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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC-18736, File No. S7-12-92]

RIN 3235-AF47

Exclusion From the Definition of Investment Company for Certain Structured Financings

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule and request for comment.

SUMMARY: The Commission is proposing a new rule under the Investment Company Act of 1940 (the "Act") to exclude certain issuers that pool income-producing assets and issue securities backed by those assets ("structured financings") from the definition of "investment company." The proposal would permit structured financings that meet the conditions of the rule to publicly offer their securities in the United States without registering under the Act and complying with the Act's substantive provisions. The proposed rule is intended to remove an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy, including the small business sector.

DATES: Comments must be received on or before August 4, 1992.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. All comment letters should refer to File No. S7-12-92. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: Rochelle G. Kauffman, Senior Counsel, (202) 272-2038, Elizabeth R. Krentzman, Attorney, (202) 272-5416, or Karen L. Skidmore, Assistant Director, (202) 272-2048, Office of Regulatory Policy, Division of Investment Management, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed rule 3a-7 under the Investment Company Act of 1940 [15 U.S.C. 80a] (the "Act"). Proposed rule 3a-7 would effectuate the recommendation made in Chapter 1 of the Division of Investment Management's recently issued report, *Protecting Investors: A Half Century of Investment Company Regulation.*[1] In addition, the Commission is requesting public comment on whether section 3(c)(5) of the Act [15 U.S.C. 80a-3(c)(5)] should be amended, particularly in light of the proposed rule.

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Executive Summary

Proposed rule 3a-7 would exclude from the definition of investment company in section 3(a) of the Act[2] certain issuers that pool income-producing assets and issue primarily debt or debt-like securities backed by those assets for the purpose of providing their sponsors financing and other related benefits. In the last decade, this finance technique, called "structured finance,"[3] has become one of the dominant means of capital formation in the United States; in 1991, structured financings accounted for approximately half of all publicly offered securities in the United States.[4]

Despite the volume of offerings, the Act to some degree has constrained the development of the structured finance market. Structured financings generally fall within the definition of investment company under section 3(a), but are unable to operate under the Act's requirements.[5] Many private sector sponsored financings have avoided regulation under the Act by relying on the exception from the definition of investment company in section 3(c)(5), which originally was intended to exclude issuers engaged in the commercial finance and mortgage banking industries.[6] The Commission has exempted by order certain other structured financings, primarily those involving mortgage-related assets, under section 6(c), the general exemptive provision of the Act.[7] Financings that

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[1] SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation, *The Treatment of Structured Finance under the Investment Company Act* 1-101 (1992) [hereinafter Structured Finance Chapter]. This report concluded a two-year examination of the regulation of investment companies and certain other pooled investment vehicles. In the course of this examination, the Division of Investment Management (the "Division") met with representatives of entities associated with the structured finance industry to discuss, among other things, how structured financings work, the roles of the various participants, the status of the structured finance market, likely developments, and investor protection concerns. The Structured Finance Chapter discusses the Division's findings. Many of the Division's recommendations were based on suggestions made by commenters responding to a Commission release requesting comment on the regulation of investment companies and related issues, including the treatment of structured financings under the Act. SEC Request for Comment on the Reform of Investment Companies, Investment Company Act Release No. 17534 § III.C. (June 15, 1990), 55 FR 25322 (June 25, 1990) [hereinafter Study Release].

[2] 15 U.S.C. 80a-3(a).

[3] Although structured finance is the term most commonly used to describe this financing technique, other terms, such as "asset-backed arrangements," "asset-backed financings," "asset securitization," and "structured securitized credit," also have been used.

[4] Michael Liebowitz, *Reversing Four-Year Trend and Swooning Economy, Wall Street Explodes in 1991*, Inv. Dealers Dig., Jan. 6, 1992, at 21-23 (statistic excludes offerings of United States Treasury obligations).

[5] For example, the limitations of section 18 on the issuance of senior securities and the prohibitions of section 17 on transactions involving affiliates conflict with the operations of structured financings. 15 U.S.C. 80a-18, -17.

[6] S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 12 (1940).

In addition, certain federally sponsored structured financings, such as those sponsored by the Federal National Mortgage Association, are exempted from the Act under section 2(b), which exempts, among other things, activities of United States Government instrumentalities and wholly-owned corporations of such instrumentalities. 15 U.S.C. 80a-2(b).

[7] 15 U.S.C. 80a-6(c). Section 6(c) provides that the Commission may exempt, by rule or order,

> any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

Id.

cannot rely on section 3(c)(5) or obtain an exemption must sell their securities in private placements in reliance on section 3(c)(1),[8] the "private" investment company exception, or outside the United States.

In sum, under the present regulatory framework, a structured financing may be entirely exempt from the Act, or it may be subject to the Act and thus sold overseas or in private placements, depending solely on the nature of the assets securitized. Ironically, the result does not depend on the structure and operation of structured financings or the credit quality of the securitized assets. Many investors may be prevented from acquiring sound capital market instruments. In addition, some sponsors are denied the opportunity to obtain the benefits of publicly offered structured financings, even though they hold assets that, as a financial matter, readily could be securitized.

Application of the Act to structured financings has broad economic implications. Excepted or exempt structured financings have increased the availability of certain financial assets, often at lower costs. Structured finance, for example, has been credited with making the home mortgage market generally resistant to funding shortages.[9] Due to the applicability of the Act, however, some sectors of the economy, including small business, generally have been unable to use structured financings as sources of capital.

Proposed rule 3a–7 would remove an unnecessary barrier to the use and development of structured financings by excluding structured financings that meet certain conditions from the definition of investment company under the Act.[10] These conditions are intended to delineate the operational distinctions between registered investment companies and structured financings, permit the continued evolution of the structured finance market, and address any investor protection concerns that could arise. The proposed rule provides an exclusion for structured financings, regardless of the assets securitized.

The Commission also is requesting comment on whether section 3(c)(5) of the Act should be amended, either to narrow or to expand its scope. Some have suggested that certain types of issuers should not be able to rely on this section, while others have argued that the section is unnecessarily narrow.

I. Background [11]

A. The Structured Finance Market

The modern structured finance market originated in the 1970's with the securitization of residential mortgages. Since then, structured financings have become a major facet of American finance.[12] In 1991, securities of structured financings publicly offered in the United States totalled approximately $292.8 billion, accounting for approximately fifty percent of total public securities issuances (debt and equity) and fifty-seven percent of total debt securities issuances in the United States.[13]

Structured financings backed by residential mortgages dominate the structured finance market; in 1991, publicly offered mortgage-backed securities issuances in the United States totalled approximately $246.21 billion, or eighty-four percent of the structured finance market.[14] The non-mortgage market, which emerged in the mid-1980's, also has grown rapidly. Volume of non-mortgage asset-backed public offerings in 1991 totalled approximately $50.8 billion, up from $10 billion in 1986.[15] Securities backed by automobile loans and credit card account receivables represent approximately eighty percent of the public non-mortgage structured finance market. Other assets presently securitized and offered publicly include home equity loans, boat loans, computer leases, airplane leases, mobile home loans, recreational vehicle loans, and hospital account receivables.

A significant domestic private placement market for structured finance issues also exists. Although some private offerings are similar to those sold publicly, many private placements involve types of structured financings that have never been publicly offered in the United States, in part because of the Act. These financings include those backed by installment loans, future royalties, high yield bonds, and Medicare receivables.

Most public offerings of structured financings are issued under programs sponsored by the federal government or by government sponsored enterprises. Securities issued under programs sponsored by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC") dominate the mortgage market.[16] In 1991, the Resolution Trust Corporation began issuing securities backed by mortgages, junk bonds, and other assets acquired from failed savings and loan associations.[17]

The private sector also is active in sponsoring structured financings. The most active sponsors in the private sector include commercial banks, savings and loan associations, automobile manufacturers, retailers, finance companies, insurance companies, and investment banks. These sponsors securitize assets for a variety of reasons. Structured financings often enable a sponsor to gain access to an alternative, usually cheaper, funding source. In addition, some sponsors find that securitizing assets allows them to manage their loan portfolios, and in turn, their balance sheets more effectively.[18] Banks and savings and loan associations also securitize assets to facilitate compliance with regulatory capital requirements.

B. The Securitization Process

The basic structures of all structured financings, regardless of the underlying

[8] 15 U.S.C. 80a–3(c)(1).

[9] *See, e.g.*, Brent K. Meller, The Collateralized Mortgage Obligation: The Latest Phase in the Evolution of Mortgage-Backed Securities, *13 Real Estate* L.J. 299, 300–301 (1985).

[10] Of course, structured financings would remain subject to various regulatory requirements under the Securities Act of 1933 [15 U.S.C. 77a–77aa], the Securities Exchange Act of 1934 [15 U.S.C. 78a–78*ll*], and the Trust Indenture Act of 1939 [15 U.S.C. 77aaa–77bbbb] as well as other federal and state laws.

[11] This section provides a brief overview of the structured finance market, the organization and operation of a structured financing, the application of the Act to structured financings, and the effects of the Act on the structured finance market. A more detailed discussion is included in the Structured Finance Chapter, *supra* note 1, §§ I–IV.

[12] As discussed below, federally sponsored financings have played a major role in this development. Most of these programs rely on the exemption in section 2(b) of the Act.

[13] Liebowitz, *supra* note. 4

[14] *Id.*

[15] Dean Witter Reynolds Inc., Asset-Backed Securities Reference Guide A–10 (Year Ended 1991). *See also* Liebowitz, *supra* note 4, at 22 (reporting $46.6 billion of non-mortgage asset-backed securities issued in the United States).

[16] In 1990, FHLMC, GNMA, and FNMA sponsored programs were responsible for 94.2% of mortgage-backed pass-through securities and 82.2% of multiclass mortgage-backed securities issued that year. *See* Federal Home Loan Mortgage Corp., *Database, in* The Secondary Mortgage Markets, Tables 2, 3 (Winter 1991/1992).

[17] In addition, the Federal Agricultural Mortgage Corporation issues securities backed by agricultural mortgages guaranteed by the Farmers Home Administration. The Small Business Administration securitizes a small portion of the loans it guarantees. Finally, as discussed in Section I.C. below, in the late 1980's, the federal government sold portions of the loan portfolios of certain government agencies, which in turn, were pooled and securitized.

[18] By converting financial assets into cash (which can be used to retire debt or acquire new receivables), structured finance enables sponsors to reduce interest rate risk and to diversify their portfolios.

assets, are remarkably similar.[19] Typically, a sponsor transfers a pool of homogeneous financial assets to the issuer, a special purpose entity,[20] in return for the proceeds from the sale of one or more classes of securities backed by these assets. The securities issued generally are debt securities or equity securities with debt-like characteristics ("fixed-income securities").[21] Payment on the securities depends primarily on the cash flows generated by the pooled assets.[22] Issuers that have more assets or that expect to receive more income than needed to make full payment on the fixed-income securities may sell interests in the residual cash flow. These interests are typically sold to highly sophisticated investors.[23]

The issuer's only business activity is to acquire the sponsor's assets and issue securities. A servicer, which often is the sponsor or an affiliate of the sponsor, is the primary administrator of the financing. Generally, the servicer collects payments on the underlying assets when due and ensures that funds are available so that investors are paid in a timely manner. An independent trustee, usually a large commercial bank, typically holds the issuer's assets, or documentation of interest in the assets, in a segregated account for the benefit of investors. The trustee also monitors the issuer's fulfillment of its obligations.

Initially, most financings were structured so that their pools were fixed at the time of issuance, with "management" of the assets (other than servicing) generally limited to the substitution of new, similar assets for defective assets.[24] As the structured finance market has evolved, structures have been developed that rely to a greater degree on management. Many financings allow the servicer or trustee to reinvest idle cash in short-term debt obligations when there is a timing mismatch between collections and payments to investors. In some financings, the issuer may acquire additional assets if the previously designated assets do not generate sufficient cash flows to pay investors.[25] Finally, recently developed structures permit an issuer to purchase assets and issue securities on an ongoing basis.[26] In each case, guidelines governing both the level and type(s) of permissible management are established prior to the issuance of the financing's securities.

Publicly offered structured financings typically issue at least one class of securities rated in one of the two highest categories by a nationally recognized statistical rating organization, or "rating agency." [27] As with a traditional corporate bond, a rating of a structured financing assesses credit risk (*i.e.*, the likelihood that the investor will receive full and timely payments).[28]

In rating a structured financing, rating agencies generally apply the same basic approach, regardless of the assets securitized.[29] Rating agencies examine (i) the structure of the financing, including the risk that the insolvency of the financing's sponsor would affect payments to investors; [30] (ii) the credit risk of the financing, including the potential impairment of the cash flows from the pooled assets due to borrower delinquencies or defaults; [31] and (iii) risks related to the actual cash flow funding the securities, including the allocation of cash flow under the financing's payment structure.[32] Based on this examination, rating agencies determine the amount of credit enhancement necessary for the structured financing to obtain the rating desired by the sponsor.

Financings typically are structured and operated in accordance with criteria developed by the rating agencies to minimize various risks. Rating agencies, for example, may require that the transfer of the assets from the sponsor to the issuer be a "true sale" and not a

[19] While this section discusses the basic components of a structured financing, there are a wide range of permutations. For a discussion of these permutations, see Structured Finance Chapter, *supra note*, 1 § III.A. *See also* Jason H.P. Kravitt, A Brief Summary of Structures Utilized in the Securitization of Financial Assets, in 1 Securitization of Financial Assets § 4 (Jason H.P. Kravitt ed. 1991) [hereinafter Securitization of Financial Assets].

[20] The special purpose entity may be a corporation, a grantor trust, an owner's trust, or a partnership. The form of organization depends generally on tax considerations and the payment structure of the financing and its securities. For a general discussion of payment structures and attendant tax issues, see, *e.g.*, William A. Schmalz *et al.*, *Tax Issues in* 1 Securitization of Financial Assets, *supra* note 19, §§ 9.01 – 9.06; Charles M. Adelman & Roger D. Lorence, *Tax Considerations*, The Asset Securitization Handbook, 48–63 (Phillip Zweig ed., 1989).

[21] These securities typically entitle the holder to a specified principal amount at maturity and bear interest at a fixed rate or at an adjustable rate, which may be determined periodically by reference to an index, through auctions among investors or prospective investors, or through the remarketing of the instrument. Interest payments also may be determined by reference to all or part of the interest received on the underlying assets.

Generally, the type of security issued depends in part on the payment structure. Under a "pass-through" structure, a single class of securities is issued, with each security representing a fractional interest in the underlying pool. A "pay-through" structure permits the issuance of multiple classes of securities, with each class having differing maturities and payment schedules. Both structures permit the issuance of "stripped securities" (such as interest-only and principal-only certificates) and classes of senior and subordinate securities.

[22] Some financings also include credit enhancements, such as irrevocable standby letters of credit ("LOCs"), financial guarantee insurance, or cash collateral accounts, that could be drawn upon if the cash flows from the assets prove insufficient to meet the issuer's obligations.

Not all financings offer securities backed by the cash flow from the underlying assets. As discussed in note 65 *infra*, a few structured financings have employed a "market value" structure, in which payment on the securities is derived from the aggregate market value of the pooled assets, rather than from the cash flow from the underlying assets.

[23] As discussed *infra* note 77, residual interests are highly volatile instruments that bear any losses first resulting from an insufficient cash flow.

[24] Circumstances under which substitution may occur are described *infra* note 80.

[25] Credit card financings, for example, are backed by current and future receivables generated by specified credit card accounts; the balance of the pooled assets fluctuate as new receivables are generated and existing amounts are paid or charged off as a default. If the accounts do not generate sufficient receivables to support the securities, the sponsor may be required to assign receivables from other accounts to the pool.

[26] These structures include master trust programs, used predominantly in financings backed by credit card receivables, and asset-backed commercial paper programs. In a master trust program, the sponsor initially transfers a large amount of assets and the structured financing issues multiple classes of securities, often with varying terms, over time. Under certain conditions, assets may be added or removed throughout the life of the issuer. Asset-backed commercial paper programs issue commercial paper on an ongoing basis and are backed by a diversified pool of assets, with assets added to the pool throughout the life of the program. Asset-backed commercial paper programs generally contain a variety of relatively short-term assets, such as credit card receivables, automobile lease receivables, trade receivables, and short-term money market instruments.

[27] At least four rating agencies, Standard & Poor's Corporation, Moody's Investors Service, Inc., Fitch Investors Service, Inc., and Duff & Phelps, Inc., currently are active in rating domestic structured financings.

Providers of external credit support, such as the issuers of LOCs or financial guarantee insurers, also may play a role in structuring the financing. As in most securities issuances, underwriters and independent auditors also are participants.

[28] A rating does not address market risks to investors that may result from changes in interest rate levels or from prepayments on the assets in the underlying pool. *See, e.g.*, Standard & Poor's Corporation, S&P's Structured Finance Criteria 101 (1988).

[29] Asset-backed commercial paper programs are subject to somewhat different rating criteria because of the nature of the securities they offer. For a more detailed discussion of the role of the rating agencies, *see, e.g.*, Peter V. Darrow, et al., *Rating Agency Requirements in* 1 Securitization of Financial Assets, *supra* note 19.

[30] Rating agencies also examine whether the issuer itself could become subject to bankruptcy proceedings. This, for example, could occur if an issuer were to engage in other business activities.

[31] Rating agencies also evaluate the quality of the servicer in connection with its responsibilities to manage and maintain the payment stream on the underlying assets. In addition, rating agencies evaluate the capability of the trustee in performing its duties.

[32] The "pass-through" and "pay-through" payment structures are described *supra* note 21.

secured loan,[33] that the pooled assets generally be representative of the sponsor's portfolio, and that the financing's servicer remit the cash flows from the financing's assets to the trustee within forty-eight hours.

Once a financing is rated, rating agencies typically monitor the financing's performance. Downgrades of financings have been infrequent, with most occurring as a result of downgrades in the ratings of providers of credit support. The Commission is not aware of any rated structured financing defaulting on its fixed-income securities.[34]

C. The Application of the Investment Company Act to Structured Financings

Despite the size of the structured finance market, its growth and development has been constrained by the Act. Structured financings meet the definition of investment company under section 3(a) because they issue securities and are primarily engaged in investing in, owning, or holding securities.[35] These financings, however, are unable to operate under the Act's requirements.[36] Accordingly, to be offered in the United States, a structured financing must either be organized to come within one of the exceptions to the definition of investment company under the Act or seek exemptive relief from the Commission.[37]

There are only two exceptions that are particularly relevant to private sector structured financings: sections 3(c)(5) and 3(c)(1).[38] Section 3(c)(5) excepts:

> [a]ny person who is not engaged in the business of issuing redeemable securities * * * and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

Section 3(c)(5) was intended to except issuers engaged primarily in the factoring, discounting, or real estate businesses.[39] Many structured financings, however, rely on this exception due to its broad statutory language. A number of no-action letters address whether an issuer is primarily engaged in one of the businesses enumerated in section 3(c)(5).[40]

Under these letters, issuers relying on subparagraphs (A) or (B) of section 3(c)(5) must primarily hold receivables, loans to refinance receivables, or loans to manufacturers made in connection with the purchase of specified merchandise and services.[41] Many non-mortgage financings whose assets meet this criteria, such as those backed by automobile loans, most credit card account receivables, and equipment leases, rely on subparagraphs (A) and (B). No-action assurance has been declined where an issuer's assets are not related to the purchase or sale of specified merchandise, insurance, or services.[42] Financings backed by general purpose commercial loans, consumer loans, or corporate bonds typically are unable to rely on subparagraph (A) or (B).

Many issuers of mortgage-backed securities and similar products rely on subparagraph (C) of section 3(c)(5). Under no-action letters, an issuer relying on this provision must invest at least fifty-five percent of its assets in mortgages and other liens on and interests in real estate ("qualifying interests"). An additional twenty-five percent of the issuer's assets must be in "real estate related assets." [43]

Qualifying interests have been interpreted to include fee interests, leaseholds, interests fully secured by mortgages solely on real estate, and so-called "whole pool certificates" issued by FNMA, GNMA or FHLMC (i.e., certificates that represent the entire ownership interest in a particular pool of mortgages).[44] So-called "partial pool certificates" issued by these agencies (i.e., certificates representing less than the entire ownership interest in a particular pool of mortgages) have not been considered to be qualifying interests, although they may be treated as real estate related assets for purposes of the twenty-five percent test.[45]

Structured financings that cannot rely on section 3(c)(5) may rely on section 3(c)(1), the private investment company exception. This exception, however, is limited to issuers that do not engage in public offerings and whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons.[46]

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[33] Structuring the financing as a "true sale" reduces the risk that the sponsor's insolvency will affect the issuer's payments to investors. Sponsors not subject to the Bankruptcy Code, such as banks and savings and loan associations, may be permitted to pledge assets to the issuer.

[34] Unrated financings, by contrast, have experienced defaults. The largest and most notable occurred in 1985 when Equity Program Investment Corporation and certain of its affiliates defaulted on approximately $1.4 billion in mortgages and privately placed mortgage-backed securities. For a discussion of the facts underlying the EPIC default, see EPIC Mortgage Ins. Litig., 701 F. Supp. 1192 (E.D. Va 1988), *aff'd in part, rev'd in part, sub nom. Foremost Guaranty Corp. v. Meritor Sav. Bank*, 910 F.2d 118 (4th Cir. 1990).

[35] Financial instruments generated in commercial transactions generally have been considered to be securities for purposes of the Act. *See, e.g.*, SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 238–39 (1966) (stating that notes representing the sales price of merchandise, loans to manufacturers, wholesalers, retailers and purchasers of merchandise or insurance, and mortgages and other interests in real estate are securities for purposes of the Act).

[36] For example, section 17(a) prohibits certain persons affiliated with a registered investment company from selling securities and other property to the investment company. 15 U.S.C. 80a-17(a). In a structured financing, this section would prohibit a sponsor's sale of assets to the issuer, as well as any substitution of assets by the sponsor.

[37] As discussed *supra* note 6, most financings sponsored by the federal government or by government sponsored enterprises are exempt under section 2(b).

[38] Other exceptions may be available for a limited number of private sector structured financings. *See, e.g.*, Investment Company Act sections 3(c)(3), (4), and (6); 15 U.S.C. 80a-3(c)(3), (4), & (6). *See also infra* note 46.

[39] See authorities cited *supra note* 6. *See also* S. Rep. No. 184, 91st Cong., 1st Sess. 37 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970).

[40] Structured financings meet the first portion of section 3(c)(5) because they do not issue redeemable securities.

[41] *See, e.g.*, Ambassador Capital Corporation (pub. avail. Oct. 6, 1986) (no-action position taken with respect to issuer holding airline credit card account receivables); Days Inn of America, Inc. (pub. avail. Dec. 30, 1988) (no-action position taken with respect to issuer holding franchise fee receivables).

[42] *See, e.g.*, World Evangelical Development Ltd. (pub. avail. Apr. 5, 1979) (no-action position declined where entity would issue general purpose commercial loans); Educational Loan Marketing Associations, Inc. (pub. avail. Feb. 4, 1986) (no-action position declined where entity would issue debt secured by the repayment of student loans financed by proceeds from the debt offering).

[43] This percentage may be reduced to the extent that more than 55% of the issuer's assets are invested in qualifying interests. *See, e.g.*, Greenwich Capital Acceptance, Inc. (pub. avail. Aug. 8, 1991); United Bankers, Inc. (pub. avail. Mar. 23, 1988). Generally, there are no restrictions on the investment of the remaining 20% of the issuer's assets. *See, e.g.*, NAB Asset Corp. (pub. avail. June 20, 1991).

[44] *See, e.g.*, United Bankers, Inc., *supra* note (fee interests); Health Facility Credit Corp. (pub. avail. Feb. 6, 1985) (leaseholds); Medidentic Mortgage Investors (pub. avail. May 23, 1984) (mortgages); American Home Finance Corp. (pub. avail. Apr. 9, 1981) (GNMA whole pool certificates).

[45] *See* Nottingham Realty Securities, Inc. (pub. avail. Apr. 19, 1984). The Division has reasoned that agency whole pool certificates should be considered qualifying interests because holders of these certificates generally have the same economic experience as an investor who purchases the underlying mortgages directly. Conversely, the Division has concluded that an investment in agency partial pool certificates is an investment in the securities of the issuer, rather than an investment in the underlying mortgages, and accordingly, should not be considered a qualifying interest.

[46] Legislation has been introduced in Congress that would, among other things, create a new

Continued

Some structured financings have obtained exemptive orders from the Commission under section 6(c), the Act's general exemptive provision. Most of the orders have concerned structured financings whose assets consisted primarily of partial pool certificates and other mortgage-related assets that are not considered to be qualifying interests under section 3(c)(5)(C).[47] These orders have been based, in part, on the legislative purpose underlying the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA").[48] In adopting SMMEA, Congress contemplated that the Commission would provide appropriate administrative relief if the Act unnecessarily hindered the development of the secondary mortgage market.[49] The Commission has issued approximately 125 orders concerning mortgage-related financings.[50]

In general, the orders have required, among other things, that (i) fixed-income securities sold to the public be rated in one of the two highest categories by at least one rating agency; (ii) substitution of assets be limited both quantitatively and qualitatively; [51] (iii) the assets be held by an independent trustee qualified under the Trust Indenture Act of 1939 (the "Trust Indenture Act") [52] who has a first priority perfected security interest or lien in the collateral; (iv) the servicer not be affiliated with the trustee; and (v) the issuer be audited annually to determine that the cash flow is sufficient for payment of principal and interest. These conditions generally parallel requirements prescribed by rating agencies.[53]

The Commission also has granted exemptive relief under sections 6(c) and 6(e) [54] for financings related to the federal government loan sales program.[55] Under this program, the federal government sold portions of the loan portfolios of certain government agencies during the late 1980's.[56] While some of these sales were excepted under section 3(c)(5), others could not have been completed without exemptive relief. A total of seven financings either received exemption from most provisions of the Act, including the registration requirements, or registered as closed-end management investment companies and received exemption from much of the Act.[57] The conditions imposed in those orders generally were similar to those required for exempting mortgage-related financings.[58]

D. The Effects of the Regulatory Structure

As a practical matter, the Act treats similar types of structured financings very differently. Some structured financings are subject to the Act's requirements, while others are excepted entirely, depending solely on the assets underlying the financing. Most structured financings backed by consumer receivables, for example, are excepted from the Act under section 3(c)(5). Structured financings backed by general purpose loans, on the other hand, are not excepted and cannot be sold publicly in the United States, even though the financing may be similar to those qualifying for an exception or receiving exemptive relief. This regulatory framework ignores both the structure and operation of structured financings, and the credit quality of securitized assets.[59] It also enforces a distinction that does not reflect the economic reality that any asset with a relatively predictable cash flow is capable of being securitized in a generally uniform manner.

The differing regulatory treatment under the Act has adversely affected the development of the structured market. According to market participants, the most widely accepted types of structured financings are those sold on the domestic public market, while financings whose distribution is limited to private placements or to overseas markets have lagged in development. In addition, United States investors are denied the opportunity to purchase high-quality securities issued by certain types of structured financings. Similarly, sponsors of financings that cannot be offered publicly in the United States are prevented from diversifying and expanding their investor base.

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section exception for issuers whose securities are held exclusively by sophisticated or "qualified" purchasers, as defined by rule. If adopted, structured financings could rely on this exception so long as their security holders consist of "qualified" purchasers. Small Business Incentive Act of 1992, S. 2518, 102d Cong., 2d Sess. (Apr. 2, 1992); H.R. 4938, 102 Cong., 2d Sess. (Apr. 9, 1992). *See Hearings on the Small Business Incentive Act of 1992*, 102d Cong., 2d Sess. (Mar. 26, 1992).

[47] *See, e.g.*, Mortgage Bankers Financial Corp. I, Investment Company Act Release Nos. 16458 (June 28, 1988), 53 FR 25226 (July 5, 1988) (Notice of Application) and 16497 (July 25, 1988), 41 SEC Docket 814 (Aug. 9, 1988) (Order); Shearson Lehman CMO, Inc., Investment Company Act Release Nos. 15796 (June 11, 1987), 52 FR 23246 (June 18, 1987) (Notice of Application) and 15852 (July 2, 1987), 38 SEC Docket 1403 (July 21, 1987) (Order).

[48] Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984). Congress enacted SMMEA in an effort to expand the participation of the private sector in the secondary mortgage market in response to concerns that GNMA, FNMA, and FHLMC would not be able to meet future demands for mortgage credit.

[49] *See* S. Rep. No. 293, 98th Cong., 2d Sess. 9 (1983) (while the Senate Committee on Banking, Finance and Urban Affairs considered whether the Act should be amended to except issuers investing in certain mortgage-backed securities from the definition of investment company, the Committee reported legislation without such an exception in light of the Commission's administrative flexibility).

[50] *See supra* note 47.

[51] For example, the orders generally have permitted substitution of pooled assets, provided, among other things, that the new assets be of equal or better credit quality than the replaced assets, and that the new assets have similar payment terms. In addition, some orders have limited substitution to no more than 40% of the aggregate face amount of the assets initially deposited (with no substitution of substituted assets). *See, e.g.*, Mortgage Bankers Financial Corp. I, *supra* note 47 (with respect to the substitution of pooled GNMA, FNMA, and FHLMC certificates).

[52] The Trust Indenture Act sets forth requirements regarding, among other things, the eligibility and qualifications of trustees, the preferential collection of claims against the issuer, and reporting obligations. The Trust Indenture Act also addresses the duties of trustees when an issuer defaults.

[53] The exemptive orders also have imposed conditions limiting the sale of residual interests.

[54] 15 U.S.C. 80a-6(e). Section 6(e) provides that if, in connection with any order under section 6 exempting any investment company from the registration provisions of section 7 (15 U.S.C. § 80a-7), the Commission finds it appropriate that certain provisions of the Act pertaining to registered investment companies be applicable in respect of such company, the specified provisions will apply to that company as though it were a registered investment company. *See, e.g.*, Community Program Loan Trust No. 1987 A, Investment Company Act Release Nos. 15900 (July 29, 1987), 52 FR 28628 (July 31, 1987) (Notice of Application) and 15948 (Aug. 24, 1987), 39 SEC Docket 65 (Sept. 8, 1987) (Order).

[55] See, e.g., Community Program Loan Trust No. 1987 A, *supra* note 54.

[56] *See* Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874; Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987).

[57] Some issuers registered as investment companies because of tax advantages. *See, e.g.*, College and University Faculty Loan Trust, Investment Company Act Release Nos. 15903 (July 31, 1987), 52 FR 28890 (Aug. 4, 1987), (Notice of Application) and 15990 (Sept. 18, 1987), 39 SEC Docket 348 (Sept. 29, 1987) (Order).

[58] The only other exemptive order issued with respect to structured financings involved trusts established by the Government of Israel to facilitate the financing of its housing program to Soviet refugees. Each trust issued non-redeemable pass-through certificates backed by a single promissory note, the payment of which was guaranteed by the full faith and credit of the United States. *See* Government of Israel, Investment Company Act Release Nos. 18047 (Mar. 18, 1991), 56 FR 11806 (Mar. 20, 1991) (Notice of Application) and 18069 (Mar. 28, 1991), 48 SEC Docket 943 (Apr. 2, 1991) (Order).

[59] In response to the Study Release, *supra* note 1, one commenter noted that "issuers of asset-backed securities whose underlying assets are credit card receivables have restrictions limiting the percentage of their assets that can be represented by cash advances. In many cases, if the percentage of cash advance receivables becomes too great, the transaction is liquidated and investments are paid earlier than expected * * *. From the point of view of the investor, [however], there is no difference between the two types of credit card receivables." Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 62-63 (Oct. 12, 1990) at File No. S7-11-90 [hereinafter Cleary, Gottlieb Study Comment].

The regulatory barriers presented by the Act also have broader economic implications. Many sectors of the economy are prevented from fully using structured finance to address capital needs. When the Act does not apply, structured finance has proved effective in increasing the availability of certain financial assets, often at lower costs. For example, structured finance has increased the availability of home mortgage funding by enabling banks and savings and loan associations to package their loans and sell them in the secondary market.

In the long-term, private sector structured finance may prove beneficial as a means of capital formation with respect to small businesses. For example, general purpose loans to small businesses could be securitized in a manner very similar to residential mortgages. Suppliers and distributors also could securitize small business payables. Finally, small businesses themselves could pool and sell their own assets, such as receivables from customers.[60]

II. Discussion

A. Proposed Rule 3a–7

Proposed rule 3a–7 would remove impediments caused by the Act by excluding any structured financing, regardless of the type of assets securitized, from the definition of investment company, provided certain conditions are satisfied. It would obviate the need for sponsors to attempt to fit their financings within the confines of section 3(c)(5)—a section that was not intended to cover these arrangements. The proposal also would eliminate the need to obtain exemptive orders covering specific structured financings.

Proposed rule 3a–7 would have four conditions:

(i) Issuers must primarily issue fixed-income securities, with the holders of all such securities entitled to receive payments based on the cash flow from pooled assets;

(ii) Securities offered to the public must be fixed-income securities (as defined under the rule) that are rated at the time of sale in one of the two highest categories by at least one rating agency;

(iii) The issuer must hold substantially all assets to maturity, except that assets may be substituted or added consistent with the interests of existing investors; and

(iv) Assets, cash flows, and other property of the issuer must be maintained in the custody of an independent trustee, except to the extent necessary to the financing's operations.

These conditions, which are discussed in greater detail below, are intended to recognize the structural and operational distinctions between registered investment companies and structured financings and to address investor protection concerns by codifying requirements currently imposed by the market itself. The conditions also are intended to accommodate future innovations in the structured finance market, consistent with investor protection.

1. Scope of the Rule

Proposed rule 3a-7 would exclude from the definition of investment company any person that is in the business of acquiring and holding eligible assets, and does not issue redeemable securities.[61] The proposed rule is intended to exclude only structured financings from the Act and to preclude excluded issuers from acting in a manner similar to registered investment companies. Only issuers whose sole business is to hold a pool of eligible assets and to issue non-redeemable securities could rely on the exclusion.

Proposed rule 3a-7 would be based on the structure and operation of the financing and not on the type of assets securitized, provided all of the issuer's assets consist of eligible assets. Proposed paragraph (b)(1) defines the term "eligible assets" generally to include obligations that have scheduled cash flows.[62] This requirement is intended to ensure that securitized assets produce cash flows of the type that may be statistically analyzed by rating agencies and investors.

2. Conditions

(i) Securities Based on Underlying Cash Flows

Proposed paragraph (a)(1) would require issuers relying on the rule to issue primarily fixed-income securities, interest-only ("IO") securities, principal-only ("PO") securities, or other securities with similar characteristics, all of which entitle their holders to receive payments that depend on cash flows generated by the underlying pool. The proposed rule is intended to provide issuers with great flexibility in choosing the types of debt or debt-like securities to issue.[63] Structured financings presently issue a variety of securities based on cash flows from the underlying pool, and the proposal is not intended to limit that industry practice.[64]

By requiring payment on the securities to be based on the cash flows from the underlying pool, proposed paragraph (a)(1) is intended to reach the predominate types of structured financings that are currently offered.[65] The provision would permit an excluded financing to use credit enhancements, such as letters of credit or financial guaranty insurance, to pay investors if the cash flow from pooled eligible assets is insufficient to meet the issuer's obligations.

(ii) Securities Offered to the Public Must Be Fixed-Income Securities Rated in the Two Highest Investment Grades

Paragraph (a)(2) of the proposed rule would require that all securities offered to the public be fixed-income securities that are rated, at the time of sale by the issuer or any underwriter acting on the issuer's behalf, in one of the two highest categories by at least one nationally recognized statistical rating organization, or "rating agency."[66]

[60] *See Hearings on the Small Business Incentive Act of 1992, supra note* 46 (testimony of Myron Glucksman, Vice President, Structured Finance Division, Citicorp Securities Markets, Inc.).

[61] In addition, issuers seeking to rely on the rule may not issue debt securities that entitle holders to receive principal and accrued interest within a short period of time after demand (i.e., within 14 days). Securities with a short-term demand feature appear more like redeemable equity securities, and investors could confuse the securities with those issued by open-end management investment companies.

[62] Under proposed paragraph (b)(1), eligible assets also would include assets that serve solely to support the credit of the securities (e.g., letters of credit). *See supra* note.

[63] *See supra* note 21. As discussed below, however, IO securities, PO securities, and securities with similar characteristics could not be sold to the public.

[64] In defining fixed-income securities, proposed subparagraph (b)(2)(i) seeks to delineate the methods currently used to calculate interest on a structured financing's securities. The Commission specifically requests comment on whether this approach may limit unnecessarily the types of fixed-income securities that may be offered in the future, and whether an alternative approach would be appropriate.

[65] Structured financings using a "market value" structure, where payment on the financing's securities is derived from the aggregate market value of the pooled assets, would not be able to rely on proposed rule 3a-7. Market value transactions present issues that differ from financings utilizing the cash flow structure. For example, because investors are paid based on the aggregate market value of the assets, rather than cash flows generated from the assets, asset valuation concerns differ with respect to the two types of structures. Accordingly, these structures should not be subject to the same regulatory treatment as cash flow transactions. Since the use of the market value structure has diminished in the last few years, this limitation should not significantly affect the structured finance market. Of course, financings using the market value structure may sell their securities in private placements or overseas, or may apply for exemptive relief.

[66] The rating agency could not be an affiliated person of the financing's sponsor, servicer, trustee, or provider of credit support.

Securities that are not rated in the two highest categories, or that are unrated, may be sold only to qualified institutional buyers, as defined in rule 144A under the Securities Act of 1933,[67] or to an affiliated person of the issuer.[68]

This provision recognizes that rating agencies already play an integral role in the structured finance market.[69] Investors generally rely on rating agencies to perform evaluations of credit risk. Of course, the Act generally is not intended to protect investors against credit risk. Nevertheless, due to the nature of structured financings, rating agency evaluations appear to address most of the Act's concerns about abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage. Determining whether a financing is structured appropriately has become increasingly difficult, due to the wide variety and growing complexity of these transactions. Rating agencies have been successful in analyzing various structures, without impeding the development of the structured finance market.[70] Accordingly, a rating requirement has been incorporated in the proposed rule. The Commission, however, requests comment on whether rating agencies should be subject to additional regulatory requirements and whether a rating requirement is necessary in proposed rule 3a-7, and, if not, on what alternative bases the Commission should exclude financings from the Act.

Proposed subparagraph (a)(2) would require that securities offered to the public be rated in one of the two highest categories by at least one rating agency. Since most structured financings publicly offer only securities that are rated in one of these categories, this requirement should not materially affect the structured finance market. Some have argued, however, that a rating within one of the four highest categories (i.e., an investment grade rating) would address investor protection concerns, while providing greater flexibility for structured financings.[71] Accordingly, the Commission specifically requests comment on whether an investment grade rating requirement would be appropriate.

The Commission also requests comment on whether rule 3a-7 should require that excluded financings be rated by more than one rating agency. Although today most financings are rated by two or more rating agencies, the Commission is concerned that requiring two ratings would impose unnecessary costs.

Under proposed paragraph (a)(2), an issuer may sell to the public only fixed-income securities as defined under paragraph (b)(2) of the proposed rule. As proposed, the term "fixed-income securities" generally includes any debt obligation or instrument with debt-like characteristics, other than IO and PO securities or other securities with similar characteristics. Thus, an issuer relying on the proposed rule would be precluded from offering to the public IO and PO securities and any other securities with similar characteristics.

IO and POs securities are highly volatile, with payment subject to extreme prepayment and interest rate risks.[72] These securities may be highly rated, since prepayment and interest rate risks are not addressed in a security's rating.[73] Unsophisticated investors, however, may not appreciate the risks associated with IO and PO securities, and sales of these instruments to such investors may raise suitability concerns. In addition, financings that offer these securities arguably may represent a type of complex capital structure that the Act was intended to address.[74] Accordingly, the Commission proposes that rule 3a–7 not encompass structured financings that sell IO and PO securities to the public.[75] The Commission requests specific comment, however, on whether this restriction is appropriate.[76]

The proposed rule would permit any class of securities, without regard to the nature of the securities or their rating, if any, to be sold to qualified institutional buyers as defined in rule 144A, or to affiliated persons of the issuer. Presently, subordinate classes of structured financings, which typically are not highly rated, if rated at all, and interests in residual cash flows [77] are

[67] 17 CFR 230.144A. Under rule 144A, a qualified institutional buyer generally includes institutional investors, such as employee benefit plans, insurance companies, banks, and investment companies, that own or invest on a discretionary basis at least $100 million in securities.

[68] Section 2(a)(3) of the Act defines affiliated person of another person as:

(A) Any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such person is an unincorporated investment company not having a board of directors, the depositor thereof.

15 U.S.C. 80a–2(a)(3).

[69] In adopting SMMEA, Congress expressly recognized the role of rating agencies in the structured finance market, by including in the definition of "mortgage related security" (the type of security that qualifies for the special treatment conferred by SMMEA) a requirement that the security be rated in one of the two highest rating categories by at least one rating agency. *See supra* note 47.

[70] *See supra* note and accompanying text.

[71] In response to the Study Release, *supra* note 1, m most commenters supporting an exemption for structured financings suggested a rating in one of the two highest categories. *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 75. A few commenters favored an investment grade standard. *See, e.g.*, Letter from the American Bar Association, Section of Business Law, 1940 Act Structured Finance Task Force to Jonathan G. Katz, Secretary, SEC 20–21 (Oct. 16, 1990), File No. S7–11–90.

[72] J.P. Morgan, for example, recently incurred a $50 million loss on its IO securities as a result of a high rate of prepayments on the underlying mortgages. *J.P. Morgan Had $50 Million in Loss in Trading Mortgage-Backed Securities*, Wall St. J., Mar. 10, 1992, at A4. The Federal Financial Institutions Examination Council adopted a supervisory policy statement that includes restrictions governing the acquisition of IO and PO securities by national banks due to the volatility of these instruments. Comptroller of the Currency, Administrator of National Banks, Supervisory Policy Statement on Securities Activities, Banking Circular No. 228 (Rev.) (Jan. 10, 1992).

[73] *See supra* note 28.

[74] The legislative history of the Act describes investment companies that offered multiple classes of debt with different preferences and priorities, making it difficult for the ordinary investor to understand the rights and risks associated with his investment. *See* SEC, Investment Trusts and Investment Companies, H.R. Doc. 707, 75th Cong., 3d. Sess. pt. 1 at 28–29 (1939); SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess. pt. 3 at ch. V (1939). Section 18 of the Act addresses these concerns by imposing restrictions on the offering of debt securities by registered investment companies. 15 U.S.C. 80a–18.

[75] In response to the Study Release, *Supra* note 1, some commenters indicated that sales of IO securities to the public should be restricted because of their extreme volatility. *See* Cleary, Gottlieb Study Comment, *supra* note 59; Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC IX–13 (Oct. 18, 1990), File No. S7–11–90 [hereinafter Merrill Lynch Study Comment].

[76] The proposed rule also would prohibit the public sale of any other securities that are highly volatile and pose risks that unsophisticated investors may not appreciate. For example, residual interests structured as debt present similar concerns to IO and PO securities and, therefore, could not be sold to the public. Of course, IOs and POs and securities with similar characteristics could be sold to qualified institutional buyers and affiliated persons of the issuer. The Commission also requests comment on this aspect of the proposed rule.

[77] Residual interests typically are structured as equity and are not rated. These interests are highly volatile instruments, with payment depending in part on the effects of prepayments on the underlying assets and/or changes in the interest rate(s) on the cash flow. Residual interests bear risks that are significantly different from those attending fixed-income securities. In the event of self-dealing or overreaching by insiders, for example, these interests (as equity) would be the first to bear any losses. Residual interests usually are retained by the sponsor or sold to institutional investors who purchase them for hedging purposes.

placed with highly sophisticated investors. These investors conduct their own due diligence reviews prior to investing, and are capable of evaluating on their own behalf whether the financing is structured so that they, as holders of subordinate securities, will receive full and timely payment.

(iii) Limited Management

Proposed subparagraph (a)(3) would require issuers to hold substantially all eligible assets, other than any form of external credit support (e.g., letters of credit), to maturity. With four exceptions, issuers relying on the proposed rule would be required to hold to maturity (i.e., the termination of the asset according to its terms) [78] substantially all assets initially deposited in the pool as well as any assets added later.[79]

Proposed subparagraph (a)(3)(i) is intended to permit asset substitution, provided the new assets are of the same type and at least as high in credit quality as those initially deposited in the pool. This provision is intended to permit the replacement of assets when necessary to the financing's operations,[80] but to prevent any change in the financing's assets to the detriment of investors.

Proposed subparagraph (a)(3)(ii) would allow financings to continue the practice of using a defeasance mechanism to enable issuers to meet their obligations. This mechanism permits the trustee to sell assets and use the proceeds to purchase Government securities,[81] usually Treasury bills, that provide sufficient cash flows to pay holders of the financing's fixed-income securities.

Proposed subparagraph (a)(3)(iii) would permit assets to be added to the financing, provided these assets do not result in a downgrading of the rating of the financing's outstanding fixed-income securities. The new assets would not be required to be of the same type as those already in the pool.[82] This provision would permit financings to add assets to support the issuance of new fixed-income securities or to support obligations already outstanding.[83] The provision also would allow financings to continue the practice of reinvesting idle cash in highly rated short-term securities.[84]

Proposed subparagraph (a)(3)(iv) would permit issuers to dispose of assets that have not reached maturity only in connection with a financing's termination.[85] In all other circumstances, assets may not be removed from the underlying pool unless they meet the requirements of subparagraphs (a)(3)(i) or (ii).

The requirements of paragraph (a)(3) are intended to limit the amount of management permitted in structured financings without unduly restricting their operations. The provision recognizes that most financings require some form of management and that more recent structures contemplate somewhat greater flexibility in the management of pooled assets.[86] At the same time, proposed paragraph (a)(3) seeks to ensure that any changes in a financing's assets would not adversely affect the holders of the financing's outstanding fixed-income securities, and that excluded financings would not be managed to the same extent and in the same manner as management investment companies.

The Commission requests comment on whether paragraph (a)(3) achieves its intended purposes by permitting the proposed types of asset turnover. The Commission also requests comment on whether other restrictions relating to the management of assets should be included, and if so, what these restrictions should be. For example, it may be appropriate to include a general prohibition on the trading of assets for profit.[87]

The Commission also requests comment on alternative approaches to proposed paragraph (a)(3). The Commission, for example, could limit management objectively by requiring that a specified percentage, for example, sixty percent, of the aggregate amount of pooled eligible assets to be held to maturity.[88] A specific percentage limitation, however, could unnecessarily limit flexibility to respond to the specific types of financings through the no-action process.

(iv) The Independent Trustee

Proposed paragraph (a)(4) would require that all eligible assets, cash flow derived from such assets, and any other property of the issuer not needed for the financing's operations, be maintained in a segregated account by a trustee meeting certain requirements.[89] All property of the issuer at the time the financing is established, including pooled eligible assets (or legal documentation of interest in such assets) and any documents relating to credit support arrangements, would be deposited with the trustee. All subsequently acquired property, including all cash flows, would be transferred to the trustee within a reasonable period from the time of receipt.[90] Property necessary to the financing's operations (*e.g.*, for servicing) could be removed from the segregated account, provided that the property is returned promptly to the trustee once it is no longer needed.[91]

Proposed paragraph (a)(4) is intended to ensure the safekeeping of the issuer's assets. The provision generally is intended to codify industry practice, except that it would prohibit any servicer from commingling the financing's cash flows with its own

[78] Thus, an asset would be considered to have reached maturity when the asset is prepaid in accordance with its terms.

[79] The requirement that substantially all eligible assets be held to maturity is intended to permit a limited amount of additional management flexibility, as determined through the no-action process.

[80] Substitution typically occurs when assets are in default or subject to imminent default, or when they do not conform to the representations and warranties made at the time the financing is established.

[81] Under section 2(a)(16) of the Act, the term "Government security" includes any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the United States Government pursuant to Congressional authority, or any certificate of deposit of the foregoing. 15 U.S.C. 80a–2(a)(16).

[82] For example, in asset-backed commercial paper programs, discussed *supra* note 26, short-term money market instruments may be added to a pool of credit card account receivables.

[83] See *supra* notes 25–26 and accompanying text.

[84] Reinvestment would be limited to eligible assets as defined in proposed paragraph (b)(1). The Commission seeks specific comment on whether this requirement would limit unnecessarily a financing's reinvestment options.

[85] In the course of winding up its operations, an issuer may dispose of a significant portion of its assets prior to maturity. Excluded financings in the process of terminating their operations would continue to be in compliance with proposed subparagraph (a)(3)(ii), provided the financing is concluded within a reasonable period of time in light of the structure of the financing, the assets involved, and prevailing market conditions.

[86] *See supra* notes 24–26 and accompanying text.

[87] *See* Letter of Citicorp to Jonathan G. Katz, Secretary, SEC (Oct. 10, 1990) File No. S7–11–90 (responding to the Study Release, *supra* note).

[88] This approach would be consistent with prior exemptive orders. *See supra* note 51. More restrictive limits (*e.g.*, seventy percent, seventy-five percent, or eighty percent) also may be appropriate.

[89] In light of the diversity of assets used in structured financings, the Commission requests specific comment on whether the physical transfer of eligible assets to the trustee would present any difficulties for particular types of financings, and if so, what alternative approach would be appropriate to accommodate these arrangements.

[90] Whether the property is transferred within a reasonable period of time would depend on a number of factors, including the type of property transferred, the circumstances surrounding the transfer, and industry practice.

[91] For example, it may be necessary to remove documentation for a specific loan to collect delinquent payments; the documentation would be returned to the trustee following collection.

assets.[92] Investor protection concerns outweigh any benefit resulting from the commingling of a servicer's assets with those of the issuer.

Proposed paragraph (a)(4) would require the trustee to be a bank that meets the requirements of section 26(a)(1) of the Act governing trustees of unit investment trusts.[93] The trustee also could not be affiliated with the other participants in the financing.[94] Absent this prohibition, one entity could act in all capacities of the financing, with no independent party safeguarding the financing's assets.[95] Virtually all trustees are unaffiliated with the other parties involved in a structured financing, and this requirement would not depart from industry practice.

Proposed paragraph (a)(4) also would require the trustee to execute an agreement stating that it will not resign until the structured financing has been completely liquidated or until a successor trustee has been designated. The agreement additionally would provide that the sponsor or an agent of the sponsor keep a record of the financing's security holders.[96] These requirements are both consistent with industry practice and are imposed under the Act with respect to registered unit investment trusts.[97]

Proposed paragraph (a)(4) would not specify other duties for the trustee. It would not require the trustee to monitor the issuer's obligations to investors or to represent the interests of investors if the financing defaults. These requirements are imposed under the Trust Indenture Act,[98] which applies to many publicly offered financings. Structured financings not subject to the Trust Indenture Act often are structured to conform to the requirements of that Act. The Commission specifically requests comment on whether proposed rule 3a-7 should specify other duties for trustees, including whether any portion of the Trust Indenture Act's requirements should be made applicable to financings that are not subject to that Act.

B. Amending Section 3(c)(5)

The Commission also is requesting comment on whether section 3(c)(5) should be amended, either to expand or narrow its scope. As noted above, section 3(c)(5) was enacted to except commercial finance and mortgage companies from the Act. The activities of those entities has evolved considerably since 1940, however. In addition, a broad range of other issuers, including structured financings, not anticipated in 1940 (or 1970, when the exception was amended) rely on the exception.[99]

According to one trade group, traditional distinctions between companies engaged in factoring, sales financing, and other types of commercial financing activities no longer exist. Today, a finance company may be engaged in several kinds of financing activities or variations thereof.[100] Moreover, the trade group has suggested that current interpretations of section 3(c)(5) may unduly constrict legitimate financing activities.[101]

Others have suggested that the section should be narrowed, to prevent structured financings and other issuers from relying on it.[102] Of course, even assuming adoption of proposed rule 3a-7, absent an amendment to section 3(c)(5), structured financings will continue to be subject to somewhat disparate treatment. Structured financings that come within the section will be excepted from the Act, while other financings will have to meet the requirements of the proposed rule (although these requirements largely codify present practice).

In addition, upon adoption of proposed rule 3a-7, the no-action position of the Commission's Division of Investment Management with respect to the treatment of whole pool agency certificates will be withdrawn.[103] Both whole pool and partial pool certificates, which are traded in capital markets, are more in the nature of securities than real estate, and should not be deemed to be interests in real estate. Moreover, with the adoption of proposed rule 3a-7, withdrawal of the position should not affect structured financings backed by whole pool agency certificates. The Commission, however, requests comment on the withdrawal of this position.

III. Cost/Benefit of Proposed Action

Proposed rule 3a-7 would remove an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy, including the small business sector. Accordingly, it is intended to allow more sponsors to obtain the benefits of structured financings, including using these arrangements as sources of capital. It also would obviate the need for sponsors to spend unproductive time attempting to fit these arrangements within the confines of section 3(c)(5), or to obtain exemptive orders from the Commission.

The Commission anticipates that for virtually all structured financings and their sponsors, the cost of compliance with proposed rule 3a–7 would be minimal because the proposed rule essentially codifies industry practice. Comments are requested, however, on the above assessment of the costs and benefits associated with the proposed rule. Commenters should submit estimates for any costs and benefits perceived, together with any supporting empirical evidence available.

IV. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding

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[92] Rating agencies generally permit a servicer with an equal or higher rating as the financing's fixed-income securities to commingle the financing's cash flows with its own assets.

[93] 15 U.S.C. 80a-26(a)(1). Section 26(a)(1) also is incorporated in section 17(f) of the Act governing the qualifications of banks that serve as custodians for registered investment companies. 15 U.S.C. 80a-17(f).

[94] Rule 405 of the Securities Act of 1933 defines an "affiliate" of, or a person "affiliated" with, a specified person as "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." 17 CFR 230.405. Subject to the requirement that the trustee remain unaffiliated with the financing, the trustee would be free to purchase the financing's securities.

The Trust Indenture Act prohibits an obligor and any person with a control relationship to the obligor from serving as the trustee for the obligor's securities. 15 U.S.C. 77jjj(a)(5).

[95] For example, banks may act as sponsors, servicers, and/or providers of credit support to structured financings.

[96] This requirement would not prevent the trustee, as an agent of the sponsor, from maintaining these records.

[97] Sections 26(a)(3) and 26(a)(4)(A) of the Act. 15 U.S.C. 80a-26(a)(3), -26(a)(4)(A).

The Commission considered but rejected proposing that the agreement include provisions in the effect set forth in sections 26(a)(2) and 26(a)(4)(B) of the Act, which also apply to unit investment trusts ("UITs"). 15 U.S.C. 80a-26(a)(2), -26(a)(4)(B). Section 26(a)(2) contains prohibitions on fees that would not be compatible with the fee structure used in structured financings, which generally are based on the cash flow generated by the pool. In addition, proposed rule 3a-7 would permit greater flexibility with respect to asset substitutions than that allowed UITs, causing a notice requirement, such as that in section 26(a)(4)(B), to be unduly burdensome.

[98] *See supra* note 52.

[99] See authorities cited *supra* notes 6 & 39.

[100] 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.

[101] *Id.*

[102] *See, e.g.,* Memorandum from the Investment Company Institute on the Regulation of Asset-Backed Arrangements under the Investment Company Act (undated), File No. S7-11-90.

[103] *See supra* note and accompanying text. The Division of Investment Management does not intend to recommend that the Commission commence enforcement action against structured financings previously established in reliance on this no-action position solely because the position has been withdrawn.

proposed rule 3a-7. The Analysis explains that the proposed rule is intended to remove an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy, including the small business sector. The Analysis describes the present regulatory framework, under which a structured financing may be entirely exempt from the Act or subject to the Act, depending solely upon the assets securitized. A structured financing, however, is not able to operate under the Act's requirements. Thus, failing exclusion or exemption, it must be sold in private placements, or outside the United States. The Analysis explains that this result has impeded the development of the structured finance industry. The Analysis states that the costs of compliance with proposed rule 3a-7 would be minimal because the proposal essentially would codify industry practice. The Analysis also describes certain significant alternatives to the proposed rule considered by the Commission. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Rochelle G. Kauffman, Esq., or Elizabeth R. Krentzman, Esq., both at Mail Stop 10-4, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

V. Statutory Authority

The Commission is proposing rule 3a-7 under the exemptive and rulemaking authority set forth in sections 6(c) and 38(a) [15 U.S.C. 80a-6(c), -37(a)] of the Investment Company Act of 1940. The authority citations for these actions precede the text of the actions.

VI. Text of Proposed Rule

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a-1 *et seq.*, 80a-37, 80a-39 unless otherwise noted:

2. By adding § 270.3a-7 to read as follows:

§ 270.3a-7 Certain issuers of asset-backed securities.

(a) Notwithstanding section 3(a) of the Act, any issuer who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets and who does not issue redeemable securities or debt securities with a demand feature providing for payment within fourteen days of demand will not be deemed to be an investment company; *provided that:*

(1) The issuer primarily issues fixed-income securities, interest-only securities, principal-only securities or any other securities with similar characteristics, all of which entitle their holders to receive payments that depend on the cash flow from the eligible assets;

(2) All securities offered or sold to persons other than qualified institutional buyers, as defined in rule 144A under the Securities Act of 1933 [17 CFR 230.144A], or affiliated persons of the issuer are fixed-income securities that are rated, at the time of sale by the issuer or any underwriter thereof, in one of the two highest rating categories assigned debt obligations by at least one nationally recognized statistical rating organization that is not an affiliated person of the issuer or of any person involved in the organization or operation of the issuer;

(3) The issuer holds substantially all pooled eligible assets to maturity, except that it may:

(i) Substitute eligible assets for other eligible assets of the same type and of the same or higher credit quality;

(ii) Pursuant to a defeasance mechanism, substitute Government securities for eligible assets, provided such Government securities produce cash flows similar to those expected from the replaced asset;

(iii) Acquire additional eligible assets that do not result in a downgrading in the rating of the issuer's outstanding fixed-income securities; and

(iv) Dispose of any eligible assets in connection with the issuer's termination; and

(4) Eligible assets, cash flow derived from such assets, and any other property of the issuer, not needed at the time for the operation of the issuer's business, are maintained in a segregated account by a trustee that meets the requirements of section 26(a)(1) of the Act, that is not affiliated, as that term is defined in rule 405 under the Securities Act of 1933 [17 CFR 230.405], with the issuer or with any person involved in the organization or operation of the issuer, and that executes an agreement or instrument concerning the issuer's securities containing provisions to the effect set forth in sections 26(a)(3) and 26(a)(4)(A) of the Act.

(b) For purposes of this section:

(1) *Eligible assets* means obligations that require scheduled cash payments, such as notes, bonds, debentures, evidences of indebtedness, certificates of deposit, leases, installment contracts, interest rate swaps, repurchase agreements, guaranteed investment contracts, accounts receivable, chattel paper, cumulative preferred stock, guarantees, annuities, and participations or beneficial interests in any of the foregoing; and other assets that serve solely to support the credit of the issuer's securities, such as letters of credit, guarantees, and cash collateral accounts.

(2) *Fixed-income securities* means any securities that 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 or an adjustable rate determined periodically by reference to an index that is generally recognized in financial markets as a reference rate of interest, through auctions among holders and prospective holders, or through remarketing of the security, or

(B) an amount equal to specified portions of the interest received on the assets held by the issuer;

provided that any interest determined as described in paragraphs (b)(2)(i)(A) and (B) of this section bears a reasonable relationship to a market rate of interest; or

(ii) a stated principal amount at maturity and no interest payments; but do not include interest-only securities or principal-only securities or any other securities with similar characteristics.

By the Commission.

Dated: May 29, 1992.

Margaret H. McFarland,

Deputy Secretary.

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DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Part 163

[Docket No. 86P-0297]

Cacao Products; Amendment of the Standards of Identity

AGENCY: Food and Drug Administration, HHS.

ACTION: Tentative final rule.

SUMMARY: The Food and Drug Administration (FDA) is issuing this tentative final rule to amend the U.S.