receivables. Such instruments generally are not securities for purposes of the Securities Act and the Exchange Act, under the Supreme Court's analysis in *Reves v. Ernst & Young*.[334] In *Reves,* the Court stated that every note is presumed to be a security, but that the presumption can be rebutted by a showing that the note bears a strong resemblance to any of the notes on a judicially crafted list of notes that are not deemed to be securities, or if it is determined, looking to four factors identified in Reves, that the note should be on the list.[335] Included on this list are notes

[333] See, e.g., Memorandum from Sidley & Austin to the Division of Investment Management, on behalf of the National Commercial Finance Association, on the Application of the Investment Company Act of 1940 to the Asset-Backed Commercial Finance Services Industry, SEC 1-2, 20, 26-27 (Oct. 23,1987) [hereinafter Sidley & Austin Memorandum], accompanying Letter from Sidley & Austin, on behalf of the National Commercial Finance Association, to Jonathan G. Katz, Secretary, SEC (Oct. 9, 1990), File No. S7-11-90 [hereinafter Sidley & Austin Study Comment].

[334] 110 S.Ct. 945, 951 (1990) (but holding demand notes in question to be securities). Commercial loans such as bank loans *are* securities for purposes of the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79a to 79z-6.

[335] 110 S.Ct. at 952.

delivered in consumer financings and notes secured by residential mortgages.[336]

This approach would be problematic in several respects. Although there are some differences in the types of assets typically held by registered investment companies and those held by structured financings, there is a significant degree of overlap. Many registered investment companies invest in instruments that generally have been held not to be securities under the Securities Act or the Exchange Act. For example, many money market funds invest heavily in instruments such as time deposits.[337] Also, a number of closed-end investment companies have as their primary investments bank loan participations, which generally have not been deemed to be securities under the Securities Act and the Exchange Act.[338] Such issuers should remain subject to the Commission's jurisdiction under the Investment Company Act.[339] Many structured financings

[336] *Id.* at 951.

[337] *See, e.g.,* Marine Bank v. Weaver, 455 U.S. 551 (1982) (holding that a bank certificate of deposit was not a security under the Securities Act and the Securities Exchange Act).

[338] *See, e.g.,* McVay v. Western Plains Corp., 823 F.2d 1395, 1399 n.4 (10th Cir. 1987); Union Planters Nat'l Bank v. Commercial Credit Business Loans, 651 F.2d 1174, 1185 (6th Cir.), *cert.* denied, 451 U.S. 91 (1981). At note 5 of its brief, as amicus curiae, in the case of Banco *Espanol* De *Credito v.* Security Pacific *National* Bunk (Nos. 91-7563, 91-7571 (2d Cir. 1992)), the Commission argued that certain short-term loan notes, bearing a "superficial resemblance to traditional loan participations" (id. at 2), were securities because, among other things, they were purchased for an investment purpose rather than as part of a commercial lending business or to facilitate an independent business relationship with the borrower. Id. at 4. The Commission distinguished the notes in question from traditional loan participations, and distinguished this case from those cases holding that traditional loan participations are not securities. Id. at 14-15. See Chapter 11 for a discussion of investment companies that invest in loan participations.

[339] In other words, while excluding commercial instruments from the disclosure requirements of the Securities Act and the Exchange Act is consistent with the purposes of those Acts, issuers that pool these instruments nevertheless may be functionally equivalent to, and present the same investor protection concerns as, investment companies that invest in securities that are registered under those Acts. See Brief for the United States as Amicus Curiae at 22-23, Marine Bank v. Weaver, 455 U.S. 551 (1982) ("While the language in the Investment Company Act's definition of the term 'security' is identical to that in the Securities Act, the regulatory context under the Investment Company Act differs fundamentally from that under the Securities Act and the Securities Exchange Act. The Investment Company Act broadly regulates the operation and management of investment companies. Because the relationship between a money market fund and its shareholders is identical to the relationship between any other investment company and its shareholders, and because the assets of both investment media are highly liquid and are subject to external management, investor protection requires that money market funds continue to be regulated under the Act.").

have as their primary assets instruments that are quintessentially securities, such as high yield bonds, industrial development bonds, and agency pass-through certificates. In addition, most structured financings provide for short-term reinvestment of proceeds collected on their assets; that reinvestment typically is in liquid instruments such as Treasury bills and commercial paper.

Moreover, a *Reves* approach would treat structured financings inconsistently: structured financings backed by commercial assets would be unconditionally exempt, while financings using financial assets would be required to register and comply with the full complement of the Act's requirements. Thus, for example, financings backed by agency securities or high yield bonds could not be publicly offered in the United States, even if their structural protections were similar to, or better than, exempt financings. The practical effect of this approach would be to continue to distort the market for structured financings.

E. Section 3(c)(5)

Finally, we address whether section 3(c)(5) should be amended to remove structured financings from the exception. Absent an amendment, structured financings that come within the exception would not be required to meet the conditions of our proposed rule for exemption. Thus, structured financings would continue to be treated inconsistently, depending solely on the type of assets being securitized.[340]

Amending section 3(c)(5) is not a simple matter. Of course, any amendment to exclude structured financings would need to be crafted so that finance companies or real estate businesses do not become subject to the Act. Some types of structured financings, however, possess attributes similar to those of commercial finance and mortgage banking companies. Moreover, the

[340]There are other issues with respect to section 3(c)(5) that could be addressed through a statutory amendment. For example, one commenter asserted that current interpretations of sections 3(c)(5)(A) and 3(c)(5)(B) are unduly narrow, so that finance companies that provide loans secured by a pledge of the borrower's inventory and receivables cannot rely on the exception. See Sidley & Austin Study Comment, *supu* note 333, at 2. See *also* Sidley & Austin Memorandum, *supra* note 333, at 15-17, 25-27, 31-43. Such issues are outside the scope of our review of the treatment of structured financings, and the Division has not developed specific recommendations with regard to these matters.

commercial finance and mortgage banking industries have evolved considerably since 1940 and it is difficult to make generalizations about them.[341]

While structured financings appear at first blush to have some operational distinctions from finance companies, upon closer examination the dividing lines are far from clear. Thus, it is difficult to amend section 3(c)(5) in a way that would prevent structured financings from relying on the 3(c)(5) exception without also inadvertently preventing some finance companies from relying on the exception.

The Division considered the suggestion made by the ICI that section 3(c)(5) be amended to exclude issuers from the exception, and thus, bring within the Act, that do not have an "active business."[342] Because there are structured finance issuers whose life extends beyond a single deposit of assets and issuance of securities, and whose acquisition of additional assets is made pursuant to carefully prescribed conditions,[343] we are not certain that this distinction is feasible.

The Division also considered whether section 3(c)(5) should be amended to exempt only those finance companies that are primarily engaged in the business of making, purchasing, or otherwise acquiring commercial assets (*e.g.*, notes, drafts, open accounts receivable) from unaffiliated parties. Some major finance companies acquire assets from affiliates, however, or originate or acquire their assets to facilitate an affiliate's operating business. For example, a number of large finance companies originate loans to support sales by affiliates (*e.g.*, the finance companies owned by automobile manufacturers). Moreover, some

[341]Non-mortgage structured financings have relied primarily on subparagraphs (A) and (B) of section 3(c)(5) to avoid regulation under the Act. See *supra* notes 259-262 and accompanying text. Apparently, the traditional distinctions between companies engaged in factoring, sales financings, and other types of commercial financing activities have been substantially reduced since 1940. Today, a finance company may be engaged in several kinds of financing activities or variations thereof. See Sidley & Austin Memorandum, *supra* note 333, at 5-6. Some finance companies originate loans, while others purchase loans or receivables, often from unaffiliated companies, which they typically hold to maturity.

[342]ICI Memorandum, *supra* note 298, at page 2 of attachment thereto (suggesting adding the following sentence at the end of section 3(c)(5): "This exemption shall be applicable only to persons engaged in an active business, and not to limited purpose entities engaged in no other business other than investing in or owning securities and receivables which are organized after [date of enactment]").

[343]For examples, see *supra* discussions of master trusts (Section III.A.3.d.) and asset-backed commercial paper programs (Section III.A.3.e.).

structured financings, such as asset-backed commercial paper programs, obtain their assets through unaffiliated transactions, and accordingly could continue to rely on the exclusion.

Finally, the Division considered recommending that the section be amended to provide that excluded companies must have internal management, in the form of their own officers and directors. At least preliminarily, we do not believe that this approach would provide meaningful distinctions. For example, while master trusts and asset-backed commercial paper programs do not have independent officers making credit determinations, they do have processes by which their assets are screened, pursuant to the terms of their organizational documents. If the exclusion were amended to require internal management, the sponsors of these issuers simply could add internal management to their structures, which would raise expenses, but would not increase investor protection. *Also,* many finance companies are wholly-owned subsidiaries of operating companies and the finance companies' managements are selected by the parent companies and cannot truly be said to be independent of the affiliates.[344]

We also considered whether the range of assets section 3(c)(5)(C) issuers may hold should be narrowed. Although the section was intended to except mortgage bankers that originated, serviced, and sold mortgages, other types of issuers have relied on it. Based on the broad language of clause (C), the Division has taken the position that issuers primarily engaged in investing in loans secured by real estate may rely on the exception as long as the principal amounts of the loans are fully secured by real estate at origination and the market value of the loans are fully secured by real estate at the time the issuers receive the loans.[345] The Division also has issued favorable no-action positions with respect to certain instruments that represent an interest (in the nature of a security) in an entity engaged in real estate activities. Most significantly, the Division has said that "whole pool" agency certificates may be considered interests in real estate.[346]

The Division has considered whether it should reconsider these positions. In particular, we believe that the whole pool interpretation may be unrealistic, since agency certificates clearly are in fact liquid securities and not interests in real estate. Moreover, whole pool holders in fact have a different economic

[344] **Until recently, another distinction between structured financings and finance companies was that structured financings were not continuous operations. This distinction ended with the development of asset-backed commercial paper programs and master trusts.**

[345] *See* **NAB Asset Corp.,** *supra* **note 263.** *See also* **Citytrust (pub. avail. Dec. 19, 1990).**

[346] *See supra* **note 267 and accompanying text.**

experience than mortgage holders, largely because of the agency guarantees and the resulting increased liquidity of their interests.

. Because of the complexity of these issues, the Division believes that the Commission may wish to request public comment on the possible amendment of section 3(c)(5), including reversal of the whole pool interpretation, in the release accompanying the proposed exemptive rule for structured finanangs.

VI. Conclusion

The Division recommends that the Commission propose a rule exempting structured financings from the definition of investment company, subject to conditions that recognize and build upon the operational and structural distinctions between structured financings and investment companies. The Commission also may wish to request public comment on the scope of section 3(c)(5)