Chapter 1

The Treatment of Structured Finance under the Investment Company Act

I. Introduction and Summary of Recommendations

Structured finance is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into capital market instruments.[1] In a typical structured financing, a sponsor transfers a pool of assets to a limited purpose entity, which in turn issues non-redeemable debt obligations or equity securities with debt-like characteristics ("fixed income securities"). Payment on the securities depends primarily on the cash flows generated by the assets in the underlying pool. Typically, the securities are rated in one of the two highest categories by at least one nationally recognized statistical rating organization ("rating agency"). Issuers that have more assets or that expect to receive more income than needed to make full payment on the fixed income securities also may sell interests in the residual cash flow.

Structured finance differs from conventional financing techniques in that it involves the pooling of financial assets, which are then removed from the sponsor's balance sheet. The risks inherent in holding the financial assets are shifted away from the sponsor to investors that believe they are in a better position to accept these risks.[2] As a result, the sponsor may be able to manage its balance sheet better, while gaining access to alternative funding sources.

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[1] Although "structured finance" is the term most commonly used to describe this financing technique, the terms "structured securitized credit," "asset-backed arrangement," "asset-backed financing," and "asset securitization" also are used. We use these terms interchangeably throughout this chapter.

[2] *See* JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 5, 9-11 (sponsored and produced by McKinsey & Company Securitization Project; 1988). The sponsor may still bear some risk, depending on whether it provides recourse or owns some of the securities issued in the financing. *Id.*

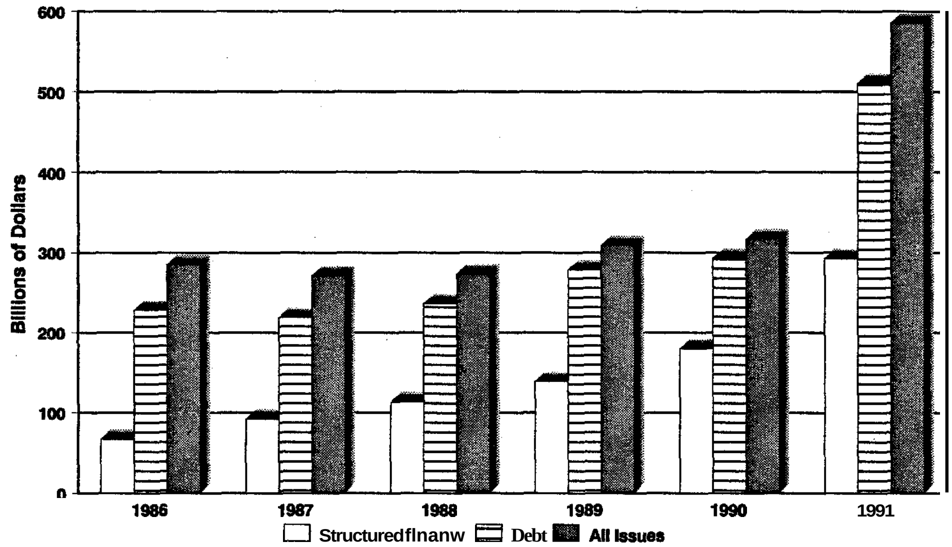
Since its inception in the 1970's, the structured finance market in the United States has grown rapidly?[3] One observer has estimated that $292.8 billion **of** structured financing securities were issued in the United States in 1991, compared with $174.0 billion in 1990.[4] The significance **of** the structured finance market is particularly apparent when its market share is compared to the market share of other types of offerings. In 1991, structured financings accounted for approximately fifty percent of total public securities issuances (debt and equity) in the United States, and approximately fifty-seven percent **of** total public debt securities issuances?[5]

[3]Structured finance is a form of "securitization." Although observers define "Securitization" in somewhat differing ways, generally it is the process by which funding that traditionally was obtained from commercial lenders, such as banks and finance companies, is obtained instead through the **use** of securities. *See, e.g., id.* at 3; LOWELL L. BRYAN, BREAKING UP THE BANK: RETHINKING AN INDUSTRY **UNDER** SIEGE **66-70 (1988).** In addition to structured finance, other forms of securitization include commercial paper, loan participations and high yield bonds. *See, e.g.,* **BRYAN,** *supra,* at *66,* **69;** TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES, § 1.2, at **6 (1991).**

[4]**In 1991,** approximately **$246.21** billion of mortgage-backed securities and **$46.60** billion of non-mortgage asset-backed securities were issued compared with reported issuance in **1990** of **$133.94** billion of mortgage-backed securities and $40.10 billion of non-mortgage asset-backed securities. Michael Liebowitz, *Reversing Four-year Trend and Swooning Economy, Wall Street Explodes in 1991*, INV. **DEALERS' DIG.,** Jan. **6, 1992,** at **26-27** [hereinafter *IDD 1991 Figures].*

[5]**In** 1991, an estimated **$585.97** billion of total United States debt and equity securities were issued of which **$510.96** billion were debt securities. *Id.* at 24, **27, 30-31.** In comparison, in **1990,** an estimated **$312.11** billion of total United States debt and equity securities were issued of which $288.36 billion were debt securities. *Id.* As the foregoing figures indicate, although total structured finance issuances grew 68% from **1990** to **1991** (mostly as a result of an 84% increase in the issuance of mortgage-backed securities), both total securities issuances and total debt securities issuances grew even faster between **1990** and **1991 (88%** and *77%* respectively). Thus, from **1990** to **1991,** structured finance issuances declined six percent as a portion of total securities issued and three percent as a portion of total debt securities issued.

FIGURE 1-1
Comparative Data Reflecting Growth of Structured Finance in the United States 1986-1991



Source: Investment Dealers' Digest

Despite this robust growth, the Investment Company Act[6] has constricted the development and evolution of the structured finance market. Structured financings fall within the definition of investment company but cannot operate under the Act's requirements.[7] Many financings have avoided regulation under the Act by rel in on the exception to the definition of investment company in section 3(c)(5), which Congress included in 1940 for the commercial finance and mortgage banking industries? The Commission has granted exemptions with

[6]Investment Company Act of 1940, 15 U.S.C. § 80a.

[7]*See* generally *infra* Section IV.

[8]15 **U.S.C.** § 80a-3(c)(5).

'Certain federally sponsored structured financings, such as those sponsored by the Federal National Mortgage Association ("FNMA"), also are exempted from the Act's provisions under section 2(b), which exempts, among other things, activities of United States Government instrumentalities or wholly-owned corporations of such instrumentalities. **15 U.S.C.** § 80a-2(b). The Division did not re-examine the treatment of federally sponsored structured financings under the Act.

respect to other finanangs, primarily those involving mortgage-related assets.[10] Financings that are unable to rely on a statutory exception or obtain an exemptive order must sell their securities either privately to no more than 100 investors in reliance on the Act's private investment company exception, or outside the United States?' Thus, the Investment Company Act distorts the structured finance market, even driving some offerings offshore. The Act also causes much unproductive discussion over whether particular offerings may rely on section 3(c)(5).

In light of these problems, the Division has re-examined the Investment Company Act's treatment of private sector structured financings.[12] We recommend that the Commission adopt a rule exempting structured financings from all provisions of the Investment Company Act, subject to conditions that would address the investor protection concerns presented by structured financings.[13] The conditions generally would restrict "management" of exempt financings; prohibit the issuance of redeemable securities; limit public securities issuances to debt or debt-like securities that are rated in the top two investment

[10]*See infra* Section IV.A.2.

[11]Investment Company Act § 3(c)(1), 15 U.S.C. § 3(c)(1).

[12]In the course of this examination, 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. In addition, the Division published a request for comments on reform of the regulation of investment companies which included a request for comments on the regulation of structured financing under the Act. Request for Comments on the Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17534, § III.C. (June 15, 1990), 55 FR 25322 [hereinafter Study Release]. The Division received many responses to the Study Release addressing structured finance issues including letters from The American Bankers Association; The 1940 Act Structured Finance Task Force of the American Bar Association; Banca D'Italia; Bankers Trust Company; Chase Manhattan Bank; Chemical Bank; Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Dean Witter Reynolds Inc.; The Equitable Life Assurance Society of the United States; Federated Investors; Financial Security Assurance; Foley & Lardner on behalf of Smith Barney Asset Capital Corp.; Tamar Frankel; Investment Company Institute; Mayer Brown & Platt; Mayer Brown & Platt on behalf of Continental Bank N.A.; Merrill Lynch & Co., Inc.; New York Clearing House; Sears, Roebuck and Co.; and Shearson Lehman Brothers.

[13]Of course, structured financings are also 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 laws and state laws. The Division examined only the Investment Company Act issues.

grades, the payment of which depend on the cash flows from the underlying assets; and require independent trustees.

Section II **of** this chapter provides an overview of structured finance, discussing the present status of the market and how it began, which institutions are securitizing their assets and why, who purchases these securities, and expectations for the future. Section III discusses the basic mechanics of structured financings, including the responsibilities of the various entities involved. Section IV describes the application of the Investment Company Act to structured financings and its effects. Section V discusses whether structured financings should be subject to the Act, examining whether structured financings present the potential for the type of abuses the Investment Company Act is designed to remedy and, if so, how structured financings could be regulated under the Act. Section V also analyzes possible reforms, including several of those suggested by commenters in response to the Division's request for comments on reform of the regulation of investment companies (the "Study Release"),[14] and discusses the Division's proposed rule.

II. Overview of Structured Finance

A. The Structured Finance Market

1. The Mortgage Market

The modern structured finance market originated in the 1970's with the securitization of residential mortgages.[15] Since then, securities backed by residential mortgages have dominated the structured finance market. **As of** September 30,1991, the aggregate amount of securities backed by one- to four-family mortgages was reported to be **$1.2** trillion, representing forty-two percent of all mortgage debt.[16] Total value of mortgage-backed securities issued in 1991

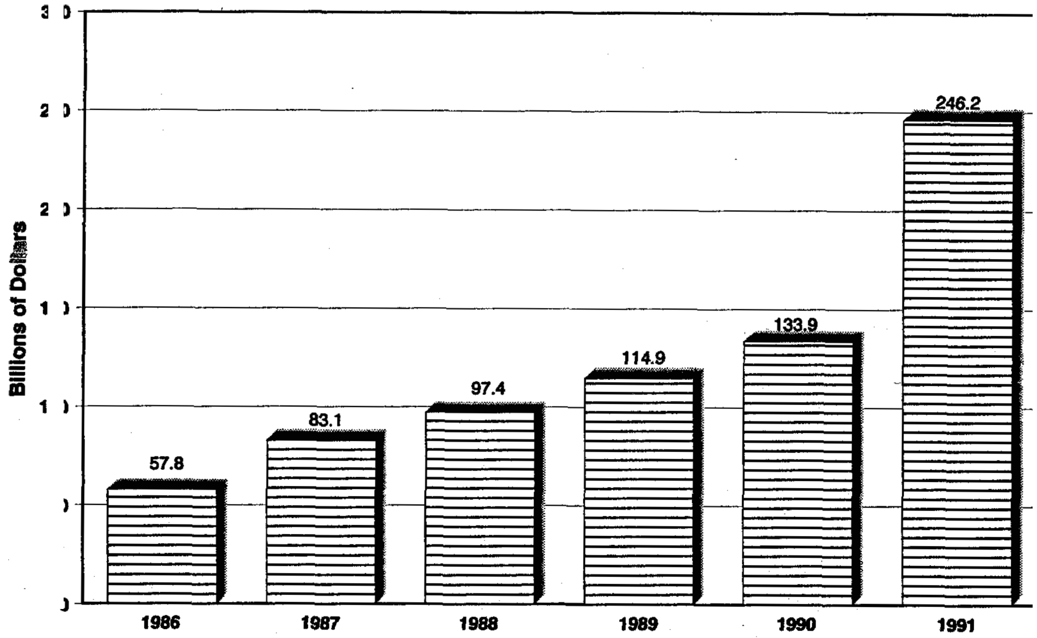
[14]Study Release, *supra* note 12.

[15]Mortgages were "securitized," in crude fashion, in the 1920's and 1930's. Typically, banks or mortgage insurers guaranteed the mortgages. Many of the mortgage pools experienced defaults and many of the guarantors failed, as a result of inadequate capital. Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497,500 (1989).

[16]Federal Home Loan Mortgage Corp., *Database, Securitized Mortgage Debt Outstanding*, in THE SECONDARY MORTGAGE MARKETS Table 5 (Winter 1991/1992) [hereinafter *Database.]* In contrast, as of the same date, only 10% of all outstanding multi-family mortgage debt had been securitized. *Id.*

was estimated to be $246.2 billion, an eighty-four percent increase from the 1990 level of **$133.9 billion.**[17] Figure 1-2 illustrates the growth of the mortgage market.

FIGURE 1-2
Mortgage-Backed Securities Issued in the United States 1986-1991[1]



[1]1986 data may not include non-debt issuances.
Source: Investment Dealers' Digest

The securitization of residential mortgages is a direct outgrowth of federal promotion of the secondary market in residential **mortgages.**[18] The Government National Mortgage Association ("GNMA"), the Federal National Mortgage Assgciation ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC") were formed to provide greater access to capital for residential

[17]*IDD* 1991 **Figures,** supra note **4**, at 21. It is likely that only a small dollar amount of securitized commercial mortgages is included in this figure. For a discussion of securitization of commercial mortgages, see note 36 and accompanying text below.

[18]*See, e.g.,* **BRYAN,** supra note 3, at **71.**

mortgage financing through development of a secondary market for residential mortgages.[19] FNMA and FHLMC promote the secondary mortgage market in part by purchasing mortgages and either holding the mortgages or selling them, in the latter case primarily by repackaging the mortgages into securities. GNMA primarily guarantees payment on the securities issued by mortgage pools that are created by financial institutions.

In 1970, GNMA created the first publicly traded mortgage-backed security?' The security, known as a mortgage pass-through certificate, represented beneficial ownership of a fractional undivided interest in a fixed pool of residential mortgage loans. GNMA guaranteed timely payment of principal and interest on the certificates. Both FNMA and FHLMC subsequently issued mortgage-backed securities; and, like GNMA, embarked on mortgage-backed securities programs ("agency programs"). The FNMA and FHLMC programs differ from the GNMA program in two significant ways. First, both FNMA and FHLMC themselves issue securities, while GNMA guarantees securities issued by

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[19]FNMA was created by Congress in **1938** as a wholly-owned government corporation for the purpose of providing a secondary mortgage market for Federal Housing Administration ("FHA") and later Veterans Administration ("VA") mortgage loans. In **1968,** pursuant to Title VIII of the Housing and Urban Development Act of **1968** (Pub. L. No. **90-448,** Title VIII, **§ 801,** Aug. **1, 1968, 82** Stat. **536)** (codified at **12** U.S.C. **§ 1716b),** FNMA was divided into two separate entities. One continued to be called FNMA, but became a privately owned entity, subject to the regulatory authority of the Department of Housing and Urban Development **("HUD"). 12** U.S.C. **§ 1723(b).** FNMA continues to provide a secondary market for FHA and VA mortgage loans, and, in **1970,** was authorized to do the same for certain other mortgage loans. 12 U.S.C. § **1718.** The other entity became GNMA, an instrumentality within HUD that generally services the portfolio of mortgages owned by the federal government. GNMA also guarantees securities issued by HUD-approved mortgagees that represent interests in pools of mortgages comprised solely of FHA, VA, and certain Farm Housing Administration loans. FHLMC was created in **1970,** pursuant to Title III of the Emergency Home Finance Act of **1970 (12** U.S.C. **§§ 1451-1459),** to develop and maintain a nationwide secondary market for conventional residential mortgages issued by savings and loans, mortgage bankers, banks, and HUD-approved mortgagees. Under the Financial Institutions Reform, Recovery and Enforcement Act of **1989** ("FIRREA"), FHLMC became privately owned, subject to the regulatory authority of HUD. Pub. L. No. **101-73,** Title VI, **§ 731(b)-(e), 103** Stat. **183, 429-435** (Aug. **9,1989)** (codified as amended at **12** U.S.C. **§§ 1451-1459).**

[20]*See* **KENNETH** G. LORE, MORTGAGE-BACKED SECURITIES DEVELOPMENTS AND **TRENDS** IN THE SECONDARY MORTGAGE MARKET **2-4 (1991-92** ed.). Mortgage-backed securities differ from mortgage-backed bonds, which were offered to the public as early as **1880.** Mortgage-backed bonds are general obligations of an issuer that are secured by a pool of mortgage loans or mortgage securities. Payment of these bonds does not necessarily depend on the underlying cash stream from the mortgage pool; it may come from the issuer's general funds. See Pittman, ***supra*** note 15, at 500.

others. Second, unlike the GNMA program, securities issued by FNMA and FHLMC are not backed by the full faith and credit of the United States. Because of FNMA and FHLMC's close association with the federal government, however, securities issued by them are perceived by many to be virtually as safe as **GNMA** securities.[21]

The design of the agency programs, as well as the characteristics of the residential mortgages in each program's portfolio, greatly simplify the securitization of mortgages. The agencies generally purchase only a relatively homogenous class of these mortgages; accordingly, these mortgages meet similar credit criteria and have similar maturities. The large volume of loan originations and the relatively small principal amounts of the loans simplify securitization by facilitating credit and cash flow analysis, among other things. Finally, the perception of a federal guaranty backing the instruments, whether explicit or implicit, promotes investor acceptance.

The development by FHLMC, GNMA, and FNMA of mortgage-backed securities ("agency securities" or "agency certificates") promoted residential mortgage financing. By increasing the liquidity of the secondary residential mortgage market, the agency programs have reduced the cost of borrowing by lowering interest rates and origination fees.[22] The agency programs also contributed to the innovation of new mortgage forms by creating a variety of new mortgage securities products.[23] For example, in 1983, FHLMC created the collateralized mortgage obligation ("CMO"). **A** CMO is a debt obligation whose structure allows the cash flows on the underlying mortgage pools to be carved up into separate classes of securities, called "tranches," each with a specified coupon

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[21] *See, e.g.*, LORE, *supra* note **20,** at **1-8;** Pittman, *supra* note **15,** at **500.** *See also* Peter V. Darrow, et al., *Rating Agency Requirements, in* 1 SECURITIZATION OF FINANCIAL ASSETS **§ 7.02[G],** at **7-44** to **7-45** (Jason H.P. Kravitt ed. 1991).

[22] Rosenthal and Ocampo reported (in 1989) that "[h]ome buyers are now paying approximately 100 basis points less in interest (versus **U.S.** Treasury yields) on fixed-rate mortgages than they were a decade ago when mortgage securitization was much less pervasive." ROSENTHAL & OCAMPO, *supra* note 2, at 12. *See* also LORE *supra* note **20,** at 1-12 (FHLMC's annual report indicated that interest rates on mortgages that qualify for sale to FHLMC are about one-half of a percentage point lower than nonconforming mortgages). *But* see Pittman, *supra* note **15,** at **542-543 (as** of 1986, the Federal Reserve Board did not credit SMMEA with any decrease in interest rates available to homeowners nor did it anticipate that SMMEA would effect any significant reduction in the future); BRYAN, supra note 3, at 86 (in 1988, a reduction in mortgage rates had not yet occurred although the author viewed that result as inevitable, eventually).

[23] WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES 12 (1989).

and stated maturity. Scheduled payments and prepayments from the mortgage pool are allocated to retire the classes in the order of stated maturities.[24]

The three agency programs dominate the secondary residential mortgage market[25] but the private sector has also participated in issuing mortgage-backed securities. Mortgage-backed securities issued by the private sector have typically been backed by agency certificates and conventional mortgages that the sponsor either originates itself or purchases in the secondary market. Many of the conventional mortgages have balances exceeding the maximum loan limits permitted to be purchased by the agencies ("nonconforming loans").[26] These securities also lack the guaranty of the agency securities, a significant handicap to the private sector in the secondary residential mortgage market.[27]

In an effort to expand the participation of the private sector in the secondary market, Congress enacted the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA").[28] Congress was concerned that the agencies would not be able to meet future demands for mortgage credit. SMMEA removed obstacles for privately sponsored mortgage-backed securities by, among

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[24]The CMO structure followed a prior unsuccessful attempt to devise a multiclass mortgage security. In 1983, Sears Mortgage Securities Corporation introduced a multiple class pass-through security, which was unsuccessful because it received unfavorable tax treatment by the Internal Revenue Service ("IRS"). *Pittman, supra* note 15, at 505-506. In 1986, Congress effectively overruled the IRS in this matter by enacting the Real Estate Mortgage Investment Conduit ("REMIC") provisions in the Tax Reform Act of 1986. Pub. L. No. 99-514, §§ 671-675, 100 Stat. 2085, 2309-2320 (1986), codified at 26 U.S.C. §§ 860A-860G. *See* Pittman, *supra* note 15, at 505, 508. For more discussion of CMOs and REMICs, see *infra* notes 146-151 and accompanying text.

[25]For example, in 1990, FHLMA, GNMA and FNMA together issued $235 billion in pass-through securities out of a total pass-through issuance of $249 billion, thus giving the agencies 94.2% of total pass-through issuances in 1990. *Database, supra* note 16, at Table 2, Part A. In addition, in 1990, FHLMA and FNMA combined issued $97.5 billion in multiclass mortgage securities (CMOs and REMICs) out of a total multiclass issuance of $118.6 billion, thus giving the agencies 82.2% of total multiclass issuances in 1990. *Id.* at Table 3. In the first three quarters of 1991, FNMA and FHLMC increased their market domination, issuing 94.2% of all multiclass mortgage-backed securities offered. *Id.*

[26]LORE, *supra* note 20, at 1-14.

[27]David Abelman, *The Secondary Mortgage Market Enhancement Act*, 14 REAL ESTATE L. J. 136, 145-147 (1985).

[28]The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified at scattered sections of 12 and 15 U.S.C.).

other things, pre-empting certain state investment laws so that state regulated institutions might purchase privately sponsored mortgage-backed securities to the same extent as agency securities, granting authority for certain depository institutions to invest in these securities, and requiring states to exempt privately sponsored mortgage-backed securities from state registration to the same extent as agency securities, unless the state specifically deemed otherwise?'

Despite SMMEA, the private sector has not made significant inroads in the secondary residential mortgage market. Indeed, in 1989, the dominance of the agencies grew even greater as private issuance slowed in response to problems in the financial market, the loss in 1986 of tax incentives, and the savings and loan crisis?' Issuance of privately sponsored pass-through certificates dropped by more than forty percent between 1988 and 1989 causing a **6.4%** decline in market share.[31] More dramatically, the market share of publicly offered multiclass securities (*e.g.*, CMOs) issued by the private sector dropped almost fifty percent between 1988 and 1989.[32] In 1990, the market share of privately sponsored pass-through certificates held steady,[33] while the market share of privately sponsored multiclass securities recovered slightly only to dip again in the first three quarters of 1991.[34]

[29]**For** more information on SMMEA, see Pittman, *supra* note **15;** Abelman, *supra* note **27.**

[30]LORE, *supra* note **20,** at **2-39.**

[31]**In 1988,** non-agency sponsors issued approximately **$20.7** billion of pass-through securities representing **12.1%** of total issuance **($170.6** billion). *Database, supra* note **16,** at Table **2,** Part A. In **1989,** non-agency sponsors issued only **$12.2** billion of pass-throughs representing **5.7%** of total issuance **($212.6** billion). Id. Although the volume of non-agency sponsored pass-through securities increased to approximately **$14.3** billion in **1990,** total issuance also increased to **$249.3** billion leaving the non-agency sponsors' market share the same as **1989.** Id.

[32]**In 1988,** non-agency sponsors issued **$51.0** billion of multiclass securities out of a total volume of **$76.8** billion for **66.4%** of the multiclass mortgage market. Id. at Table **3.** In **1989,** non-agency sponsors experienced a precipitous **49.8%** drop in multiclass market share (and a **67.3%** drop in volume) issuing **$16.7** billion of multiclass securities out of a total volume of **$100.5** billion or **16.6%** of the multiclass mortgage market. Id.

[33]*See supra* note **31.**

[34]**In** 1990, non-agency sponsors issued $21.1 billion of multiclass securities out of a total volume of **$118.6** billion for **a** slight market share increase to **17.8%** of the multiclass mortgage market. *Database, supra* note **16,** at Table **3.** In the first three quarters of **1991,** however, non-agency sponsors issued only **$10.5** billion of multiclass securities out of a total volume of **$137.6** billion for **a** mere **7.6%** of the multiclass market, of which **$2.5** billion or **1.8%** consisted of (continued...)

The private sector has begun to securitize commercial mortgages and mortgage products. Sponsors have publicly offered securities backed by small commercial loans, large single mortgages on office buildings, and commercial mortgage loans in the form of tax-exempt industrial development bonds.[35] The development of these securities has been slowed, in part, by the lack of standardization in loan structure and documentation and soft real estate markets.[36]

In addition to the public mortgage market, there have been a number of private placements of mortgage products. Private placement of securities backed by residential mortgages apparently is unusual. The opposite is true for commercial mortgages, with many, if not most, commercial mortgage-backed securities sold in private placements, perhaps because of the lack of standardization.[37]

2. **The** Non-Mortgage Market

Since the mid-1980's the techniques pioneered in the secondary residential mortgage market have been used by the private sector to securitize other assets. **As** of year-end 1991, approximately **$158.34** billion of non-mortgage asset-backed

[34](...continued)
securities issued under the securitization program of the Resolution Trust Corporation (the "RTC"). Id. For further information about the RTC's securitization program, see *infra* notes 96 & 97 below and accompanying text.

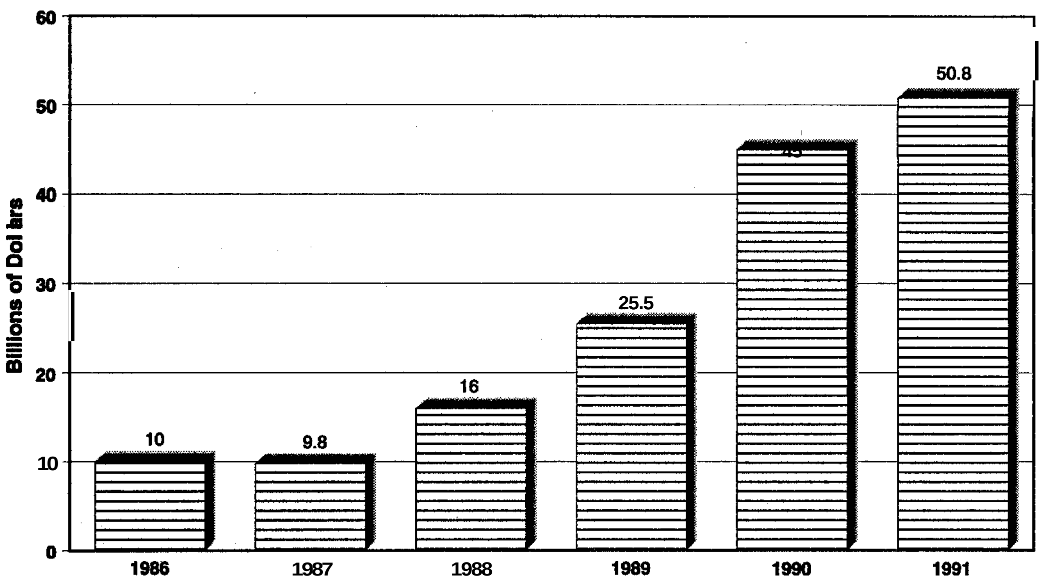
[35]PAVEL, *supra* note 43, at 77-78.

[36]*See* LORE, *supra* note *20,* at 1-3, 1-6, 2-41. *See also* Suzanne Wittebort, *Asset-Buck& Come of Age,* INSTITUTIONAL INVESTOR, Dec. 1991, at 80 ("[M]ortgages on commercial property tend to be more individualized and cash flows on a package of them can be lumpy.'").

[37]Wittebort, *supra* note 36, at 80 (reporting that most of the anticipated commercial mortgage-backed structured financings in 1991 would be issued in private placements). Standard & Poor's ("S&P") has estimated that 75% of the commercial mortgage-backed securities it has rated have been privately placed. *See Commercial Mortgage Securitization -- It's Time Has Come,* STANDARD & POORS CREDITREVIEW COMMERCIAL MORTGAGE SECURITIES, Apr. 8,1991, at 3. *But* see LORE, *supra* note *20,* at 1-3, 2-42 (the earliest commercial mortgage-backed securities issuances took place in the private market but subsequently the market saw a series of public transactions involving pools of smaller commercial mortgages).

securities had been publicly **issued.**[38] One observer has estimated that the volume of non-mortgage asset-backed public issuances in 1991 totalled approximately $50.8 billion, up from a $10 billion total in 1986.[39]

FIGURE 1-3
Non-Mortgage Asset-Backed Securities issued in the United States 1986-1991



Source: Dean Witter Reynolds, Inc.
Asset-Backed Securities Reference Guide
Year Ended 1991

[38]DEAN WITTER **REYNOLDS,** INC., ASSET-BACKED SECURITIES REFERENCE **GUIDE** A-22 (Year Ended 1991) [hereinafter DEAN WITTER]. This figure is still dwarfed by the aggregate amount of mortgages securitized, which was estimated as of September 30,1991 to have amounted to $1.2 trillion. See supra note 16 and accompanying text.

[39]*Id.* at A-10. But see *IDD* 1992 ***Figures,*** supra note **4**, at 22 (reporting $46.6 billion of asset-backed securities issued in 1991).

Securities backed by automobile loans and credit card receivables represent approximately eighty percent of the public non-mortgage asset-backed market and also constitute by far the two largest segments of that market.[40] In 1991, securities backed by credit card accounts receivable represented approximately forty-three percent of the non-mortgage asset-backed securities issuances.[41] Other assets presently being securitized publicly include home equity loans,[42] boat loans, computer leases, airplane leases, mobile home and recreational vehicle loans, vacation timeshares, hospital accounts receivable, Small Business Administration loans,[43] and industrial development bonds backed by different types of assets, including equipment leases.[44]

[40]As of year-end 1991, securities backed by credit card receivables and automobile loans together amounted to $129.4 billion out of $158.3 billion total asset-backed securities original issuance. DEAN WITTER, *supra* note 38, at A-16. Financings backed by automobile loans were among the first non-mortgage structured financings publicly offered, and, until recently, represented the largest segment of the public market. *Id.* at A-17. By year-end 1991, financings backed by credit card receivables had surpassed automobile loan transactions in market share of outstanding securities. *Id.* at A-16.

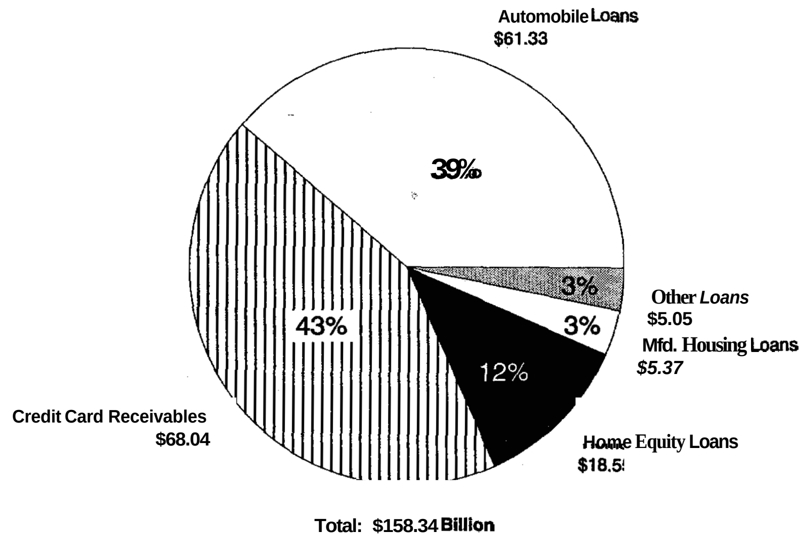
[41]*Id.* at A-16. In 1991, credit card receivables backed the issuance of $21.6 billion out of a total issuance of $50.8 billion in non-mortgage asset-backed securities. *Id.* at A-1.

[42]Technically, home equity loans are mortgage products. Nevertheless, because home equity loans have many of the same characteristics as credit card receivables, structured financings backed by these loans are considered by many to be part of the non-mortgage asset-backed market.

[43]The Small Business Secondary Market Improvements Act of 1984 (Pub. L. No. 98-352, 98 Stat. 329 (1984) (codified at 15 U.S.C. §§ 633-634, 639)), authorized the Small Business Administration ("SBA") to establish a program for securitizing SBA loans. SBA also acts as a guarantor of such securities packaged by the private sector. For a more detailed discussion of such securities, see CHRISTINE A. PAVEL, SECURITIZATION 152-155 (1989).

[44]*See* DEAN WITTER, *supra* note 38, *passim.*

FIGURE 1-4
Total Issuance of Non-Mortgage Asset-Backed Securities by Collateral Type



Source: Dean Witter Reynolds, Inc.
Asset-Backed Securities Reference Guide
Year Ended 1991

Most of the assets that have been securitized have homogeneous characteristics, including similar terms, structures, and credit characteristics.[45] The assets tend to have payment streams with proven histories of performance, which in turn make future payments reasonably predictable. These characteristics facilitate analysis of the credit risks.

Other types of assets lack the homogeneity necessary for easy credit risk analysis and therefore are just beginning to be securitized. For example, non-performing loans, middle market loans, and other types of commercial loans are in the beginning stages of securitization.[46] The obstacles associated with

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[45]PAVEL, supra note 43, at 17-20.

[46]*Id.* See also Christopher L. Snyder, Jr., Securitizing Middle Market *Loans* in THE ASSET SECURITIZATION HANDBOOK 440-476 (Phillip Zweig ed., 1989) [hereinafter THE ASSET SECURITIZATION HANDBOOK]. But see Jean-Louis LeLogeais and Don Kerr, Applying the Strategic View to Asset *Securitization* Decisions, AM. BANKER (Special Adv. Supp.), May 30,1989, at 4A to 5A. (Securitization is prohibitively expensive for banks whose asset mix is concentrated in the middle market with its relatively higher spreads and returns; this is true because of the nonuniform nature of business risks and the inherent inability to pool loans effectively.)

securitizing these assets include the lack of reliable data on losses, uniform underwriting and collection standards, standardized documentation, and similar loan balances. In addition, the transaction must be structured so that credit risk analysis can be accomplished without loan-by-loan review.[47]

A number of non-mortgage, asset-backed securities have been privately placed. Although some of these securities are similar to those sold publicly,[48] many private placements involve types of structured financings that have never been publicly offered in the United States, in part because of the Investment Company Act. For example, financings backed by high yield bonds ("collateralized bond obligations" or "CBOs"), installment loans, future royalties, and Medicare and Medicaid receivables have all been issued in private placements, but have never been sold publicly in the United States.

B. Sponsors of Structured Financings

With the exception of the federal government and federally sponsored entities, the most active sponsors of structured financings are commercial banks and savings and loans. In 1988, the last year the private sector was relatively active in the residential mortgage-backed securities market, the major issuers were savings and loans, responsible for half of private sector mortgage-backed issuances, and commercial banks, responsible for fourteen percent of such issuances in 1988.[49] Other active sponsors of residential mortgage-backed securities in 1988 included investment banks (twenty-four percent), insurance

[47] *See* Peter Haidorfer, Assessing Consumer Debt Risk is Vital *for* Credit Enhancers, AM. BANKER (Special Adv. Supp.), May 30, 1989, at 10A to 11A.

[48] Some of the first sales of assets now commonly securitized and sold publicly were initially sold in private placements. For example, the first structured financing backed by credit card receivables was placed privately in March 1986, with the first public transaction occurring in 1987. See PAVEL, supra note 43, at 109.

[49] LORE, supra note 20, at 2-38 to 2-39.

companies (eight percent), and conduits[50] (four percent).[51] Although these types of entities continue to sponsor mortgage-backed securities, since 1989 their volume and market share have dropped considerably with the increase in the strength of the agency programs.[52]

In the non-mortgage market, as of year-end 1991, commercial banks had originated approximately 45.6% of total issuances.[53] Other sponsors included auto manufacturers (28.0%), retailers (7.1%), and savings and loans (5.5%).[54]

From a sponsor's perspective, there are sound reasons to securitize assets.[55] The sponsor may be better able to manage its loan portfolio, and, in turn, its balance sheet: asset securitization permits a sponsor to convert financial assets into cash, which can be used to retire debt or acquire new receivables. Asset securitization can increase the liquidity of a loan portfolio, permitting a sponsor to select the financial assets it wishes to keep, and to sell the assets it does not want. Asset securitization also permits a sponsor to reduce its interest rate risk resulting from its funding fixed-rate, long-term assets with floating rate and/or short-term liabilities, a particularly attractive option in times of volatile interest rates.[56] Alternatively, by selling portions of portfolios concentrated in

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[50] A mortgage conduit is an organization that purchases mortgages, packages the mortgages into pools, and sells the mortgages through the capital markets. For information on the evolution of conduits, see BARTLETT, *supra* note **23,** at **9-11.**

[51] LORE, *supra* note **20,** at **2-38** to **2-39.**

[52] *See supra* notes **30-36** and accompanying text. *See* also LORE, *supra* note **20,** at **2-38.**

[53] DEAN WITTER, *supra* note **38,** at **A-26.**

[54] *Id.*

[55] Originators that sell assets to a financial intermediary, such as a conduit, that in turn sponsors a structured financing backed by the assets, receive many of the same benefits as originators that sponsor a financing. Originators may choose to sell to these intermediaries if they do not hold enough assets to make sponsorship economical.

[56] *See, e.g.*, Thomas R. Boemio & Gerald A. Edwards, Jr., *Asset Securitization: A Supervising Perspective,* **75 FED. RES. BULL. 659,663 (1989);** BRYAN, *supra* note **3,** at **85;** ROSENTHAL, *supra* note 2, at 10-13. Savings and loans, for example, securitized portions of their mortgage portfolios in part to address risks of rising interest rates. Mortgage loans traditionally had maturities of 30 years and had fixed interest rates. By contrast, **65%** of a typical savings and loan's liabilities are time and savings deposits that mature in less than one year. *See* Pittman, *supra* note 15, at **501.** In response to increasing competition from national residential mortgage originators, savings and (continued...)

a single industry or geographic area, for example, a sponsor may use structured financings to diversify its credit risk.[57]

By being better able to manage its loan portfolio, a sponsor also can strengthen its financial condition. Removing certain assets from the balance sheet can boost the return on assets and on equity. If the transaction is considered to be a sale of assets, income recognition may be accelerated by permitting the sponsor to realize a gain (or loss) upon sale?' Income may also be recognized from previously deferred loan fees.

Structured financings also allow sponsors to gain access to alternative funding sources.[59] Some sponsors, particularly those that enter the capital markets frequently, find it useful to be able to offer new instruments. In addition, structured financings allow sponsors to broaden their investor base.[60]

Structured financings also provide sponsors with access to funding sources that, depending on the sponsor's credit rating, may be less expensive and more feasible than traditional sources.[61] Because securitized assets usually are no longer assets of the sponsor, the structured financing may be rated independently of the sponsor's rating. Sponsors find structured financings particularly beneficial during economic downturns when there frequently is widespread downgrading of corporate credit, making the issuance of corporate debt or equity through the markets less attractive.[62]

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[56](...continued)
loans also have used structured financing to lower their costs of funding and to sell off assets with inadequate spreads. *Innovations in Thrift Financing: Opportunity and Risk,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1987, at 3.

[57]*See, e.g.,* BRYAN, *supra* note 3, at 82-83; Boemio & Edwards, *supra* note 56, at 663; ROSENTHAL, *supra* note 2, at 9-10; Wittebort, *supra* note 36, at 78.

[58]Boemio and Edwards, *supra* note 56, at 663.

[59]*See, e.g.,* BRYAN, *supra* note 3, at 84.

[60]*See, e.g.,* Wittebort, supra note 36, at 78.

[61]*See, e.g.,* BRYAN, *supra* note 3, at 81-82, 124.

[62]*See* Richard Benson, *Recession and Credit Crunch Will Spur Asset Securitization,* MORTGAGE-BACKED SEC. LETTER, Nov. 12,1990, at 8.

Banks have been particularly active in using structured financings.[63] This activity can be traced in part to the severe financial pressures in the United States banking industry. Bank credit quality steadily declined throughout the 1980's, with a considerable acceleration of this decrease occurring within the last few years as a result of deterioration of real estate assets and loans to highly leveraged borrowers.[64] The deteriorating quality of bank assets has resulted in a significant number of downgrades of the credit ratings of United States banks.[65]

In some cases, structured financings may provide regulatory benefits for banks, savings and loans, and other regulated entities, by enabling them to meet their reserve and capital requirements. For example, banking and thrift regulatory a encies have adopted "risk-based" capital requirements for depository institutions4 The risk-based capital requirements for banks assign assets and credit equivalent amounts of off-balance sheet items to risk categories, depending on each asset's level of credit risk.[67] The level of capital that a bank must maintain depends on the level of risk -- or "risk weight" -- assigned to that bank's assets. Many banks have had to increase their capital ratios to meet these requirements, but, because of market concerns about their creditworthiness, have

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[63] *See, e.g.,* Boemio & Edwards, *supra* note **56,** at **662.**

[64] Andrew Freeman, *Credit Downgrades on* US *Banks Predominate amid Asset Worries,* FIN. TIMES, Aug. 16, **1990,** at **19.** *See also Bank Profitability in the 1990's,* FITCH RESEARCH FINANCIAL INSTITUTIONS (Special Report), Dec. **20, 1991,** at **2.**

[65] *See Pressures on U.S. Bank Ratings,* Presentation by Christopher T. Mahoney, Vice President/Associate Director, Financial Institutions Group, Moody's Investor's Service, to the American Bankers Association CFO Forum, New York, September **11, 1990** in MOODY'S STRUCTURED FINANCE RESEARCH AND COMMENTARY, Oct. **1990,** at **9.** *See also U.S. Money Center Banks,* MOODY'S INDUSTRY OUTLOOK, Aug. **1990,** at **4.**

[66] Risk-based capital requirements are set forth at **12** C.F.R. pt. **3,** App. A (for national **banks); 12** C.F.R. pt. **208,** App. A (for state member banks insured by the Federal Deposit Insurance Corporation ("FDIC")); **12** C.F.R. pt. **225,** App. A (for bank holding companies); **12** C.F.R. pt. **325,** App. **A** (for FDIC-insured state non-member banks); and **12** C.F.R. pt. **567** (for savings associations). For **a** general discussion of risk-based capital requirements, see, *e.g.,* Michael G. Capatides, et **al.,** *Bank and Savings and Loan Association Regulatory Considerations,* in **2** SECURITIZATION OF FINANCIAL ASSETS, *supra* note **21, § 12.03** at **12-19** to **12-38;** FRANKEL, *supra* note **3,** § 7.14, at 224-234.

[67] For example, most securities issued or unconditionally guaranteed by United States government agencies are assigned **a** zero percent risk weight. **12** C.F.R. pt. **3,** App. A, § 3(a)(1)**(iii)** & (iv). An example of **a** high risk **(100%** risk weight) asset is stripped mortgage-backed securities **(12** C.F.R. pt. **3,** App. A, § 3(a)).

had difficulties raising the necessary capital.[68] To meet their capital needs, many banks have sponsored structured financings, either by securitizing assets, such as credit-card receivables, or, less frequently, by setting up "bad banks" whereby non-performing loans are sold to newly created entities chartered as banks, whose primary function is to liquidate these assets. Structured financings have enabled banks to meet risk-based capital requirements by securitizing "higher risk-weighted assets" and either taking the sale proceeds and purchasing "lower risk-weighted risk assets" (which require less capital), or keeping the proceeds in cash or other liquid assets.

Even without higher capital requirements, structured financings may be very attractive for banks.[69] In addition to obtaining capital by selling their assets through structured financings, banks may also obtain funding by retaining the servicing rights to those assets and retaining a possibly economically valuable residual interest.[70] Also, structured financings can benefit banks by increasing the liquidity of their loan portfolios.[71]

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[68] For a discussion of the use of securitization by banks and bank holding companies to manage their risk-based capital and capital adequacy requirements, see Boemio and Edwards, supra note **56,** at **664-669.**

[69] It has been argued that even a bank with a AAA rating would benefit in terms of capital cost savings by securitizing those high-quality assets for which regulatory capital requirements overestimate actual expected credit losses. See BRYAN, *supra* note 3, at 83.

[70] For a discussion of residual interests, see infra notes 143-145 and accompanying text. By retaining the servicing rights to the assets, banks may continue existing lending relationships with their customers even though the original loans are no longer on their balance sheets.

[71] The advantages of increased liquidity are discussed supra notes 55-56. Some observers believe that structured financings could lead to a more stable and less costly financial system. See ROSENTHAL **& OCAMPO,** *supra* note **2,** at 13-17, **21.** See *also* **PAVEL,** *supra* note **43,** at **227-229** (suggesting a variety of scenarios in which securitization would help to make the banking system more efficient). Others have suggested that the technology of structured financing could be used to help restructure the banking industry. One observer has written that the technology of structured financing would enable the banking industry to separate the depositing and lending functions of a bank and permit banks to establish separate businesses around the functions that it is the most capable of delivering at the best price. This would address what the observer believes is one of the fundamental flaws of the present banking system, the cross-subsidy of deposits and loans, and promote a competitive banking environment, with only the depository institutions being protected by a federal guarantee. BRYAN, *supra* note 3, at vii-x, 92-98, and **passim.**

C. Purchasers of Structured Financings

1. Institutional Investors

Institutional investors, including banks, savings and loans, pension funds, insurance companies, and mone managers have been the predominant purchasers of asset-backed issues?' These investors find asset-backed securities attractive for several reasons. First, institutional investors generally consider most asset-backed securities to be relatively safe investments because such securities generally are highly rated by one or more rating agencies.[73] Also, in many instances, institutional investors conduct their own due diligence review prior to investing.[74] Second, the securities typically offer returns that are higher than those of United States Treasury securities with comparable maturities.[75] Third, some asset-backed securities, such as certain mortgage-backed securities, are relatively liquid, enabling the investors to resell the securities to meet changed portfolio objectives or new liquidity needs. Fourth, most agency securities and

[72]ROSENTHAL & OCAMPO, *supra* note 2, at **13;** LORE, *supra* note **20,** at **2-48.** *See also* Boemio and Edwards, *supra* note **56,** at **663.** Until recently, savings and loans were the largest holders of mortgage-backed securities. Their share of this market has **shrunk,** in part, because undercapitalized savings and loans must sell substantial amounts of assets. KENNETH G. LORE, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MARKET **2-53** (1990-91 ed.). *See also* LORE, *supra* note **20,** at **2-38.** Banks and insurance companies have taken up some of the slack; one observer has reported that insurance companies presently hold approximately one-third of the mortgage-backed securities market. *IDD* 1991 *Figures, supra* note **4,** at **22.** *See also* Phil Roosevelt, *Banks Halt Their Binge in Mortgage Securities,* AM. BANKER, May 8,1990, at **1;** *Bank Profitability in the 1990's, supra* note **64,** at **2/12.** Banks and insurance companies also have been active in purchasing non-mortgage asset-backed securities. Although at first blush it may Seem ironic that the sponsors of structured financings are among the most active purchasers, asset securitization may allow institutions to diversify their assets. *Boemio and Edwards, supra* note **56,** at **663.** For example, a Californian bank may find it desirable to securitize mortgages on properties on the West Coast and use the proceeds to buy CMOs backed by mortgages on East Coast properties.

[73]Boemio and Edwards, *supra* note **56,** at **663;** ROSENTHAL AND OCAMPO, *supra* note **2,** at **13.**

[74]In some cases, particularly for private placements, institutional investors are involved in structuring the financing.

[75]Wittebort, *supra* note **36,** at **79** (according to Sears, "spreads over five-year Treasuries for credit card issues now run roughly **30** basis points below an index of single- and double-A corporate debt issues, versus about **40** basis points above the index in **1988. . .**"). *See also Boemio & Edwards, supra* note **56,** at **663.**

CMOs backed by agency securities have low risk weightings under depository institution capital requirements.[76]

In addition to the highly rated fixed income securities that are the predominant type of securities offered, many structured financings include other securities that are riskier such as stripped securities and residual interests. Some institutional investors find these securities attractive because they often have higher yields than the highly rated fixed income securities. In addition, institutional investors find that certain of these securities may be useful for hedging.[77]

2. The Retail Market

Although institutional investors are the predominant purchasers of structured financings, there is also a retail market in these securities. Some residential mortgage market products have been specifically targeted to retail investors. For example, since 1985, many CMOs and other multiclass mortgage-backed securities have been structured to include classes that are designed for the retail investor, with minimum denominations as low as $1000.[78]

There are fewer retail transactions in the non-mortgage asset-backed market. In 1990, approximately $1 billion of these securities were sold to individual investors, a seventy-six percent increase from 1989.[79] All were backed by credit card receivables originated by Sears Credit Account Trust or Standard Credit Card Trust.[80] Securities targeted for the retail market typically

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[76] *See supra* note 67.

[77] In 1990, banks and savings and loans became less active in purchasing some of these securities, possibly in anticipation of regulatory changes. *See Banks Halt Their Binge in Mortgage Securities, supra* note 72; *IDD* 1991 *Figures, supu* note 4, at 22. For further discussion of these securities and the proposed regulatory changes, see *infra* notes 132-138 and accompanying text.

[78] One observer has estimated that thus far, individual investors have accounted for approximately five percent of all REMIC sales. Richard Chang, *Promising Year for Mortgage Backeds,* AM. BANKER, Jan. 6, 1992, at 20.

[79] DEAN WITTER REYNOLDS, INC., ASSET-BACKED SECURITIES REFERENCE GUIDE A-1, (Jan. 1991) [hereinafter DEAN WITTER].

[80] *See* DEAN WITTER, supra note 38, at A-18.

have been rated **AAA** and sold in denominations as low as $1000.[81] In 1991, no non-mortgage offerings were specifically targeted for retail investors.[82]

Retail investors find structured financing securities attractive because of their high ratings and because their yields are higher than those of comparable Treasuries[83] (although their yields usually are not as high as the yields on comparable structured financings sold on the institutional market).[84] Sponsors sell to retail investors to diversify and expand their investor base, as well as to ensure a liquid secondary market for their securities. Selling to the retail market is very labor intensive, however, and thus underwriting fees for structured financings directed to the retail market may be more expensive than for structured financings targeted for institutions.

3. The International Market

A significant number of structured financings sponsored by United States institutions are sold abroad. International issues have been structured both as unregistered Eurobonds in bearer form and as registered securities in the country or countries where the offering is sold. In addition, they have been sold overseas to both institutional and retail investors.

United States sponsors of structured financings have targeted the international market for a variety of reasons. Some have sold their issues overseas because their large portfolios need broad distribution. Others have gone overseas to avoid compliance with the Investment Company Act.

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[81]For example, "through its Dean Witter Reynolds subsidiary, [Sears] has sold $1 billion in asset-backed securities to the retail market in denominations as low as $1,000." Wittebort, *supra* note 36, at **79.**

[82]DEAN WITTER, *supra* note **38,** at A-18.

[83]In addition, one investment columnist has suggested that investors who desire more yield than that available from the average money market fund or certificate of deposit should investigate asset-backed securities. See James E. Lebherz, Asset-Backed Securities Can Be *Higher-Yield* Investment, WASH. POST, June **30,1991,** at **H9.**

[84]DEAN WITTER, *supra* note 38, at A-18. For example, spreads on credit card asset-backed securities issued on the institutional market from January **1,1989** to December **30,1991,** averaged approximately **83** basis points, while the spreads on similar asset-backed securities sold to retail investors averaged **46** basis points. Id.

Although many offerings have been structured and sold directly in the international market, several sponsors have recently conducted "global" offerings, in which offerings are conducted simultaneously in the United States and abroad.[85] Global offerings provide a larger market for distribution and promote liquidity for sales on the secondary market.[86]

International investors find asset-backed securities attractive investments for many of the same reasons that domestic investors find them attractive. International investors, like domestic investors, are attracted to these securities, typically high ratings and view them as an alternative to corporate debt securities, which, in uncertain economic times, are less desirable investments.[87] Many international investors consider asset-backed securities "cheap investments" because they have higher yields than other, similarly rated debt.[88]

Notwithstanding the fact that a significant number of United States sponsors are selling structured finance offerings abroad, international offerings have not been entirely successful. For many global offerings, a majority of the securities are ultimately placed in the United States.[89] Because structured financings are still in their infancy abroad, international investors must be educated as to the merits of these securities, particularly in light of their unfamiliar structure. This is particularly true for global offerings which must be

[85]For example, 17 issues of non-mortgage asset-backed securities were sold in global offerings in 1991, more than double the number offered in all of 1990. DEAN WITTER, *supra* note 38, at A-1; DEAN WITTER, *supra* note 79, at A-1.

[86]In 1990, two Eurobond settlement agencies, Cedel S.A. and Euroclear System, began handling Citicorp-sponsored credit card structured financings, thereby linking international clearinghouse systems and permitting local clearance. *See* Michael R. Sesit, *Citicorp Forges "Global Bonds" with Credit-Card Link*, WALL ST. J., Aug. 30, 1990, at C1, C8.

[87]*See* Tracy Corrigan, *Asset-Backed Securities Make Their Mark on Europe*, FIN. TIMES, June 25, 1990, at I24.

[88]*See* Sesit, *supra* note 86, at C8.

[89]*See, e.g.*, Tracy Corrigan, *Europe Grows Cautious of Credit Card-Backed Issues*, FIN. TIMES, June 21, 1990, at 22 (dealers report stronger demand in United States than in international markets for latest issues of bonds backed by credit-card receivables); Corrigan, *supra* note 87 ("asset-backed securities market remains substantially US-based, in terms of both issuers and investors"); *Citicorp Deal Well Received but Retail Holders Want Out*, THOMSON'S GLOBAL ASSET BACKED MONITOR, Aug. 31, 1990, at 1, 2. Foreign investors bought 48% and 45% respectively of Citicorp's first two global credit card offerings. *See* Sesit, *supra* note 86, at C8.

structured to be attractive to both United States and foreign investors. For example, the limited European participation in one global offering was attributed in part to the fact that the payment schedule for the arrangement which, while typical for securities issued in the United States, was unfamiliar to European investors?'

D. Expectations for the Future

The future of structured financings is subject to some debate. Proponents have argued that this type of financing will become and remain in the long term as prevalent a financing technique as equity, conventional debt, or bank loans,[91] but others disagree.[92]

Most commenters, however, believe that, at least in the short term, structured financings will continue to have a large presence in the United States capital markets. One observer has predicted that 1992 will be a record-setting

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[90]The arrangement required coupons to be paid monthly, and the redemption of the principal to be spread out over the last year of the issue's life. *See* Tracy Corrigan, *MBNA America Bank in Asset-Backed Loan Debut,* FIN. TIMES, Nov. **2,1990,** at **130.**

The difficulty in selling structured financings abroad is illustrated by the recent problems in the credit card backed securities market. Overseas issuances of financings backed by United States generated credit card receivables were virtually nonexistent in late **1990** and early **1991.** This was due, in part to the rise in default rates on credit card receivables increasing the possibility of accelerated payments to investors, which caused anxiety among foreign investors that were unfamiliar with the concept of prepayment risk. As a result of this concern, sponsors have structured recent transactions to reduce the chance of prepayment. *See* Sears *Taps International Bond Markets with $750M of Card-Backed Securities,* THOMSON'S GLOBAL ASSET BACKED MONITOR, Apr. **12,1991,** at 3; Patrick Harverson, *Back* to *Normal* **After** *Scares over Prepayment Risk,* FIN. TIMES; Jun. **19, 1991,** at § III, p. III.

[91]*See* ROSENTHAL & OCAMPO, *supra* note **2,** at **221-22;** John B. Caovette, As *the Capital Markets Unbundle What Will the Future Bring?,* THOMSON'S GLOBAL ASSET BACKED MONITOR, **Aug. 17,1990,** at **6;** *Wittebort,supra* note **36,** at 80. One observer has predicted that within the next 10 to 15 years, **60%** to 80%, or more, of all new loans may be securitized. BRYAN, *supa* note **3,** at 81.

[92]*See, e.g.,* LeLogeais & Kerr, *supra* note **46.** These observers argue that the need to securitize may not necessarily be as important in the future as it is today. They also assert that not all assets can be securitized because of their lack of uniformity, an assertion echoed by Rosenthal and Ocampo. Rosenthal and Ocampo acknowledge that some commenters believe that the recent growth of structured financings is only a "temporary exploitation of certain regulatory loopholes," although they conclude that securitization is not simply regulatory arbitrage. ROSENTHAL & OCAMPO, *supra* note **2,** at 5.

year for mortgage-backed securities, as low-interest rates prompt large increases in refinancings and initial loan originations.[93] The non-mortgage market also should remain strong to the extent that structured financings remain the best funding techniques for car companies and banks.[94]

In addition, some observers believe that more sponsors -- both financial and non-financial institutions -- will become interested in asset securitization. Such sponsors could seek to issue securities backed by assets that are not presently among those commonly being securitized.[95]

Finally, two federally sponsored entities have recently begun securitization programs. The Resolution Trust Company has begun to securitize more than seventy percent of the assets amassed from failed savings and loans.[96] Of the approximately $67 billion in financial assets that will be used, $57 billion are mortgage loans, $3.2 billion are high yield bonds, and $6.9 billion are consumer loans.[97]

In addition, in mid-1991, the Federal Agricultural Mortgage Corporation ("Farmer Mac"), which administers the secondary market activities for agricultural real estate loans, began issuing securities backed by pools of loans guaranteed by the Farmers Home Administration. In the near future, Farmer Mac intends to offer guarantees for securities backed by agricultural mortgages that are issued by conventional lenders.

111. The Securitization Process

All structured financings share the same basic structure. We outline below the basic components of a typical structured financing and discuss how the

[93]Chang, *supra* note 78.

[94]*IDD* 1991 *Figures, supra* note 4, at 23.

[95]For example, one observer predicted that financings backed by computer and other equipment leases would soon flourish. Wittebort, *supra* note 36, at 80.

[96]Susan Schmidt, *Cleanup Agency to Back Bonds With Thrift Assets,* WASH. POST, Oct. 25, 1990, at El.

[97]*Id.* For additional discussion of the RTC securitization program, see Paulette Thomas, *S&L Liquidators Get $294.5 Million in Junk Bond Sale,* WALL ST. J., Oct. 2, 1991, at B12; Paulette Thomas, *Mortgage-Backed 'Ritzy Maes' Stroll Down the Street with RTC,* WALL ST. J., Jul. 12, 1991, at C1.

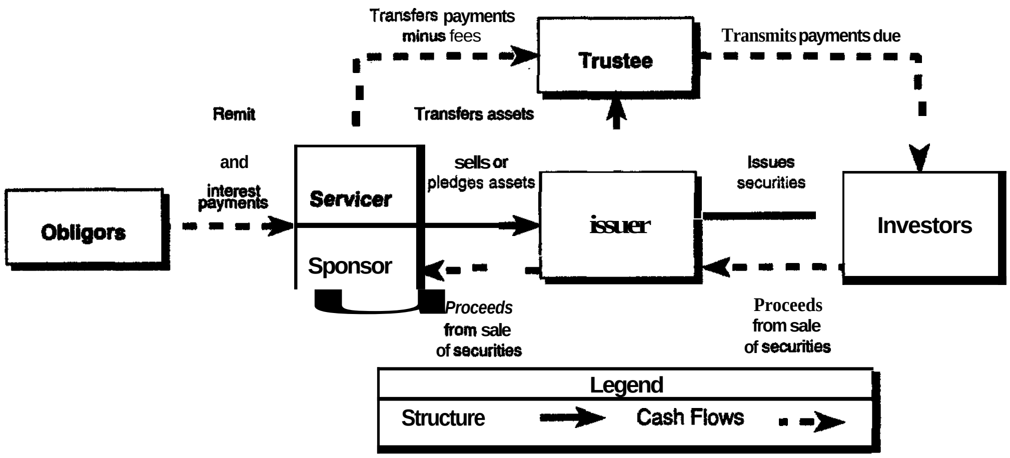
financing works. We also discuss investor protection issues, the role of the rating agencies, and the use of credit enhancement. Finally, we consider the differences between unrated and rated structured financings. Our discussion is necessarily general; there is a wide range of permutations used in practice.

A. The Components of a Structured Financing

1. The Participants

A typical structured financing has four primary participants: the sponsor, who often is the initial owner of the assets; the issuer, who obtains the assets and issues the securities; the servicer, who takes ultimate responsibility for servicing the assets in the pool; and the trustee, who is assigned and holds the assets through the life of the issue and monitors the activities of the servicer.[98] The basic components of a structured financing are shown in Figure 1-5 below.

FIGURE 1-5
Structured Financing Components



[98]Credit enhancers and the rating agencies may also participate in structuring the transaction. Because not all structured financings are rated or contain external credit enhancement, the roles and responsibilities of these parties are discussed separately. For a discussion of credit enhancement see Section III.B.2 *infra.* For a discussion of rating agencies, see Section III.B *infra.* Of course, as in most securities issuances, underwriters and independent auditors are also participants.

A structured financing begins with a pooling and servicing agreement ("P&S agreement") among the sponsor, the trustee, and the servicer. The P&S agreement establishes the issuer and governs the transfer of the assets from the sponsor to the issuer (and ultimately to the trustee). It also sets forth the rights and responsibilities of the participants and typically contains a number of representations, warranties, and covenants about the characteristics of the assets. Finally, the agreement may require that periodic reports be sent to investors, the trustee, and other parties.

Typically, under the P&S agreement, the sponsor transfers a fixed pool of homogeneous assets, which it owns, to the issuer (either directly or through a subsidiary of the sponsor) in return for the proceeds from the sale of securities backed by these assets. In order for the sponsor to remove the assets from its balance sheet and therefore to obtain many of the benefits of asset securitization, the transfer must be a sale for accounting purposes?' Whether the transaction

[99]Under generally accepted accounting principles ("GAAP), a sale occurs when both the risks and rewards of ownership have been transferred to the purchaser. Under GAAP, a sponsor may remove assets from its balance sheet if the sponsor sells the assets without recourse. For many sponsors, a transfer with recourse may still be a sale, provided that the transfer meets the conditions set forth in Statement of Financial Accounting Standards No. 77 ("FAS 77"). FAS 77 generally provides that a transfer of receivables with recourse shall be recognized as a sale if (i) the transferor surrenders control of future economic benefits of the sold receivables, (ii) the transferor cannot be required by the transferee or any other entity to repurchase the receivables except in accordance with the recourse provisions, and (iii) the transferor's recourse obligation can be reasonably estimated. FAS 77 is currently under review **as** part of a re-examination of financial instruments and off-balance sheet accounting.

Historically, banks and savings and loans have generally been subject to regulatory accounting principles **("RAP')**. RAP, like GAAP, has allowed a sponsor to remove assets from its balance sheet if the sponsor sells the assets without recourse. Unlike GAAP, however, RAP generally has required an asset sale with recourse to be treated as a borrowing. The seller must continue to hold the full amount of regulatory capital reserves against the proceeds from the transfer of the assets. There are two relevant exceptions. First, in regard to sales of participations in pools of residential mortgages, the bank may treat the transfer as a sale as long as the bank does not retain any "significant risk of loss," which generally has been viewed as being more than 10% recourse. The other exception pertains to the use of "spread accounts," which are also a type of credit enhancement, discussed *infra* note 232 **and** accompanying text. For more information about the accounting aspects of securitization, *see* Ernest L. Puschaver, ***Accounting*** Issues, ***in 2*** SECURITIZATION OF FINANCIAL ASSETS, ***supra*** note 21, at §§ 18.01-18.04; ROSENTHAL & OCAMPO, ***supra*** note ***2,*** at 65-73; PAVEL, ***supra*** note 43, at 163-181 (Chapter 7, "Accounting for Securitization: GAAP versus **RAP')**.

Recently, section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (continued...)

between the sponsor and the issuer constitutes a sale also is relevant to determining whether the assets transferred and the cash flow therefrom could be used to pay the sponsor's creditors should the sponsor become insolvent. (What constitutes a sale for bankruptcy purposes may differ from what constitutes a sale for accounting purposes.)

The issuer is typically a special purpose entity whose only business activity is to acquire and hold the assets, and issue securities backed by the assets. Because the issuer has no significant facilities or employees, its duties are contracted out to other parties, primarily the servicer.[100]

The form of organization of the issuer generally depends on tax considerations and the desired payment structure of the financing.[101] There are two basic types of payment structures that are used: pass-through and pay-through.[102] In a pass-through structure, the issuer typically is a grantor trust.[103] A grantor trust essentially is a trust that acts as a conduit for the

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[99](...continued)
(Pub. L. **102-242, 105** Stat. **2236, 2250-51** (Dec. **19, 1991),** codified at **12** U.S.C. § 1831n) amended the Federal Deposit Insurance Act to require that financial statements submitted to federal banking agencies be prepared in accordance with GAAP, unless an agency determines that a particular GAAP principle is inconsistent with certain stated objectives, in which case the agency may prescribe **an** accounting principle no less stringent than GAAP.

[100]2 FRANKEL, *supra* note **3, § 14.1,** at **80-81;** The *Importance of the Role of the Servicer in Securitized Transactions,* MOODY'S STRUCTURED *FINANCE* RESEARCH & COMMENTARY, Apr. **1990,** at **12** [hereinafter The *Servicer in Securitized Transactions].*

[101]The form of organization of an issuer holding mortgagerelated assets need not affect the payment structure of the financing if the issuer elects REMIC status. *See infra* note **149** and accompanying text.

[102]For a general discussion of these structures and the attendant tax issues, see, *e.g.*, William A. Schmalzl et al., Tax *Issues, in* **1** SECURITIZATION OF FINANCIAL ASSETS, *supra* note **21, §§ 9.01-9.06;** Charles M. Adelman & Roger D. Lorence, Tax *Considerations,* THE ASSET SECURITIZATION **HANDBOOK**, *supra* note **46,** at **298-334;** ROSENTHAL & OCAMPO, *supra* note 2, at **48-63.**

[103]ROSENTHAL & OCAMPO, *supra* note **2,** at **49.** Although securitizations of credit card receivables use trusts that issue certificates and often are characterized as pass-through *(see* DEAN WITTER, *supra* note 38, at **B-37** to **B-43** (characterizing Sears Credit Card Account Trusts as pass-through)), the structure of this type of financing generally prevents the issuer from qualifymg as a grantor trust for **tax** purposes. See Jason H.P. Kravitt, A *Brief Summary of Structures Utilized in the Securitization of Financial Assets, in* **1** SECURITIZATION OF FINANCIAL ASSETS, supra note 21, § **4.03[C], at 4-39.**

outright sale of assets to the investors. Investors purchase certificates representing a fractional undivided interest in the trust and are entitled to a pro rata share of the cash flows from the assets.[104] To be considered a grantor trust for tax purposes, the trust must be passive. Thus, this structure generally requires that the pool remain fixed, except for limited substitutions to replace "defective" assets, and does not allow for management of cash flows.[105]

In a pay-through structure, the issuer typically is a special purpose corporation or an owner trust.[106] Most of the securities issued are structured as debt, permitting deduction of interest payments which offsets the income received on the assets. Issuers structured in this manner need not be subject to the constraints imposed by the grantor trust tax classification. Thus, payments to investors need not be tied to the incoming cash flows from the underlying assets, but rather may be structured to permit the creation of classes of securities with different payment schedules that are tailored to investor demand.[107]

The servicer is the primary administrator of the financing. Often the sponsor or an affiliate of the sponsor is the servicer.[108] In other financings, the

[104] The certificates are considered to be equity (1 FRANKEL, supru note 3, § 8.2, at 289), although in many respects they have debt-like characteristics. One drawback of these securities, from a marketing standpoint, is that investors are subject to greater prepayment risk. ROSENTHAL & OCAMPO, supru note 2, at 53. For a discussion of the characteristics of these securities, see *infra* note 128 and accompanying text.

[105] The trust must be passive to avoid being classified as an association, which would be taxable as a corporation. Such a characterization could have adverse tax consequences because the interest income to the trust from the assets would be taxable while the payments from the trust to the investors would be nondeductible distributions. Consequently, the trust would have a substantial tax liability, and investors would receive yields substantially less than anticipated. ROSENTHAL & OCAMPO, *supru* note 2, at 51.

[106] *Id.* at 54.

[107] *Id.* at 55.

[108] *See Credit Curd Deals Aren't Equal*, FITCH STRUCTURED FINANCE (Special Report), Apr. 10, 1990, at 5. If the sponsor is the servicer, the sponsor typically agrees that, in servicing the accounts, it will impose the same terms as those it imposes with respect to its own portfolio of accounts. In some mortgage transactions, where the sponsor is a conduit, each originator of the mortgages in the pool may act as a "subservicer," and perform many of the functions that the servicer would perform, but only for the mortgages it originates. A "master servicer" is responsible for overseeing the subservicers and tracking the funds from subservicers to investors. See STANDARD & POOR'S CORPORATION, S&P'S STRUCTURED FINANCE CRITERIA 98 (1988) [hereinafter S&P'S STRUCTURED FINANCE CRITERIA].

servicing function is carried out by a third party that may not necessarily be in the business of generating the type of assets that it is servicing.

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.[109] The servicer's specific obligations depend on the transaction and the assets involved. Generally, the servicer is responsible for collecting on delinquent accounts.[110] The servicer may commingle collections on the assets with its own funds until payment to investors, may remit the collections to the trustee, or maintain the funds in custodial accounts.[111] The servicer may also reinvest idle cash in short-term investments when there is a timing mismatch between the collections and distributions to investors.[112]

In addition, the servicer oversees the substitution of assets as permitted by the P&S agreement. For example, the agreement may permit the substitution of assets that are determined not to meet specified eligibility criteria. A servicer also may monitor tax and insurance payments, maintain escrow accounts, advance funds to provide liquidity to cover loans in arrears, maintain all relevant documentation, and administer other day-to-day operations of the issuer.[113]

The trustee is appointed to monitor the issuer's obligation to investors. Generally, publicly issued structured financings that issue debt are subject to the Trust Indenture Act.[114] The Trust Indenture Act sets forth requirements

[109] *See* 2 FRANKEL, *supra* note 3, § 14.8, at 91.

[110] *Id.*

[111] If the credit quality of the servicer is low, some risk is created by the servicer commingling collections. The funds may become subject to claims of the servicer's creditors if the servicer becomes insolvent. See Darrow, et al., *supra* note 21, § 7.02[D][2], at 7-14.

[112] *Id.* at 7-13.

[113] *See* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 24.

[114] Congress amended the Trust Indenture Act in 1990. See Trust Indenture Reform Act of 1990, Pub. L. 101-550, 104 Stat. 2721 (1990), codified at 15 U.S.C. §§ 77ccc-77eee, 77iii-77rrr, and 77vvv (effective November 15, 1990). The 1990 legislation, among other things, removed the prohibition against an otherwise qualified trustee that has one of the statutorily specified relationships with the obligor on the indentured securities (formerly "conflicts of interest") from serving as trustee provided that there is no default. The legislation also expressly incorporated provisions previously required to be specifically placed in the trust indenture, and gave the Commission exemptive authority.

regarding, among other things, the eligibility and qualifications of trustees,[115] 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.

The Trust Indenture Act applies only to financings that issue debt. Because pass-through certificates are regarded as equity, transactions issuing such securities are not subject to that Act. As a practical matter, however, the structures of many such transactions are similar to transactions that are subject to the Trust Indenture Act.[116] , Similarly, although private placements are exempt from the Trust Indenture Act, some of these transactions also are structured in a way that is consistent with that Act's requirements.

In a publicly offered structured financing, the trustee typically is a bank that is not affiliated with the sponsor or any other parties to the transaction.[117] only a few entities currently are in the business of acting as trustees in structured financings.

[115] Generally, the Trust Indenture Act requires the appointment of one or more trustees, at least one of which is a corporation organized under the laws of the United States or a state (or organized under the laws of a foreign government as permitted by the Commission), with a minimum combined capital and surplus of $150,000. 15 U.S.C. § 77jjj (a) (1)& (2). The Trust Indenture Act prohibits an obligor or its affiliate from serving as trustee for indentured securities offered by the obligor. 15 U.S.C. § 77jjj(a)(5). Also, if a trustee has or becomes subject to a conflicting interest, the trustee must resign or remove the conflict. 15 U.S.C. § 77jjj(b). A conflicting interest generally arises if the indentured securities are in default and the trustee has one of the relationships with the obligor set forth in section 310(b) of the Trust Indenture Act. 15 U.S.C. § 77jjj(b).

" See LORE, *supra* note 20, at 4-49.

[117] Because the Trust Indenture Act prohibits the obligor or its affiliates from serving as trustee, neither a sponsor of a structured financing that falls within that Act, its affiliates, nor a credit enhancer (which meets the definition of obligor under Section 303(12) of that Act) may act as trustee. The Trust Indenture Reform Act of 1990, *supra* note 114, amended the Trust Indenture Act to provide that an underwriter may act as trustee so long as there is no default. See 15 U.S.C. § 77jjj(b)(2).

Generally, the trustee is assigned and holds the underlying assets (or documentation of interest in the assets) in accounts designated for each structured financing for the benefit of investors. The trustee also receives payments from the servicer and any credit enhancers, and remits them to investors.[118] The trustee also may reinvest the funds on a short-term basis prior to payment.[119] In addition, the trustee reviews the activities of the servicer, in part by receiving periodic reports from the servicer on payments and future projections. The trustee may be expected to calculate the payments and future cash flow projections if the servicer fails to perform this duty.[120] Similarly, if the servicer becomes insolvent or withdraws, the trustee may act as interim servicer until another servicer has been appointed. Finally, the trustee may act to represent the interests of investors if there is a default.[121]

2. The Securities Issued

Almost all issuers, whether using a pass-through or pay-through structure, offer fixed-income securities (*i.e.,* securities that are either debt obligations or that have debt-like characteristics).[122] The securities typically entitle the holder or owner to a specified principal amount at maturity and bear interest based on the principal amount at a fixed rate, a floating rate determined periodically by reference to an index, or a rate determined through periodic auctions among investors or prospective investors, or through the periodic remarketing of the instrument.[123] The interest rate also may be determined by reference to

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[118] Asset Finance Group, The First Boston Corp., *Overview of Assets and Structures, in* THE ASSET SECURITIZATION HANDBOOK, *supra* note **46,** at **35-36.**

[119] E. Kay Liederman, *The Role of the Trustee in Securitization,* AM. BANKER (Special Adv. Supp.), Dec. 17,1991, at 13A.

[120] *See* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at **24.**

[121] For a more detailed discussion of the role of the trustee, see Liederman, *supra* note 119.

[122] The traditional distinction between debt and equity is somewhat blurred in the context of structured finance. For further discussion, see 1 FRANKEL, *supra* note 3, § 8.9 at 301.

[123] A few issuers, mainly finance subsidiaries of thrift institutions and corporations, have offered asset-backed auction rate preferred stock. *See* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 51. *See also* 1 FRANKEL, *supra* note 3, § 8.6.

specified portions of the interest received on the underlying assets. The average life of most non-mortgage structured financings ranges from one to five years; mortgage-backed securities usually have a longer duration.[124] The securities are not redeemable at the option of the holder.

The payment of the security derives directly from the cash flow generated by the portfolio of assets.[125] The yields paid to investors obviously must be lower than the effective yield on the underlying assets. For example, securities backed by credit card receivables may yield onl nine percent, even though the receivables themselves yield eighteen percent." Investors, in effect, give up a substantial portion of the yield spread because the transformation of these assets into securities enables investors to receive what they consider to be safer and more liquid investments than if they had purchased the assets without the financing being structured.[127]

The structure of the security depends in part on whether the payment structure is pass-through or pay-through. In the case of a pass-through structure, with two exceptions discussed below, the issuer must issue a single class of securities. Each security represents a fractional interest in the trust. Investors are entitled to a pro rata share of the cash flows, net of fees. This structure requires that all payments, including prepayments, be passed through to investors almost immediately after receipt. Accordingly, the timing of payments and maturity of

"'The average life of a debt security is the expected average time it will take to repay each dollar of principal. Most securities backed by automobile loans, for example, run from one to two years, while credit card-backed securities typically have a maturity of two to six years. DEAN WITTER, supra note **38,** at **A-28.**

[125]There are two other payment structures used in structured finance for which payment does not depend directly on the cash flow on the assets. "Market value transactions" are financings in which payment on the securities sold depends on the market value of the underlying assets. This structure has been used primarily in securitizing high yield bonds. *See infra* note **162.** "Third party credit-supported debt" involves the issuance of securities the payment on which is derived primarily from third-party credit support. Darrow et al., supra note 21, § 7.02[B], at 7-9. Because the overwhelming majority of structured financings are cash flow transactions, these other payment structures generally are not discussed in this chapter.

[126]The differential usually is used to pay fees for servicing and credit enhancement and to cover losses on the underlying assets. Any remaining spread may be allocated to the holder of the residual interest. *See infra* notes **143-145** and accompanying text.

[127]*See* BRYAN, *supra* note **3,** at **81-82.**

a pass-through security is uncertain, and investors may receive payment of principal when reinvestment opportunities are relatively unattractive.[128]

In contrast, the pay-through structure allows allocation of cash flow to permit the issuance of securities with maturities and payment schedules different from those of the underlying assets. Although structured financings using the pay-through structure may issue only one class of securities, many issue several classes. One common form of this structure, often called the "sequential-pay structure," permits the issuance of several classes of securities with differing maturities. Typically, interest is paid concurrently on most or all of the classes, but principal is allocated to one class until that class is retired. The other classes are retired sequentially in order of maturity date.[129] Yields and ratings may vary among the classes. In addition, the pay-through structure permits the use of different payment schedules. Thus, the pay-through structure permits securities to be structured with maturities and payment schedules that meet the needs of particular investors.[130]

Both structures permit the issuance of stripped securities. Stripped securities are created by splitting the cash flow from an asset pool into separate components of interest and principal, so that investors of different classes receive unequal proportions of principal and interest. There are an infinite number of possible principal and interest combinations. In simplest form, strips are issued in interest only ("IO") and principal only ("PO") classes. IO certificates entitle the holder to a pro rata share of interest paid on the assets, without any preference or priority in the class. PO certificates entitle the holder to a pro rata share of principal payments made on the assets. Stripped securities were developed for and are used primarily in the mortgage market.[131]

[128] *See, e.g.,* ROSENTHAL & OCAMPO, *supra* note 2, at 52-54; CRAIG J. GOLDBERG, MERRILL LYNCH MORTGAGE CAPITAL INC., INVESTING IN ASSET-BACKED SECURITIES 9-10 (1988).

[129] A multiclass structure may contain classes that issue more complicated types of securities, such as zero coupon and floating rate bonds and stripped securities. *See, e.g.,* Pittman, *supra* note 15, at 506-507; *Rating Whole-Loan Backed Multiclass Securities,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1989, at 12.

[130] *See* GOLDBERG, *supra* note 128, at 9-10. *See also supra* text accompanying note 107.

[131] *See, e.g.,* Pittman, *supra* note 15, at 511. When we refer to "stripped securities," we are excluding stripped Treasury Securities where principal and interest components of Treasury notes and bonds are separated.

IO and PO certificates are volatile securities. The investor in an IO or PO certificate is paying for an interest in a payment stream that is priced based upon an assumed prepayment pattern. Accordingly, changes in interest rates or other factors that alter prepayments on the assets greatly affect the timing and amount of payment on the securities and thus the value of the securities.[132]

Despite this volatility, or because of it, many institutional investors have purchased stripped securities either as stand alone securities or for use as hedging devices.[133] Because of the risks inherent in investing in stripped securities and similar instruments, the Federal Financial Institutions Examination Council ("FFIEC")[134] has issued for comment a Supervisory Policy Statement concerning the selection of securities dealers by, and certain securities activities of, depository institutions.[135]

[132]*Id.* at **511-512.** If the assets are prepaid faster than expected (*e.g.*, when interest rates decline), IO investors may suffer large losses. In the case of a sudden drop in interest rates, IO investors may lose most of their investment. PO investors would experience a gain in this situation since PO certificates are sold at discount and investors would recover their investment sooner than anticipated. Conversely, if the assets are prepaid more slowly than expected (*e.g.*, when interests rates are rising), IO investors benefit because maturities lengthen and more interest is collected. PO investors effectively would experience a loss because the yield to maturity on the certificates would be lower since the term to maturity of the assets is extended. *Id.*

[133]The credit quality of stripped securities may be rated. The ratings, however, do not address prepayment risk. *See Stripped Mortgage Securities,* STANDARD & POOR'S CREDITREVIEW: COLLATERALIZED MORTGAGE OBLIGATIONS, Aug. **29, 1988,** at **5.**

[134]The FFIEC consists of the Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration.

[135]In January **1991,** the FFIEC published for comment Supervisory Policy Statement Concerning Selection of Securities Dealers, Securities Portfolio Policies and Strategies and Unsuitable Investment Practices, and Stripped Mortgage-Backed Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds, **56** FR **263 (Jan. 3,1991).** In response to comments, in August, **1991,** the FFIEC published for comment a revised portion of the Supervisory Policy Statement that pertained to the acquisition of stripped mortgage-backed securities, certain CMO tranches, residual interests, and zero coupon bonds. Supervisory Policy Statement on Securities Activities, **56** FR **37095** (Aug. **2, 1991)** [hereinafter Supervisory Policy Statement].

Under the proposal, stripped securities and certain other securities that the FFIEC considers to be "high-risk mortgage securities"[136] are deemed to be "[un]suitable investments for depository institutions" because of their volatility. Accordingly, the proposal would prohibit most depository institutions from investing in such securities unless they are urchased for the purpose of reducing the institution's overall interest rate risk.[137] Depository institutions wanting to purchase these securities must have the internal ability to determine both prior and subsequent to purchase that the securities would actually reduce interest rate risk. Depository institutions would be required to dispose of high-risk mortgage securities that do not reduce interest rate risk in an orderly fashion.[138]

In addition, both pass-through and pay-through structures permit the issuance of classes of senior and subordinate securities. The senior/subordinate structure splits the cash flow into at least two classes. The senior class has first claim on the cash flow from the pool; the subordinate class absorbs credit losses before the senior class.[139]

The senior class usually is offered publicly and is considered to be insulated from credit risk in part because of the presence of the subordinated class. Performance of the classes depends on the specific senior/subordinate structure adopted and on the actual level of defaults on the assets. The

[136] In general, the FFIEC considers any mortgage derivative product that possesses average price volatility or average life greater than a standard, fixed-rate 30-year mortgage-backed pass-through security to be "high risk." Thus, the policy also applies to certain CMOs, certain REMICs, and CMO and REMIC residuals. Supervisory Policy Statement, *supra* note 135, at 37096-98. In addition, the policy applies to residuals issued in non-mortgage structured financings. Id. at 37097. For a discussion of residuals, see *infru* notes 143-145 and accompanying text. The National Association of Insurance Commissioners is drafting a proposal limiting insurance company purchases of these securities. *See IDD* 1991 *Figures, supra* note 4, at 22.

[137] Depository institutions with "strong capital and earnings and adequate liquidity" and with "closely supervised trading department[s]" would be permitted to purchase high-risk mortgage securities for trading purposes. *See* Supervisory Policy Statement, *supra* note 135, at 37096 n.1.

[138] *Id.* at 37098. The proposal would also require that the depository institutions develop written portfolio policies, approved by their boards, regarding the purchase of these types of securities. Id.

[139] Some senior/subordinate structures split the cash flows into several senior sequential-pay classes. Similarly, some structured financings have more than one subordinated class. *See Rating Whole-Loan Bucked Multicluss Securities, supra* note 129, at 11-12.

subordinate class may be privately placed, publicly offered,[140] with yields higher than those of the senior class certificates,[141] or held by the sponsor.[142]

Finally, most structured financings include residual interests, which are equity interests backed by cash flow not needed to pay the holders of the fixed-income securities or to pay administrative expenses. This cash flow may be derived from income generated by the reinvestment of collections on the assets prior to disbursement to investors, by overcollateralization, or by the spread between the interest rate on the assets and the interest rate on the fixed-income securities.[143]

Residuals may have a high return, but they are volatile, unpredictable securities. Predicting the ultimate return on residual interests is highly complicated, and requires a high degree of sophistication, given the variety of sources of cash flows and the effects of changes in prepayments and interest rates on the cash flow. The risks vary from transaction to transaction, depending on the transaction's structure and assets. The interdependency of these factors "leads to myriad analyses and predictions for residual interest investors."[144]

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[140]The market for subordinate securities has grown tremendously in the last two years, with estimated issuance for **1991** totaling over **$2** billion. Wesley **W.** Sparks, *The Consumer Asset-Backed Market: A Trader's Perspective, AM.* BANKER (Special Adv. Supp), Dec. 17, **1991,** at 1A, 6A.

[141]The subordinate class may or may not be rated. GOLDBERG, *supra* note **128,** at **12.** If the subordinate class is rated, it usually has a rating lower than the senior piece. In many cases, the subordinate class has an external credit enhancement and is thereby protected to some degree against default losses. The amount of credit enhancement needed to achieve an investment grade rating is relatively **high** due to the greater risk of default. See *Credit Card Deals Aren't Equal, supa* note **108,** at 13.

[142]The sponsor's retention of the subordinated class is considered by some to be a form of recourse, and therefore the transfer of the receivables to the pool may not be considered a true sale for bankruptcy concerns. For example, following a downgrade of the rating of Sears' senior debt, Fitch downgraded from AAA to AA certain structured financings where Sears retained the subordinate class. *See Sears' Debt, Asset-Backed Ratings Cut,* FITCH INSIGHTS, Apr. 16, **1990,** at 4.

[143]*See, e.g.,* Pittman, *supra* note **15,** at **509-510;** Boemio & Edwards, Jr., *supra* note 56, at 662.

[144]*CMO Residuals,* STANDARD & POOR'S CREDITREVIEW: COLLATERALIZED MORTGAGE OBLIGATIONS, Aug. **29, 1988,** at **4.** Residuals structured as equity are not rated. Some residuals are structured as debt, having stated principal amounts (which often are extremely small) and bearing interest at a minimum stated rate. These securities can be rated. As with other debt-like obligations, the rating does not address prepayment and interest rate risk, which can be extreme for residuals.

Initially, residual interests usually were retained by the sponsor. In the last several years, residual interests increasingly have been sold to institutional investors, which usually purchase them for hedging purposes.[145]

3. Types of Structured Financings

Many structured financings, regardless of their underlying assets, are structured and operate generally in the manner set forth in the previous two subsections. Some structured financings, however, possess different attributes than other types of structured financings, in part because of the nature of their assets. This section briefly describes some of these differences.

a. CMOs and REMICS

CMOs are multiclass, sequential pay, debt obligations backed by various types of mortgage loans or by mortgage-backed securities.[146] Most CMOs issue at least four tranches, with each tranche typically having a different maturity, interest rate, and prepayment risk. Like most sequential pay securities, the first tranche on which principal is paid typically is the class with the shortest maturity.

That class generally bears the highest prepayment risk, while classes with longer maturities bear less of a prepayment risk. To reduce prepayment risk, CMOs may contain tranches that issue "planned amortization class" bonds ("PACs"). Investors in PACs receive principal and interest payments that are made in accordance with a fixed amortization schedule that does not depend on the rate of prepayments of the underlying mortgages, thereby providing a high degree of predictability regarding final maturity and expected average life. Prepayment risk is shifted to other tranches in the CMO, which consist of "companion" bonds that are subordinate to PACs and which have more volatile prices and expected average lives. Some CMOs also include tranches that issue stripped securities, zero coupon bonds, floating rate bonds, and debt-like residual securities.

[145] *See* 1 FRANKEL, *supra* note 3, § 8.3.2.

[146] Of the approximately $118.6 billion in CMOs and other multiclass mortgage securities offered in 1990, approximately $112.8 billion or ninety-five percent held pass-through securities as collateral. *Database, supra* note 16, at Table 3. Of the approximately $138.0 billion in CMOs and other multiclass mortgage-backed securities offered in the first three quarters of 1991, approximately $134.8 billion or 97.7%, held pass-through securities as collateral. *Id.*

Many issuers elect to be treated as "real estate mortgage investment conduits" ("REMICs"), which were created by the Tax Reform Act of 1986.[147] The election of REMIC status permits the issuance of multiple classes of securities without tax constraints.[148] REMIC status affects only the taxation of the issuer and the investors -- the securities law and accounting requirements remain the same.

Under the REMIC provisions, the issuer's form of organization does not affect the payment structure. The issuer may be a grantor trust, corporation, partnership, or even a designated pool of mortgages that is not a separate legal entity. The securities issued may be pass-through securities, debt, stock, or partnership interests. Only issuers of securitized mortgage products can elect REMIC status.[149]

In practice, REMICs are very similar to CMOs (and are considered by some to be a subset of CMOs), with the exception of their tax treatment. A REMIC must issue at least two types of securities: regular interests and residual interests. A REMIC may have multiple classes of regular interests, each with varying maturities, but only one class of residual interests.[150] Although REMIC status is elective, as of January 1, 1992, it is generally the only means for issuing

[147] Tax Reform Act of 1986, Pub. L. No. 99-514,100 Stat. 2309, Title VI, § 671(a)(Oct. 22,19861, codified and amended as 26 U.S.C. §§ 860A-860G.

[148] For example, non-REMIC multiclass securities generally must be issued as debt obligations to avoid dual taxation. See *supu* notes 106-107 and accompanying text.

[149] *See* Kravitt, supu note 103, § 4.02[c], at 4-16. Substantially all of the assets of a REMIC must consist of "qualified mortgages" or "permitted investments." I.R.C. § 860D(a)(4). The term "qualified mortgage" includes "any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property," among other things (I.R.C. § 860G(a)(3)), such as residential and commercial mortgages and mortgage-backed securities. The term "permitted investment" includes any cash flow investment, qualified reserve asset, or foreclosure property. I.R.C. § 860G(a)(5).

[150] For tax purposes, regular interests are considered debt, notwithstanding the actual form of ownership interest, while residual interest holders are treated much like partners in a partnership. Residual interest holders do not, however, have the disadvantages associated with owning a partnership interest, *i.e.*, the limited ability to transfer the interest, and personal liability. See ROSENTHAL & OCAMPO, *supra* note 2, at 60-62; Pittman, *supra* note 15, at 508-09.

multiclass mortgage-backed securities without certain adverse tax consequences.[151]

b. Revolving Accounts Receivable

Many of the assets being securitized are fixed payment obligations; that is, they are loans for a fixed amount of credit, amortized according to a fixed schedule of payments. Such assets include fixed rate residential mortgages, consumer automobile loans, boat loans, and manufactured housing loans.

Revolving accounts receivable also are being securitized, however. A revolving account generally allows a borrower to draw on a line of credit up to a certain limit and repay only a minimum amount on a monthly basis. A borrower may pay more than the minimum monthly amount or repay the entire outstanding balance when billed. Thus, unlike a fixed payment obligation, the outstanding balance in a revolving account is unpredictable and may vary significantly every month. The type of revolving account most commonly securitized is the credit card account receivable.[152]

The structure of a financing backed by credit card accounts receivable reflects the characteristics of the asset. Typically, the sponsor pools and transfers to a trust current and future receivables generated by specified credit card accounts. The accounts themselves do not become the property of the trust. Although the portfolio of the accounts from which the receivables are generated is fixed at the time the securities are issued, the balance of the pooled assets will fluctuate as new receivables are generated and existing amounts are paid or charged off as a default. Although credit card balances fluctuate, the balance of a large pool of credit card receivables is generally predictable over time, which permits credit card receivables to be securitized.[153] In the event that the

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[151] *See* Kravitt, *supra* note 103, § 4.02[C], at 4-16, and Robert E. Gordon, et al., *Real Estate*, *in* 2 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, § 15.02[E][2], at 15-39 to 15-40.

[152] Revolving home equity lines of credit and revolving wholesale automobile loans also are beginning to be securitized. For a discussion of the securitization of home equity loans, see *Securitizing a New Industry*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 27,1989, at 49-54.

[153] *See Credit Card Deals Aren't Equal*, *supra* note 108, at 7.

accounts do not generate enough receivables to support the securities, the sponsor may be required to assign receivables from other accounts to the pool.[154]

In most cases, to accommodate the fluctuating balances, at least two classes of certificates are issued: the investor certificates and the seller (sponsor) certificates. The interests of these securities typically are equal in priority (*i.e., "paripassu")*. The outstanding principal amount of the seller's certificate, however, will fluctuate to absorb variations in the balance of the pool, thereby enabling the principal balance of the investors' certificates to be maintained at a fixed level for a stated term.[155] The investor certificates, which represent most of the interests in a pool (typically eighty percent or more), are usually sold in a public offering. The remaining interest is allocated to the seller's certificate, and is retained by the seller.

A credit card portfolio typically liquidates at a rapid rate (eight percent to twenty percent per month). Thus, the expected life of a credit card portfolio is less than one year, assuming a constant portfolio size.[156] To extend the life of the securities, investors are paid only interest during the transaction's initial stages, typically eighteen to thirty-six months. During this period, principal payments are allocated to the sponsor and used to purchase additional receivables arising from the pooled accounts. The "interest-only" period (also called the "non-amortization" or "revolving period') is followed by an "amortization" period in which investors receive distributions of principal in accordance with a specified payment schedule.[157] The basic components of a financing backed by credit card accounts receivable are illustrated in Figure 1-6 below.

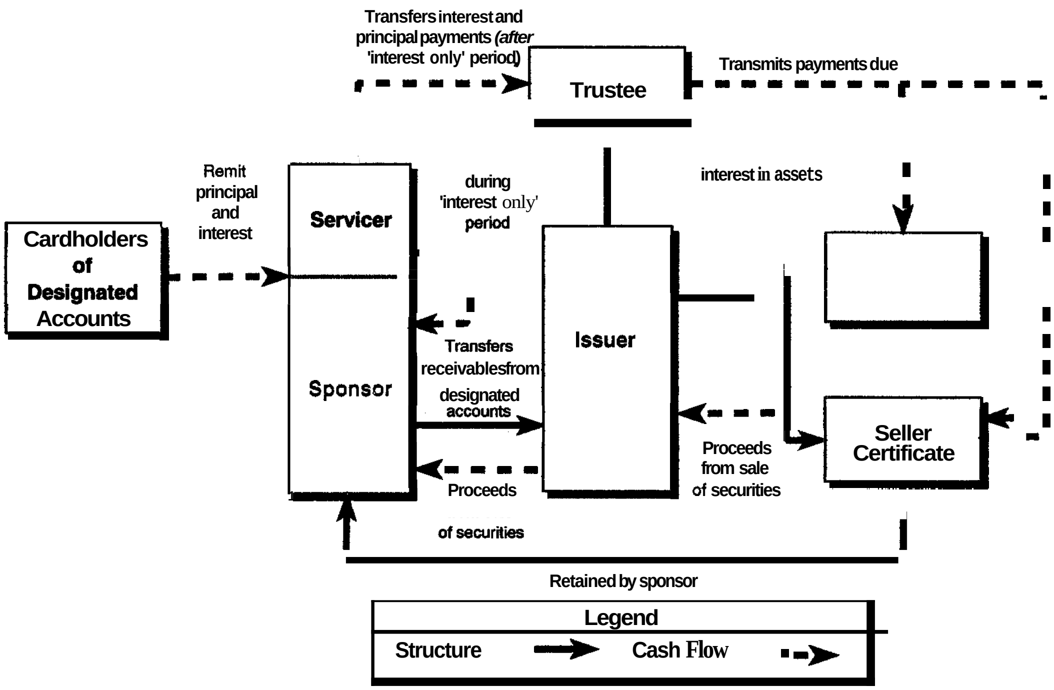
[154] *Id.* **at 15.**

[155] *See id.* **at 7;** *Credit Card-Bucked Securities' Innovations,* **STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Sept. 12, 1988, at 34.**

[156] *See Credit Card-Bucked Securities Innovations, supra* **note 155, at 34.**

[157] Several **amortization methods have been used to make the schedule of principal distributions more predictable. For more information on these methods, see** *Credit-Curd-Bucked Securities: Understanding the Risks,* **MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY (Special Report), Jan. 1991, at 18-19;** *Credit Curd Deals Aren't Equal, supra* **note 108, at 8-12.**

FIGURE 1-6
Financing Backed by Credit Card Accounts Receivable



Unlike most other assets used in structured financings, pooled credit card accounts receivable return to the balance sheet when the securities are retired. To continue to keep these assets off the sponsor's balance sheet new financings must be offered.[158]

Credit card transactions also differ from other structured financings in that the sponsor has a continuing relationship with the borrowers. The sponsor may be in a business that depends on continuing sales to the card holders whose obligations are transferred to the issuer. In addition, the sponsor continues to own the accounts throughout the term of the financing, even though the receivables generated may be owned by the issuer. Accordingly, the sponsor

[158] *See Credit Card Deals Aren't Equal, supra* note 108, at 12. For example, one observer has estimated that, between January 1991 and December 1992, banks will be returning to their balance sheets more than $6 billion of previously securitized credit card accounts receivable, representing approximately 14% of all credit card offerings by banks. See Kelley Holland, *Card-Backed Issuers Bracing for Repeat Securitizations*, AM. BANKER, Sept. 4, 1991, at 1.

typically will make representations that it will not amend the terms of its credit card program so as to affect adversely the structured financing.

c. Poorly Performing Assets

Interest in securitizing low quality and poorly performing assets has increased recently. Many of these assets are difficult to securitize because they lack the homogeneous characteristics necessary to assess credit risks easily.[159] Almost all financings backed by these assets have been either privately placed in the United States or sold overseas, in part because of the application of the Investment Company Act.

The poorly performing assets most often securitized have been high yield or "junk' bonds. Finance companies, savings and loans, and insurance companies (directly or through affiliates), among others, have sponsored structured financings backed by high yield bonds to reduce their portfolio of these instruments. Savings and loans also are sponsoring structured financings to liquidate their high yield bond portfolios by 1994, as required by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA").[160] Other sponsors have acquired high yield bonds on the secondary market solely to repackage them to take advantage of the interest rate arbitrage.[161]

The structure used most frequently to securitize high yield bonds is the CBO. The payment of CBOs, like most types of structured financings, is derived from the cash flow from a relatively fixed pool of high yield bonds.[162] With

[159] *See supra* text accompanying notes 45-47.

[160] Pub. L. No. 101-73, Title VI § 222, 103 Stat. 183, 270 (codified as amended at 12 U.S.C. § 1831e(d)). *See also Securitized Corporate Debt,* STANDARD & POOR'S CREDITREVIEW: STRUCTURED FINANCE, Feb. 26 1990, at 3-4.

[161] *See* Donald J. Korn, *Split-Level Junking,* FINANCIAL PLANNING, Apr. 1990, at 79/81; Constance Mitchell, *One Man's Junk Becomes Another's CBO,* WALL ST. J., Dec. 14, 1989, at C1.

[162] The other structure used in securitizing high yield bonds is the market value structure. Securities issued using this structure differ from CBOs in that the payment on the securities is derived from the aggregate market value of the pooled bonds, rather than from the cash flow on the assets. The pooled assets are marked to market on a regular basis. If the market value declines beyond certain limits, then new collateral must be obtained. If the issuer is unable to raise the market value of the pool to the required limit, the pool is liquidated, with the proceeds used to retire the securities. All market value transactions are significantly overcollateralized, sometimes as much as 220%. *See Rating Cash Flow Transactions Backed by Corporate Debt,* MOODY'S (continued...)

a typical CBO, however, bonds can be sold to prevent the deterioration of the pool or to capture appreciation of portfolio assets, with reinvestment of the proceeds in other high yield bonds meeting certain criteria.[163] CBOs can be issued as pass-through certificates or as multiclass sequential pay-through securities. Residual interests also may be sold.[164] For most CBOs, the senior class is rated by at least one rating agency.[165]

Another type of asset that has been securitized is the non-performing bank loan. A number of banks have considered disposing of their non-performing assets by establishing a spin-off entity, called a "bad bank," whose primary function is to liquidate those loans. Although there have been relatively few transactions to date, and each has been structured differently, the leading model is the Grant Street National Bank ("Grant Street") transaction, which occurred in October 1988. In this transaction, Mellon Bank Corp. ("Mellon") sold to Grant Street, a newly chartered bank established solely for the transaction,[166] non-

[162](...continued)
STRUCTURED FINANCE RESEARCH & COMMENTARY, Sept. 1989, at 6-8; *Junk Bond Securitization Initiated,* STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Sept. 12,1988, at 39.

[163]The rating agencies impose reinvestment criteria to ensure that the terms of the replacement securities reasonably match the terms of the bonds that were sold. *See High Yield Cash Flow Criteria,* STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIES, Mar. 27, 1989, at 88-89.

[164]Savings and loans previously were active in purchasing the residuals. In 1990, most of these securities were placed with international investors, particularly with Japanese accounts. *See FSA Reports No Claims As CBO Deal Is Scuttled,* GLOBAL GUARANTY, Sept. 10, 1990, at 1, 6.

[165]Theodore V. Buerger, et al., *An Overview of Securitization Risks, in* THE ASSET SECURITIZATION HANDBOOK, *supra* note **46,** at 515. Some rating agencies may not monitor **a** CBOs portfolio for credit quality maintenance after issuance, unless new bonds are added or the CBO contains covenants requiring the manager to maintain **a** certain credit quality in the portfolio. *See* Anne Schwimmer, *Moody's May Downgrade First Boston CBO,* INV. DEALERS' DIG., July 1, 1991, at 17. Most CBOs appear to have weathered the recent downturn in the high yield bond market *(see, e.g., Junk Bond Structures Withstand Stress,* STANDARD & POOR'S CREDITREVIEW: STRUCTURED FINANCE, June 11, 1990, at 17-18), although at least one financing has been downgraded. *See* Schwimmer, *supra.* One CBO was liquidated when the holders of the equity interest decided to exercise **a** right to withdraw from the transaction. All senior debt holders were repaid at par. *See FSA Reports No Claims As CBO Deal is Scuttled, supra* note 164.

[166]As **a** bank, Grant Street was excepted from the Investment Company Act by section 3(c)(3).

performing loans, foreclosed real estate, and other repossessed assets.[167] Grant Street purchased these assets with the proceeds of a public offering of two classes of rated debt obligations, with maturities of three and five years, respectively.[168] In addition, Mellon received Grant Street senior and junior preferred stock, and Grant Street common stock. Mellon distributed the common stock to Mellon's shareholders, and distributed the junior preferred to Grant Street directors.

Unlike most structured financings, the Grant Street assets were actively managed. Employees of Mellon were transferred to a subsidiary of Mellon that was dedicated solely to the servicing of the assets. The servicer had substantial discretion in the strategy employed for liquidating the assets. Mellon and the servicer received fees based on the amount of recoveries.

Grant Street retired the three-year term notes in six months due to the servicer shifting its strategy to accelerate collection more rapidly than initially planned, in part because of the deteriorating real estate market. The acceleration of the liquidation plan also resulted in almost half of the five-year notes being redeemed within one year of their issuance.[169]

Finally, highly leveraged transaction ("HLT") loans, primarily resulting from leveraged buyouts and other acquisition activity, have been securitized. As of June 1990, approximately $2.5 billion of HLT loans had been securitized; another $50 billion of HLT loans remained in the portfolios of large United States banks.[170]

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[167]The assets were sold at approximately 50% of their face value. *See Securitizing Problem Loans*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 1989, at 82-83.

[168]Standard & Poor's rated the shorter-term class BBB-, while the other class was rated B-. *Id.* To our knowledge, bad banks are the only structured financings backed by poorly performing assets that have been publicly offered.

[169]*Grant Street National Bunk (in liquidation)*, STANDARD & POOR'S CREDITREVIEW: STRUCTURED FINANCE, Feb. 26,1990, at 63.

[170]*See* Sheila M. Cahill & Susan R. Chalfin, *HLTs Still Hampered by a 50-Year-0111 Law*, AM. BANKER, June 3,1991, at 26.

d. Master Trusts

One variant of the traditional structured financing structure is the "master trust." Master trusts have been used predominately in financings backed by credit card accounts receivable, but the structure may also be used to securitize other types of assets.[171]

As with traditional structured financings, the sponsor of a master trust transfers assets to a special purpose entity that issues securities backed by the assets. The master trust structure allows sponsors to transfer large amounts of assets at one time, however.[172] In addition, under certain conditions, assets may be added[173] or removed throughout the life of the trust.[174]

The master trust structure also permits the issuance of multiple series of securities over a period of time, with varying terms.[175] Each asset-backed

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"'For example, Chrysler Financial Corp. recently sponsored a financing backed by "wholesale floorplan loans" that used the master trust format. Chrysler used this format to facilitate future securitizations. *See* Kathleen Devlin, *Chrysler Financial Returns for Dealer-Backed Notes*, INV. DEALERS' DIG., May **27,1991,** at 14.

[172]For example, the aggregate amount of assets initially included in the master trust sponsored by Citibank totalled **$6.4** billion; the Chase Manhattan Credit Card Master Trust was established with **$4.7** billion of assets. *See Standard Credit Card Master Trust I,* RTCH RESEARCH STRUCTURED FINANCE, Aug. 12, **1991,** at **2;** *Chase Manhattan Credit Card Master Trust Series 1991-2*, RTCH RESEARCH STRUCTURED FINANCE, Sept. **23,1991,** at 1-2.

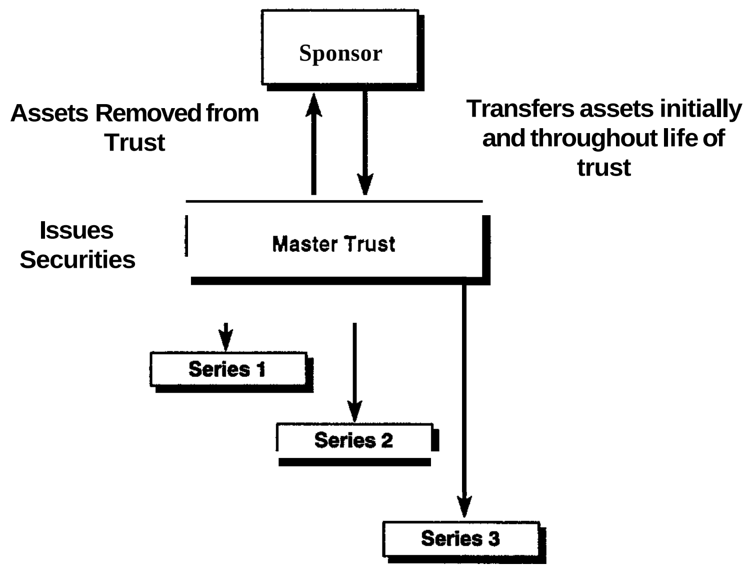
[173]For example, under Citibank's master trust structure, receivables from new credit card accounts may be sold to the trust on a daily basis. Other receivables that may be added on a periodic basis include those arising from accounts acquired from other credit card issuers, accounts of a type that have not been previously securitized by Citibank, and accounts from maturing stand-alone trusts. Participations representing undivided interests in a pool of assets primarily consisting of credit card accounts receivable and their collections also may be added periodically. *See* Letter from Edward J. O'Connell, Vice President, Citibank, to Matthew A. Chambers, Assistant Director, Division of Investment Management, SEC **2** (Jan. 16, 1991), File No. **57-11-90.**

[174]Typically, such transactions may be effected only if at least one rating agency concludes that the addition or removal of assets will not result in the downgrading of any outstanding securities.

[175]For example, the first series of securities issued by the CARCO Auto Loan Master Trust paid a floating rate of interest; the second and third series were structured with fixed interest rates. *See CARCO Auto Loan Master Trust,* FITCH RESEARCH STRUCTURED FINANCE, Aug. **26,1991,** at **2, 4, 6.**

security, regardless of the series to which it belongs, represents an undivided interest in the trust. The formula for allocating collections and administrative costs among the different series has varied among the master trusts thus far established.[176]

FIGURE 1-7
A Master Trust Structure



The master trust structure offers several advantages over traditional structured financings. It permits a sponsor to securitize assets without the cost of establishing a new structured financing for each offering. Also, the size and diversity of the asset pool reduces the trust's volatility in performance, lessening credit and prepayment risk. These advantages make it possible that more sponsors will use this structure in the future.

e. Asset-Backed Commercial Paper Programs

Asset-backed commercial paper programs also are becoming increasingly popular. At year-end 1990, outstanding asset-backed commercial paper totaled

[176] *See* Kravitt, *supra* note 103, § 4.03[D].

$50 billion, up from the previous year's total of **$42 billion.**[177] Banks have sponsored most asset-backed commercial paper programs.[178] **As** with other structured financings, in an asset-backed commercial paper program **assets** are transferred to a special-purpose entity that issues securities backed by the assets. Asset-backed commercial paper programs differ from traditional structured financings in several significant ways, however.

First, most of these programs issue only commercial paper, on a continuing basis. The paper issued typically has a minimum denomination of $100,000 and is highly rated.[179]

Second, commercial paper programs are backed by a diversified pool of assets that often are acquired from a number of different originators. Most pools contain a variety of relatively short-term assets, such as credit card receivables, auto lease receivables, trade receivables, equipment lease receivables, and short-term money market instruments.[180]

Third, the pool is not fixed, with additional assets being purchased throughout the life of the program, and, although the cash flow on the assets may be applied to repayment of maturing commercial paper, repayment of maturing paper is frequently funded with the proceeds from new issuances.[181] Thus, an asset-backed commercial paper program will not necessarily terminate when the

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[177] Kelley Holland, *Regulators Examine Risk of Asset-Backed Paper, AM.* BANKER, Mar. 12, 1991, at 16.

[178] As of year-end 1990, asset-backed commercial paper programs sponsored by banks had issued almost **90%** of the asset-backed commercial paper outstanding. ***Id.***

[179] At least one issuer has offered medium-term notes. *See, e.g.,* Kravitt, *supra* note **103, §4.03[D],** at **4-40.** By offering medium-term notes the sponsor can minimize reliance on the commercial paper market.

[180] In some asset-backed commercial paper programs, the issuer may use the proceeds from the commercial paper to purchase higher coupon, longer-term assets in the secondary market. These assets include agency securities, mortgage loans, commercial loans, corporate bonds, and sovereign debt. See *Third-Party and Asset-Supported Commercial Paper,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Nov. 1989, at ***22-23.***

[181] Liquidity usually is provided by a bank line of credit to support payment to commercial paper holders if the issuer is unable to roll over the commercial paper due to market conditions. See ROSENTHAL & OCAMPO, ***supra*** note 2, at 200; *Pooled Receivables' Robust Growth,* STANDARD & POOR'S **CREDITREVIEW:** ASSET-BACKED SECURITIZATION, Mar. 27,1989, at 89-90.

assets are paid off or deemed to be in default or when the Commercial paper initially issued matures.

These programs are attractive to originators for several reasons. First, unlike a traditional structured financing, which generally is not economically feasible with less than $100 million in assets,[182] an asset-backed commercial paper program can be initiated with smaller pools.[183] The structure also permits securitization of diversified pools of assets. In addition, because asset-backed commercial paper programs, like master trusts, provide a continuing vehicle for securitizing assets, originators can securitize assets more readily once the program begins, without the cost of a new structure. Finally, originators may find asset-backed commercial paper programs attractive because commercial paper generally is exempt from registration under section 3(a)(3) of the Securities Act[184] and issuers of commercial paper may be excepted from the definition of investment company under section 3(c)(1) of the Investment Company Act.

B. The Role of the Rating Agencies

The rating agencies play an integral role in most structured financings. There are six well-known rating agencies that provide credit ratings on debt securities, with four, Standard & Poor's Corporation ("S&P"), Moody's Investors Service, Inc. ("Moody's"), Fitch Investors Service, Inc. ("Fitch"), and Duff & Phelps, Inc., being particularly active in rating domestic structured financings.[185]

As with a traditional corporate bond, a rating of an asset-backed security assesses only credit risk, *i.e.,* the likelihood that the investor will receive full and timely payments. The rating generally does not address market risks to investors

[182]Michael BeVier and Tom Kaplan, *Asset-Bucked Commercial Paper: Structure With Cure*, AM. BANKER (Special Adv. Supp.), May 30, 1989, at 5A.

[183]*Id.*

[184]15 U.S.C. § 77c(a)(3).

[185]The other most widely followed rating agencies are IBCA (which includes IBCA Limited and its subsidiary IBCA Inc.), a London based rating agency, and Thomson BankWatch. The Division met with S&P, Moody's, and Fitch in the course of its review. Generally, the rating categories used by the various rating agencies are similar for investment grade securities. In addition, their general methodologies for rating structured financings appear to be similar, although the criteria for a given rating vary among the agencies.

that may result from changes in interest rates or from prepayments on the underlying asset pool.[186]

Almost all structured finance fixed-income securities offered publicly are rated by at least one rating agency,[187] with most containing at least one class of securities that is rated in one of the top two categories.[188] The larger, privately placed financings are often rated, with the range of ratings being much broader. The fact that structured financings are subject to the scrutiny of the rating agencies and are typically rated in one of the top two rating categories makes them attractive to some investors.[189]

We discuss below the role of the rating agencies in structured financings. We first review the process of obtaining a rating and the factors used to determine a rating. We then focus on the use of credit enhancements. Finally, we describe what happens after the rating is given.

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[186]Of course, the ratings are based primarily on the information supplied to the rating agencies. Thus, ratings do not address fully the possibility of inaccurate information or fraud, although the agencies often insist on verification of information by independent auditors and others.

[187]With the exception of securities backed by residential mortgages, most publicly offered structured financings are rated by two rating agencies.

[188]*See, e.g.*, DEAN WITTER, supra note 38, at A-28. In 1991, a large majority of structured financings involving automobile loans, credit card receivables, and home equity loans were rated AAA, although some lower-rated transactions were issued. Id. at A-29. Other types of non-mortgage financings do have AA, or lower, ratings. *See id.* Mortgage-backed securities offered by the federal agency programs have an implicit AAA rating and are not subject to rating agency scrutiny. To be a "mortgage-related security" under the Exchange Act, a security must be rated AAA or AA. Exchange Act § 3(a)(41), 15 U.S.C § 78c(a)(41). Finally, some multiclass transactions (mortgage and non-mortgage) contain classes that, if rated, are rated lower than AA. See, *e.g.*, DEAN WITTER, supra note 38, at A-29.

[189]Because of the complexity of structured financings, it appears that many investors rely heavily upon the rating of these securities in making their investment decisions. Of course, many other investors also conduct their own due diligence review. See supra text accompanying note 74.

1. Rating the Deal

a. The Process

The process for rating a structured financing is generally the same regardless of the underlying assets. The sponsor and/or its underwriter meets with a rating agency to discuss the proposed structure and provide an overview of the sponsor's business. A rating agency may not agree to rate the transaction if it believes that the assets being used do not have sufficient credit history to enable the rating agency to predict the pool's future performance. A rating agency also may decline to rate the transaction if the company originating the assets is a new company.[190] If rating the proposed transaction appears viable, the sponsor and/or underwriter officially requests that the ratin agency rate the transaction, and agrees to provide all relevant information.[191] The sponsor and/or underwriter also agrees to pay the rating agency for its rating services.[192]

In determining the rating, the rating agency reviews the relevant documentation regarding the transaction, including the P&S agreement, the prospectus or private placement memorandum, and any indenture. The rating agency also may conduct an on-site due diligence inspection of the sponsor and the servicer. Typically, the agency reviews the underwriting and servicing operations, particularly the credit and collection processes. This may entail tracking an application through the credit review and approval process and tracking collection on a delinquent receivable. The historical, current, and expected performance of the sponsor's portfolio (from which the pool will be taken) also may be discussed. In addition, the rating agency may review whether

[190] *See, e.g., Start-up Companies Pose Risk,* STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 1989, at 5. For example, as of March 1989, S&P had never rated asset-backed securities supported by assets from a start-up company, because of the material risks these companies face. Id. As of that date, S&P insisted on a minimum of one to two years' operating history and receivables performance, unless the assets were originated by a new business unit of an established operating company.

[191] Fitch and S&P rate transactions only upon request. Moody's rates every publicly offered transaction regardless of whether it is asked and compensated. According to Moody's, sponsors provide them with information necessary to rate the deal because it is in a sponsor's best interest to do so.

[192] S&P's fees, for example, range from $8,000 to $75,000 with additional "surveillance" fees of $500 to $2,500, although S&P may charge special fees for new vehicles.

the sponsor has the capability to track the assets that will be pooled separately from the overall portfolio.[193] Finally, an agency will review its own internal resources to obtain information about the sponsor, historical performance data on the type of assets being securitized, and other relevant information.

After completing its review, the agency's rating committee decides on a rating. The decision is then communicated to the underwriter. Typically, the rating process may take several weeks, although more complicated transactions have taken over a year, depending in part on whether the financing involves a type of asset previously securitized.

b. Determining the Rating

A structured financing is rated so that the credit risk is equivalent to the credit risk of a corporate bond, or other security, rated in the same category. Similarly, regardless of the nature of the underlying assets, a structured financing is rated so that all financings that are rated in a particular category are deemed to have equivalent credit risk.[194]

Rating agencies apply the same basic criteria to almost all structured financings that issue securities with maturities exceeding one year.[195] They analyze the structure of the transaction, including the quality of the assets, and

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[193] These on-site meetings do not necessarily duplicate the due diligence performed by many underwriters. Rather, the rating agency may review the underwriter's due diligence process, work and results. *See, e.g., Competition Threatens "Due Diligence" Standards,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Dec. 1988, at 3. According to Moody's, increase in the number of intermediaries entering the field, and the "commoditization of the business created by an increase in volume and augmented by the negotiating power of large, repeat issuers have resulted in competitive pressures on underwriters to lower their underwriting fees and cut back on the expensive due diligence process. *Id.* If Moody's finds that the due diligence conducted by the underwriter is less than satisfactory, it requires a higher level of credit support to achieve a given rating. *Id. See Structured Finance Annual Report: 1989 Review and* 1990 *Outlook,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Jan. 1990, at 5-6.

[194] According to Moody's "[r]atings for structured finance classes are intended to be consistent with ratings assigned to corporate, municipal, and other structured finance securities . . . . the expected reduction in annual yield from credit losses should be approximately the same for two equally rated securities." *See Rating Whole-Loan Bucked Multiclass Securities, supra* note 129, at 11.

[195] Asset-backed commercial paper programs are subject to somewhat different rating criteria, in part because of their need to have the liquidity to pay off commercial paper when due. *See supra* note 181 and accompanying text.

then determine the amount of credit enhancement that is needed for the transaction to obtain the rating category desired by the sponsor. In reviewing the structure, a rating agency generally looks at three areas: legal issues, credit quality, and cash flow.

(1) Legal Issues

One legal question inherent in structured finance is whether the issuer's assets and the cash flow on those assets will be available to pay investors in a timely manner notwithstanding the insolvency or bankruptcy of the sponsor. Rating agencies have developed criteria to address this question. If these criteria are not met, the rating on the securities generally will not be higher than the sponsor's rating.[196]

The criteria depend on whether the sponsor is subject to the Bankruptcy Code. Section *362* of the Bankruptcy Code provides that the filing of a bankruptcy petition automatically stays all creditors from exercising their rights with respect to the sponsor's assets.[197] Unless a financing is structured properly, a stay could prevent investors from receiving full and timely payment. Although bankruptcy courts may lift stays under certain circumstances, even if a stay is lifted, timely payment to investors could be jeopardized. Furthermore, under some circumstances other provisions of the Bankruptcy Code could be interpreted as permitting the assets and the cash flow on them to be returned to the sponsor.[198]

If a sponsor is subject to the Bankruptcy Code, the agencies typically review two related items. First, the rating agencies examine whether the assets and liabilities of the issuer are likely to be consolidated with those of the sponsor

[196] *See, e.g.,* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 33. Rating agencies may conclude, on a case-by-case basis, that the likelihood of a sponsor becoming insolvent during the term of the structured financing is sufficiently remote to overcome noncompliance with some of these criteria. *Id.* at 34.

[197] 11 U.S.C. § 362.

[198] For a more detailed discussion of structured financings and the Bankruptcy Code, see generally Thomas S. Kiriakos, et al., *Bankruptcy,* in 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 21, at §§ 5.01-5.06; Thomas W. Albrecht, *Securitising Receivables: Protecting Against Bankruptcy,* 9 INT'L. FIN. L. REV. 33-37 (Sept. 1990); Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets,* 11 CARDOZO L. REV. 607,611-627 (Feb. 1990); Neil Baron, *Asset-Backed Securities and U.S. Bankruptcy Laws,* 6 INT'L. FIN. L. REV. 19-23 (Dec. 1987).

in a bankruptcy proceeding. To address this concern, the rating agencies examine whether the issuer is separate from the sponsor. Factors demonstrating this separation include whether the issuer maintains separate books and records and office space from the sponsor, maintains separate accounts from the sponsor, and, in the case of a corporation, observes appropriate corporate formalities.[199] In addition, the agencies may require an opinion from counsel that the assets and liabilities of the issuer would not be consolidated with the sponsor in the event of the sponsor's bankruptcy?''

The rating agencies also examine whether the transfer of the assets from the sponsor to the issuer is a true sale and not a secured loan. If the transaction is characterized as a secured loan, the pooled assets may be deemed to be assets of the sponsor. The rating agencies look for indicia of a sale, which may include that the transfer is treated as a sale for accounting and tax purposes, that the level of recourse to the sponsor is less than a reasonably anticipated default rate (based primarily on historical default data),[201] that the sponsor does not retain the benefits of ownership of the transferred assets (*i.e.*, that the sponsor may not receive any of the assets' appreciation or their cash flow), and that neither the assets nor their cash flow is commingled with the property of the sponsor.[202] The rating agencies also may require an opinion from counsel that the transfer of the assets from the sponsor to the issuer would be characterized by a court as a sale ("true sale opinion").[203] In transactions where a true sale opinion is given but not all indicia of a sale are met, the rating agencies may consider the financial strength of the sponsor in determining the rating.[204]

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[199]*See* Darrow, et al., *supra* note 21, § 7.03[C]; *see generally* Kiriakos et al., *supra* note 198, § 5.05(G).

[200]*See* Darrow et al., *supra* note 21, § 7.03[C]; S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 34, 69.

[201]Recourse may take several forms, such as the retention of a subordinate class or the obligation to repurchase defaulted assets, the substitution of good assets for defaulted assets, or the reimbursement of a third party credit enhancer. *See Legal Issues in Transferring Assets*, STANDARD & POOR'S CREDITREVIEW: ASSET-BACKED SECURITIZATION, Mar. 1989, at 7.

[202]*See* id. at 7. *See also* Darrow et al., *supra* note 21, § 7.03[B].

[203]*See Legal Issues in Transferring Assets*, *supru* note 201, at 7-8.

[204]*Id.*

The insulation of the structured financing from sponsor insolvency is less difficult for sponsors that are not subject to the Bankruptcy Code, such as banks and savings and loans. Generally the rating agencies have concluded that such sponsors may pledge, instead of sell, the assets to the issuer (or, in some cases, to the investors), if the issuer (or investors) have at least a first perfected security interest in the assets.[205] In addition, the rating agencies require an opinion of counsel that the investors' rights with respect to the assets of and the cash generated by the financing would be enforceable in the event of the insolvency or receivership of the seller or pledgor of the assets.[206]

The rating agencies also evaluate whether the issuer itself could become the subject of bankruptcy proceedings. To minimize this risk, the rating agencies may require, among other things, that the issuer restrict its business to the purchase of the assets and the issuance of securities, incur additional debt only in limited circumstances, be capable of paying for expenses out of its capital and revenues, and be able to institute bankruptcy proceedings only in limited circumstances.[207]

(2) Credit Quality

The most important and time consuming role of the rating agencies is analyzing the credit risk of the financing. The principal credit risk in a structured financing is the potential impairment of cash flows resulting from shortfalls due to borrower delinquencies or losses due to defaults.[208]

[205] *See* Darrow, et al., *supra* note 21, § 7.03[B]; S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 70.

[206] *See* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 70. As of October 1, 1990, savings and loans had been quite successful in insulating their structured financings from their own insolvency. As of that date, no structured financing sponsored by a failed savings and loan had defaulted as a result of a sponsor's insolvency, although several issues had been redeemed or accelerated. *See Bright Spot in S&L Crisis,* FITCH INSIGHTS, Oct. 1, 1990, at 7.

[207] S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 29-30, 70; Darrow et al., *supra* note 21, § 7.03[D].

[208] Credit and legal analysis are closely related. A high credit quality may mitigate rating agency concerns relating to legal risks. Darrow et al., *supra* note 21, § 7.02[C]. Also, with enough credit enhancement, a structured financing with a perceived "risky" sponsor may nevertheless receive a high rating.

The rating agencies typically evaluate a sponsor's historical and expected financial performance, organizational strengths and weaknesses, and competitive position in the industry from which the assets are being sold. The rating agencies also examine the characteristics of the sponsor's portfolio from which the pool will be drawn, including any relevant customer concentrations,[209] historic origination and repayment statistics, and delinquency and loss statistics.[210]

The process of selecting a pool from the portfolio is critical. The agencies generally prefer that a pool be representative of the portfolio. The selection is usually done randomly, although, in some cases, the assets for the pool are "cherry picked." If the latter method is used, however, the pool may not consist of predominately lesser quality assets. Typically, an independent auditor confirms that the pool is representative of the sponsor's portfolio.[211]

The rating agencies forecast pool performance by examining the credit characteristics of the assets. While the factors used and their weightings differ depending on the type of assets, they invariably include the historical performance of the assets.[212] The methodology used also varies according to the type of assets. Typically, rating agencies use an actuarial or statistical approach to make generalized assumptions regarding future Performance when a pool contains a large number of assets with homogenous characteristics, such as credit card receivables, auto loans, or home equity loans. Where a pool contains a small number of assets, typically with limited standardization, such as high yield bonds, probable future performance is assessed by examining each asset.

The rating agencies attempt to predict whether the financing will pay full and timely interest and principal in a "worst case" scenario. The transaction must

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[209]One important factor is the diversification by borrower and geographic area of the assets.

[210]In selecting the pool, however, the sponsor may improve the credit quality by excluding from the portfolio delinquent and unseasoned accounts and reducing geographic concentrations.

[211]An unrepresentative sample may add expense to the sponsor, resulting from either the need for additional credit enhancement or a lower rating. To market a security with a lower rating, a higher yield is needed, reducing the proceeds received by the sponsor.

' 'For example, to obtain performance criteria for automobile loan and credit card-backed transactions, S&P reviewed more than 10 years of history, over a number of economic cycles.

be structured to be able to survive this scenario to obtain the desired rating.[213] In theory, the rating will not change even if this scenario does occur. Thus, in a highly rated financing, the transaction is structured so that the assets' performance would have to deteriorate greatly before investors in the fixed-income securities would not be fully paid.

As part of the review of the credit quality of the transaction, rating agencies evaluate the servicer.[214] The quality of servicing may be important to the rating, depending on the importance of the servicer's responsibilities.[215] The rating agencies evaluate the servicer in terms of its responsibilities to manage and maintain the payment stream on the underlying assets. The rating agencies generally insist that a servicer that is not rated as high as the fixed-income securities not commingle its own funds with the cash flow from the transaction, but remit the cash flow to the trustee within forty-eight hours.[216] The rating agencies also will take into consideration the servicer's rating if the servicer is responsible for making advances on delinquent assets or repurchasing assets that have defaulted.[217]

In addition, the rating agencies have developed criteria for permitting reinvestment of cash flows in short-term investments?" such as commercial

[213]For example, Fitch uses the mortgage default patterns in Texas during the 1980's as benchmarks for assessing the credit loss levels of mortgage-backed securities. *See Mortgage Criteria Update,* FITCH RESEARCH STRUCTURED FINANCE (Special Report), July 8, 1991.

[214]The rating agencies also may evaluate the trustee. Because generally only a few entities act as trustees for structured financings, the rating agency generally will not perform any due diligence if one of these entities is trustee. For a discussion of the rating agencies' concerns with respect to the trustee, see Darrow et al., *supra* note 21, § 7.02[D][3].

[215]For example, Moody's has stated that extremely weak servicing could result in an otherwise AAA transaction being given an A or AA rating. *The Servicer in Securitized Transactions, supra* note 100, at 12.

[216]*See, e.g.,* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 67. A rating agency's concern also may be alleviated if the servicer obtains a letter of credit or some other form of credit enhancement.

[217]*See* Darrow et al., *supra* note 21, § 7.02[D][2].

[218]*See, e.g., Eligible Investment Guidelines in Structured Securities,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Feb/Mar. 1990, *reported in Moody's Approach to Rating Residential Mortgage Pass-Throughs,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY (Special Report), Apr. 1990, at 45.

paper, which may include paper issued by the sponsor. Finally, the rating agencies evaluate the amount and method of payment of the servicing fee and the difficulty of obtaining an alternative servicer, if necessary.[219]

(3) Cash Flow Analysis

Cash flow analysis examines the risks related to the cash flow funding the securities. Rating agencies examine the cash flow generated by the underlying assets. Such an examination may include, among other things, a review of the assets' payment speeds, delinquency and loss rates, and interest rates and basis risks.[220] The agencies also analyze the allocation of the cash flow, including the financing's payment structure. For example, with respect to a financing using a pay-through structure, the rating agencies may examine how the financing addresses concerns relating to the reinvestment of cash flows prior to payment, the calculation of stated maturities, and the trustee's powers with respect to the assets in the event of a default.[221]

2. Credit Enhancement

Once the structure is analyzed, the agencies determine the amount of credit enhancement needed to obtain the desired rating. Credit enhancement is intended to protect investors from the continuing effects of shortfalls due to borrower delinquencies or losses due to defaults, or other adverse events.

Most structured financings include some credit enhancement. The amount of enhancement needed for a given rating depends on the historical performance of the assets[222] and the structure of the transaction. Consequently, the actual

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[219]The rating agencies may insist that the fee be a percentage of the outstanding principal balance and be subordinated to payments of principal and interest to investors. S&P's STRUCTURED FINANCE CRITERIA, *supra* note 108, at 68.

[220]*See Asset Securitization and Secondary Markets: Hearings Before the SubComm. on Policy Research and Insurance of the House Comm. on Banking, Finance and Urban Affairs,* 102nd Cong., 1st Sess. 4-5 (July 31, 1991) (statement of Clifford Griep, Executive Managing Director, Structured Finance Rating Department, S&P's Rating Group).

[221]*See* S&P'S STRUCTURED FINANCE CRITERIA, *supra* note 108, at 66-67; Darrow et al., *supra* note 21, § 7.02[E].

[222]Thus, the amount of credit enhancement depends on the assets. For example, without credit enhancement, most credit card transactions would be rated BB or BBB. Credit enhancement is necessary for an AAA rating. *See Credit-Card Deals Aren't Equal, supra* note 108, at 12. Because (continued...)

amount of credit enhancement in a structured financing largely depends on what rating the sponsor believes is needed to sell the securities and what a rating agency requires for the transaction to obtain that rating.

Credit enhancements can be divided into two types: external and internal. External credit enhancements are provided by the sponsor or highly rated third parties; internal credit enhancements are those structural protections inherent in the design of the financing.

The most common external credit enhancements are irrevocable standby letters of credit ("LOCs"), sponsor guaranties or "recourse," and financial guaranty insurance. External credit enhancements are more common than internal enhancements, but their use has declined somewhat because the rating of a structured financing depends on that of the provider of the credit enhancement. If the provider subsequently is downgraded below the rating of the structured financing, the structured financing likewise may be downgraded.

Historically, LOCs have been the most common external credit enhancements.[223] Typically, an LOC provides a limited guaranty against defaults and payment delinquencies up to either a fixed dollar amount or a percentage of the outstanding principal balance of the financing. The amount of the LOC depends on the particular transaction and the underlying assets.[224] Draws against the LOC provider limit the coverage amount available. The LOC provider may be reimbursed by the sponsor, from a reserve account that is funded by the sponsor, or by excess cash flow on the assets.[225]

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[222](...continued)
the historical loss experience of a pool of credit card receivables is typically lower and less variable than a pool of high yield bonds, the amount of credit enhancement needed to obtain an AAA rating on a credit card pool is much lower than that needed for a CBO. In fact, most CBOs are not rated AAA in part because of the expense of the requisite credit enhancement.

[223]Approximately 26.2% of all non-mortgage structured financings issued as of year-end 1991 used an LOC as the sole means of credit enhancement. DEAN WITTER, *supra* note 38, at A-23. An additional 17.3% used an LOC in conjunction with some other credit enhancement. *Id.*

[224]For example, LOC coverage on credit card transactions existing as of April, 1990 ranged from 5%-30% or a stated dollar amount. *See Credit-Card Deals Aren't Equal, supra* note 108, at 13.

[225]LOCs reimbursed by a reserve fund are used in almost all transactions in which the sponsor is a bank because reserve accounts are not considered recourse for purposes of regulatory requirements. *See supra* note 99.

Most LOCs have been provided by foreign commercial banks, primarily because of the limited number of AAA-rated United States banks.[226] Recently, however, many foreign commercial banks have experienced rating downgrades, resulting in the downgrading of structured financings supported by LOCs from these banks.[227] Accordingly, many sponsors have turned to other credit enhancements.[228]

Sponsor guaranties or recourse require the sponsor to cover any losses up to either a fixed dollar amount or a fixed percentage of the declining principal balance of the financing. It may be used alone or, more typically, in conjunction with some other form of credit enhancement. Because the rating of the structured financing will not be higher than that of the sponsor, this form of credit enhancement is used only by highly rated sponsors. It also generally is not used in savings and loan or bank-sponsored structured financings because of regulatory requirements.[229]

Financial guaranty insurance policies typically guarantee the timely payment of principal and interest in accordance with the insurer's original payment schedule during the term of the structured financing. According to insurers, in deciding whether to issue a financial guaranty, they underwrite to a zero-loss standard, rather than using actuarial assumptions about future

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[226] Of the 13 largest LOC providers for non-mortgage structured financings as of year-end 1991, only two (Morgan Guaranty Trust Co. of N.Y. and State Street Bank and Trust Company) were United States banks, each having provided LOCs for three issues. DEAN WITTER, *supra* note 38, at A-33. The leading LOC provider as of that date was Union Bank of Switzerland (61 issues), followed by Credit Suisse (38 issues). *Id.*

[227] *See, e.g., Downgrade: To Aa1 Credit Ratings on Letter-Of-Credit-Supported And Guaranteed Issues of Dai-Ichi Kangyo Bank,* MOODY'S STRUCTURED FINANCE RESEARCH AND COMMENTARY, Aug. 1990, at 49; *Downgrade From Aaa to Aa1: Credit Ratings on Letter-@-Credit-Supported and Guaranteed Issues of Fuji Bank, Ltd.,* MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Aug. 1990, at 48.

[228] One relatively new form of credit enhancement is the "cash collateral account." In a cash collateral account, a third party deposits cash in a trust prior to the offering. The cash may be drawn upon during the life of the issue if needed and is typically invested in highly rated short-term securities with the income allocated to the depositor. *See* Cash *Collateral Support for ABS Hot New Financial Product in NY,* THOMSON'S GLOBAL ASSET BACKED MONITOR, Apr. 12,1991, at 1-2.

[229] *See supra* note 99.

claims.[230] Guarantors often require that other types of credit enhancement also be obtained.

Financial guaranties typically are obtained from insurers who are rated **AAA** by at least one rating agency. Because these guaranties are expensive, they usually are used only in types of structured financings that are new or perceived as being more speculative (such as CBOs).[231]

Internal credit enhancements have become more common. The most common types are overcollateralization, spread accounts, senior/subordinated structures, and payout or amortization events.

Overcollateralization means that the amount of the assets in the pool exceeds that needed to make full payment on the securities and to pay expenses. The cash flow from the excess collateral offsets any defaults or delinquencies on the assets. Many financings use overcollateralization, usually in conjunction with some other credit enhancement.

Spread accounts are escrow accounts whose funds are derived from the spread between the interest earned on the assets in the underlying pool and the amount needed to pay servicing fees and interest on the securities.[232] Typically, the differential in interest (less fees) is placed in the account as the payments are made on the underlying pool until the account reaches a stated level. Any additional spread is returned to the sponsor or to residual interest holders, while the funds in the spread account provide credit support. When the fixed-income securities are completely paid off, the remaining funds in the spread account either return to the sponsor or residual holders.

The senior/subordinate structure uses two different classes of securities, with the senior class having the first claim on the cash flow. Thus, the

[230]*See, e.g.,* FINANCIAL SECURITY ASSURANCE, 1989 ANNUAL REVIEW 6 (1990).

[231]For more information on the financial guaranty industry, see *Bund Insurers' Turbulent Future,* FITCH FINANCIAL INSTITUTIONS (Special Report), June 4, 1990.

[232]For example, for a transaction in which the pool of assets has a yield of 20%, the investor coupon of the asset-backed security has a yield of 10%, and the servicing fee is 2.5%, the spread would be 7.5%, assuming no defaults and no other expenses.

subordinate class absorbs credit losses before any are charged to the senior class. The amount of coverage by the subordinate class varies by transaction.[233]

Payout or amortization events are events specified in the P&S agreement that trigger early retirement of the securities and are intended to ensure that investors in the fixed- income securities receive all principal and accrued interest. Payout events have included charge-offs on assets rising above a certain level for specified periods or the net yield on the assets falling below certain levels for specified periods. This form of credit enhancement has been used primarily in financings backed by revolving accounts receivable, where all principal payments on receivables may be used to amortize the remaining balances, rather than reinvest in new receivables.[234]

At least one financing has accelerated payment as a result of the occurrence of a payout event.[235] Investors received all principal and interest due. Of course, acceleration causes investors to lose interest payments they would have received had the financing continued. In addition, if prevailing interest rates have declined, investors must reinvest in lower yielding instruments.

Most structured financings allow for asset substitution to protect the credit quality of the pool, although this is not considered to be a credit enhancement. Assets often are substituted for similar assets that are deemed defective, or, after pooling, are determined not to meet the requirements of the P&S agreement. In addition, some structured financings include a "defeasance mechanism." This mechanism permits the trustee to sell assets in the pool and to use the proceeds to purchase Treasury bills that will, in turn, provide sufficient cash flow so that investors will receive full and timely principal and interest payments.

3. Monitoring a Financing

Once a financing is rated, the rating agencies typically monitor its performance monthly or quarterly. The agencies review factors such as asset

[233]For example, the typical subordinate loss coverage of structured financings backed by credit card receivables ranges from 7% to 15% of the original outstanding principal amount. *See Credit-Card Deals Aren't Equal, supra* note 108, at 13. If the loss ratio is 10%, a $100 million pool may be divided into $90 million senior securities and $10 million subordinate securities, with investors holding the senior securities being protected for up to $10 million in losses.

[234]*See supra* note 157 and accompanying text.

[235]*See Credit Card Prepayment Risk*, STANDARD & POOR'S CREDIT WEEK, July 1, 1991, at 45.

performance, including default and delinquency rates, and the credit enhancement, including whether there has been any change in the creditworthiness of a credit enhancement provider. Historically, downgrades have been infrequent, although they have increased in recent years.[236]

Most downgrades have occurred as a result of downgrades in the rating of the providers of external credit enhancements. Downgrades due to poor pool performance have been rare, perhaps because the rating agencies, in determining the amount of credit enhancement needed for a high rating, incorporate delinquency and loss levels of three to five times historical performance. Very few of the downgrades have resulted in the securities being rated below investment grade.[237]

On occasion, a financing may be restructured to preserve a rating. Typically, a financing is restructured to provide added credit enhancement to support the pool. The sponsor generally has an additional incentive to add such support, so that it may sponsor additional financings.[238]

C. Unrated Transactions

Not all structured financings are rated. Most unrated structured financings are privately placed. These transactions are relatively small, and because of their size, sponsors may find it uneconomical to obtain a rating.

The structure of unrated private placements varies. Some transactions look very similar to those that are rated and sold publicly, but many do not. For example, the issuer may not be bankruptcy-remote or an unrated servicer may commingle the cash flow with its own funds. The assets may not consist of a representative sampling of the portfolio; in fact, in some transactions the sponsor's entire portfolio may be securitized. Finally, these transactions may not have any

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[236] *See Annual Report:* **1990** *Review &* **1991** *Outlook,* **MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY (Special Report;), 1991, at 3.**

[237] **The Division knows of only two financings that have been downgraded below investment grade. According to S&P, it is highly unlikely that an AAA rated asset-backed issue suddenly could be downgraded below investment grade as a result of some unforeseen event, given the structure of such highly rated transactions.** *See Asset-Backed Event Risk and the Seller's Rating,* **STANDARD & POOR'S CREDITREVIEW, June 1990, at 15.**

[238] *See, e.g.,* **Steven Lipin,** *Citicorp Acts to* ***Prop*** *Rating of its Securities,* **WALL ST. J., Oct. 24,1991, at C1.**

credit enhancement. Investors may not be concerned about the lack of these attributes because they are involved in structuring the transaction, and are familiar with the sponsor and the assets.[239]

Some unrated financings have been sold publicly. Many of these financings were mortgage-backed securities that were sold prior to the enactment of SMMEA.[240] Today, almost all publicly offered financings issue at least one highly rated class of securities.

Unlike rated structured financings, there have been instances where unrated structured financings have defaulted. The largest and most notable of these defaults occurred in 1985, when Equity Programs Investment Corporation ("EPIC"), and certain of its affiliates, defaulted on approximately $1.4 billion in mortgages and privately placed mortgage-backed securities.[241]

Beginning in 1975, EPIC organized, syndicated, operated, and served as general partner of real estate limited partnerships with interests in model homes that were purchased from home builders.[242] Subsequently organized partnerships invested in unsold homes also purchased from home builders. Much of the partnership property was located in the southwest section of the United States. Mortgages on the properties were obtained from an EPIC affiliate, typically at ninety-five percent of the properties' appraised value. EPIC represented that, during the period of the partnership, the residential units were to be leased back to the builders or leased for tenant occupancy, with an EPIC

[239] For example, banks often invest in structured financings sponsored by their customers.

[240] *See* Sears Mortgage Securities Corp. (pub. avail. May 21,1985) (stating that traditional shelf registered "mortgage related securities" were direct pass-through securities that differed from the definition of the term "mortgage related security" in section 3(a)(41) of the Exchange Act (15 U.S.C. § 78c(a)(41)) "primarily because they had not received a rating from a nationally recognized statistical rating organization").

[241] The first two EPIC-sponsored financings were rated by S&P and investors did not experience any loss. Those offerings were structured differently from the unrated financings that were subsequently issued (and that defaulted) in terms of, for example, their underlying collateral and loss coverage. See *infra* notes 248-249 and accompanying text.

[242] The facts summarized below are derived in part from the opinion issued in re 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). The EPIC default resulted in extensive litigation initiated by two insurance companies that had insured some of the mortgages backing the defaulted securities. See *infru* note 247 and accompanying text.

affiliate managing the property. The mortgage obligations were to be paid through the rental income, builders' rebates to EPIC (called "rental deficit contributions"), the limited partner's capital contributions, and if necessary, advances from EPIC. EPIC represented that funds obtained through these sources would be used for the sole benefit of each individual partnership. Under the contemplated arrangement, the properties would be sold, typically after four years, and the partnership liquidated, with the profits distributed to the partners.[243] By mid-1985, EPIC managed over 18,000 partnership homes owned by more than 350 limited partnerships.

From January 1980 through July 1985, EPIC privately placed approximately $935 million in pass-through securities backed by pools of mortgages on partnership properties. Credit enhancement consisted of private mortgage insurance that covered up to a certain percentage of any loss.[244] An EPIC affiliate was the servicer, with the underlying mortgages assigned to an independent trustee.

The actual operation of the EPIC enterprise differed significantly from that which was represented. First, EPIC partnerships did not operate as separate entities. Rather, EPIC commingled the funds of each partnership with its general funds, and then advanced such funds to the various partnerships based solely upon the partnership's needs. In addition, the EPIC companies were unable to sell the partnership properties and, beginning in 1984, new partnership interests, both of which resulted in shortfalls of funds. EPIC subsequently became dependent on the acquisition of new properties and the formation of new types of partnerships to generate the funds to pay obligations of older partnerships, and in turn, the outstanding mortgage-backed securities.[245] In 1982, EPIC acquired Community Savings and Loan, Inc., to eliminate EPIC's cash concerns; as of May 1985, the savings and loan had advanced over *$26* million to the EPIC limited partnerships, primarily in the form of unsecured second trust mortgages on the

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[243] In the earlier years of EPIC, when the interests primarily consisted of model homes that were leased back to the builder, positive cash flow was generated, and those partnerships were syndicated as "income" partnerships. In the later years of operation, the Partnerships were syndicated as tax shelters.

[244] For example, on some of the pass-through securities sold immediately prior to EPIC's default, the first 25% of the risk was to be borne by a primary insurer, with a reinsurer bearing up to 33.3% of the excess loss.

[245] EPIC created "pac-man" partnerships to purchase unsold units and to subsequently syndicate them. These partnerships only delayed the problem since these too had to be sold.

properties. When, in mid-August 1985, the savings and loan was eliminated as a funding source,[246] EPIC defaulted on its loans, with the partnerships being placed in bankruptcy shortly thereafter. The default resulted in extensive litigation brought by several of the mortgage insurers who unsuccessfully sought to rescind mortgage insurance coverage, claiming that the insurance was procured by fraud,[247] and the subsequent liquidation of the insurer that had insured the largest amount of EPIC mortgages.

The characteristics of the defaulted EPIC financings differed in significant respects from rated financings.[248] For example, the assets used to back the securities -- particularly the mortgages on unsold units in developments -- were very risky, and to be rated would have required a loss coverage (*i.e.*, credit enhancement) far in excess of what was actually incorporated. This risk was exacerbated because appraisals of the units were often inflated, thereby understating the loan to value ratios of the mortgages. Also, the mortgages were concentrated heavily in a region that was not economically diverse.[249]

In addition, according to one rating agency, if the later financings had been rated, their structure would have been subject to much more scrutiny, including EPIC's role as servicer. In this regard, EPIC likely would not have been permitted to commingle the partnerships' funds with its own.

IV. The Investment Company Act and Structured Finance

A. Applicability of the Act

Most, if not all, structured financings meet the definition of investment company under section 3(a) of the Investment Company Act, because they both issue securities and are primarily engaged in investing in, owning, or holding

[246] In September 1985, the Maryland Deposit Insurance Fund placed the savings and loan into conservatorship, after determining that its fiscal mismanagement contributed to Maryland's 1985 savings and loan crisis.

[247] *See* Foremost Guaranty Corp. v. Meritor Sav. Bank, 910 F.2d 118 (4th Cir. 1990).

[248] Of course, ratings are not complete protection against fraud, such as was prevalent in the operation of the EPIC enterprise.

[249] *See EPIC Revisited*, MOODY'S STRUCTURED FINANCE RESEARCH & COMMENTARY, Mar. 1988, at 3.

securities.[250] Structured financings use special purpose entities that issue debt or equity interests. In the context of the Investment Company Act, the financial instruments held by the issuers in structured financings generally have been considered to be securities.[251]

Because the structured finance market did not exist in **1940,** the Act was not drafted to regulate or exclude structured financings. The drafters of the Act simply were attempting to devise a regulatory framework for the types of investment companies that existed at that time.[252]

Not surprisingly, structured financings cannot operate under the Act's requirements. For example, section 17(a) prohibits certain affiliates of registered investment companies from selling securities and other property to the investment

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[250]Section 3(a)(1) defines an investment company as any issuer of securities which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. 15 U.S.C. § 80a-3(a)(1). Section 3(a)(3) defines an investment company as any issuer of securities which "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities [as that term is defined in the Act] having a value exceeding 40 per centum of the value of such issuer's assets (exclusive of Government securities and cash items) on an unconsolidated basis." Almost all structured finanangs meet one, if not both, of these definitions. *See* C. Thomas Kunz, *Securities Law Considerations, in* THE ASSET SECURITIZATION HANDBOOK 347, 374 (Phillip L. Zweig ed., 1989) ("because the issuer in an asset securitization transaction (whether a grantor trust, a finance subsidiary, or an asset-backed securities issuer) issues a 'security' and holds 'receivables' of some kind, which are both 'securities' and 'investment securities' within the Investment Company Act, an exemption from compliance therewith or a ,safe-harbor' thereunder must be sought.").

[251]*See, e.g.,* SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 328 (1966) [hereinafter PPI REPORT] (stating that notes representing the sales price of merchandise, loans to manufacturers, wholesalers, retailers and purchasers of merchandise or insurance, and mortgages and other interest in real estate are investment securities for purposes of the Act). *See also infra* notes 333-339 and accompanying text.

[252]*See, e.g., Investment Trusts and Investment Companies: Hearings on S.3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 43 (1940) [hereinafter 2940 *Senate Hearings]* (statement of Robert E. Healy, Commissioner, SEC) ("[T]he bill does not attempt to set up an ideal form of investment company and then compel all companies to conform to the ideal. Its provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions."). Although interests in pools of mortgages were sold to the public in the 1930's and in fact raised a number of investor protection concerns (see *supra* note 15), there is no indication that Congress or the Commission intended them to be covered by the Act. Section 3(c)(5)(C), discussed *infra* notes 263-269 and accompanying text, excepts many, if not most, of these issuers. *See* 15 U.S.C. § 80a-3(c)(5)(C).

company.[253] In a structured financing, this section would prohibit the sponsor's sale of assets to the issuer, or any substitution of assets by the sponsor. In addition, section 18 limits management investment companies from issuing senior securities, which includes debt. These restrictions are fundamentally inconsistent with the operations of virtually all securitized credit offerings.

Thus, sponsors must find a way to avoid application of the Act. They must either structure their transactions to come within one of the statutory exceptions to the definition of investment company or seek exemptive relief from the Commission.

1. Statutory Exceptions

Although section 3(c) of the Act excepts from the definition of investment company a number of issuers, only two exceptions are particularly relevant to private sector structured financings: sections 3(c)(5) and 3(c)(1).[254]

a. Section 3(c)(5)

Many structured financings have relied on section 3(c)(5), which, as enacted in 1940 and amended in 1970, was intended to except issuers engaged primarily in the factoring, discounting, or real estate businesses.[255] Such activities were "generally understood not to be within the concept of a

*For a more detailed discussion of section 17(a), see Chapter 12.

[254]Other exceptions may be available for a limited number of private sector structured financings. For example, some structured financings may be able to avoid application of the Act by relying on section 3(c)(4), which excepts issuers whose businesses are substantially confined to making small loans, industrial banking, or similar businesses. In addition, some financings may be able to rely on section 3(c)(6), which pertains to holding companies of entities in the businesses described in sections 3(c)(3), 3(c)(4), and 3(c)(5). The "bad bank finanangs have received bank charters and relied on section 3(c)(3). Some financings sponsored by the federal government are excepted from the Act by section 2(b). See, *e.g.*, Cleary, Gottlieb, Steen & Hamilton (pub. avail. Jul. 18, 1991) (no-action position regarding proposed CBOs sponsored by issuers created and controlled by the RTC).

[255]S. REP. NO. 1775, 76th Cong., 3d Sess. 13 (1940); H.R. REP. NO. 2639, 76th Cong., 3d Sess. 12 (1940); S. REP. NO. 184, 91st Cong., 1st Sess. 37 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 17 (1970). See *also* 1940 *Senate* Hearings, supra note 252, at 181-182 (testimony of David Schenker, Chief Counsel, SEC Investment Trust Study).

conventional investment company which invests in stocks and bonds of corporate issuers."[256]

Section 3(c)(5) was added at the request of sales finance companies. By its terms, the section excepts:

> [a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, 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.

Thus, to be within section 3(c)(5), an issuer may not issue certain types of securities and also must be primarily engaged in one or more of the businesses enumerated in the section.

Many sponsors of structured financings have relied on section 3(c)(5) to avoid regulation under the Act. Virtually no structured financings issue redeemable securities, face-amount certificates, or periodic payment plan certificates.[257] (Certain other issuers are required to register under the Act

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[256] PPI REPORT, *supra* note 251, at 328. In 1940, the exclusion was limited to factoring, discounting and real estate businesses that did not engage in issuing face-amount certificates of the installment type or periodic payment plan certificates. This limitation was in response to the abuse found prior to 1940 in the sale of these types of securities, usually to relatively unsophisticated investors, by companies, including those of the type that would have been excluded by this provision but for the limitation. *See* 1940 *Senate Hearings, supra* note 252, at 182 (statement of David Schenker). In 1970, Congress amended section 3(c)(5) to prohibit the issuance of redeemable securities. The purpose of the amendment was to prevent excepted companies from capitalizing on the popularity of open-end investment companies by selling shares of redeemable securities. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 2(a), 3(b), 84 Stat. 1413 (1970) *(codified us amended* at 15 U.S.C. §§ 80a-2(a)(32), 3(c)(5)).

[257] Section 2(a)(32) (15 U.S.C. § 80a-2(a)(32)), defines "redeemable security" to be "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." Numerous (continued...)

because they issue redeemable securities, even though they invest in section 3(c)(5) assets. For example, so-called GNMA funds, *i.e.,* issuers that invest in GNMA certificates, register as open-end investment companies or unit investment trusts because they issue redeemable securities.)[258]

To rely on section 3(c)(5), a structured financing must be "primarily engaged" in one or more of the types of businesses described in subparagraphs (A), (B), and (C). The issues relevant to whether a structured financing comes within subparagraphs (A) or (B) differ somewhat from those relevant to whether a structured financing comes within subparagraph (C). Accordingly, we discuss subparagraphs (A) and (B) separately from subparagraph (C).

(1) Subparagraphs (A) & (B)

Subparagraph (A) refers to the *purchase or other acquisition* of notes and other evidences of indebtedness representing the sales price of merchandise, insurance, and services. Subparagraph (B) refers to the *making* of *loans* to manufacturers, wholesalers, retailers, and prospective purchasers of specified merchandise, insurance, and services. A number of no-action letters have been issued to entities holding a wide variety of receivables, loans to refinance receivables, open accounts receivable, and loans to manufacturers of specified merchandise and services.[259] When the assets the entity acquires are not

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[257](...continued)
no-action positions have been issued with respect to the definition of redeemable security in the context of section 3(c)(5). For example, a debt security may be a redeemable security. See G.A.B.E. Inc. (pub. avail. Feb. 15,1974). No-action positions also have treated a security that may be presented to the issuer by the holder as not being a redeemable security if substantial restrictions are placed on the right of redemption. *See, e.g.,* California Dentists' Guild Real Estate Mortgage Fund II (pub. avail. Jan. 4, 1990) (restrictions included prohibiting investors from withdrawing funds during the first 12 months after purchase, after which withdrawal could occur only on a quarterly basis and with 90 days prior notice; limiting the amount an investor could withdraw; and limiting the amount available to fund withdrawals).

[258]Some GNMA certificates are considered to be section 3(c)(5)(C) assets. See *infra* note 267 and accompanying text.

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

Whether an issuer is "primarily engaged" in one or more of these activities for purposes of subsections (A) and (B) generally has not been an issue. But see Econo Lodges of America, Inc. (pub. avail. Dec. 22, 1989) (no-action position taken where franchise royalty fee receivables
(continued...)

related to the purchase or sale of specific merchandise, insurance, or services, the no-action request has been **refused.**[260]

Many non-mortgage structured financings, including financings backed by automobile loans, boat loans, credit card receivables, and equipment leases, among others, rely on subparagraphs **(A)** or (B).[261] **All** of these financings are backed by assets that relate to the purchase or sale of specified goods or services. Other financings, such as those using commercial loans, student loans, and CBOs, typically are unable to rely on these subparagraphs because their assets do not meet the criteria of subparagraphs **(A)** and (B).

Not all financings backed by revolving credit card accounts receivable are able to rely on subparagraph **(A).** Although most financings using these assets

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[259](...continued)
obtained from entity's parent represented at least 55% of the entity's assets, and at least 85% of the net proceeds from the sale of notes backed by the receivables were subsequently loaned to parent). This issue, however, has been the subject of a substantial number of no-action letters in the context of section 3(c)(5)(C). **See,** *e.g.*, no-action letters cited *infra* notes **263-269** and accompanying text.

[260]*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).

[261]*See* Letter from Thomas R. Smith, Jr., Brown & Wood, on behalf of Merrill Lynch Capital Markets et al., to Kathryn B. McGrath, Director, Division of Investment Management, SEC **7-14** (Feb. **27, 1990),** File No. **S7-11-90** (arguing that credit card receivable financings are excepted from the Investment Company Act). The Investment Company Institute ("ICI") has argued that financings backed by credit card receivables are investment companies and should be regulated under the Act. The ICI has argued that section **3(c)(5)** does not exempt these financings because they have little in common with traditional commercial finance companies. The ICI has also argued, among other things, that the relationships among the participants of credit card-backed financings give rise to the types of potential Self-dealing and conflicts of interest concerns that the Investment Company Act is intended to address. **See** Letter from the ICI to Richard C. Breeden, Chairman, SEC **2** (Feb. **2, 1990),** File No. **S7-11-90.** The ICI had previously sent a similar letter to the Division. **See** also Letter from Tamar Frankel, Professor of Law, Boston University, to Kathryn B. McGrath, Director, Division of Investment Management, SEC **1, 6** (Jan. **26, 1990),** File No. **S7-11-**90 (suggesting the Commission design a regulatory system under the Act for financings backed by credit card receivables).

have not registered as investment companies in reliance on this section, they generally have limited the percentage of their assets that consist of obligations resulting from cash advances out of concern that, since such advances are general purpose consumer loans, a significant amount of these assets could cause a financing to be outside section 3(c)(5).[262]

(2) Subparagraph (C)

Many issuers of mortgage-backed securities and similar products have relied on subparagraph (C). An issuer seeking to rely on this exception 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, although this percentage may be reduced to the extent that more than fifty-five percent of the issuer's assets are invested in qualifying interests.[263]

A number of no-action letters have been issued explicating what are qualifying interests for purposes of subparagraph (C). These interests include fee interests,[264] leaseholds,[265] and interests fully secured by a mortgage solely on real estate ("whole mortgages")[266]. Qualifying interests also include agency "whole pool certificates."[267] The rationale is that the holder of these certificates generally has the same economic experience as the investor who purchases the underlying mortgages directly, including the receipt of both principal and interest payments and the risk of prepayment on the underlying mortgage loans, notwithstanding the guarantees provided by the agencies.

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[262] *See* Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, **SEC 62** (Oct. **12, 1990),** File No. **S7-11-90** [hereinafter Cleary, Gottlieb Study Comment].

[263] *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).**

[264] **United** Bankers, Inc., *supra* note **263.**

[265] *See* Health Facility Credit *Corp.* (pub. avail Feb. **6,1985).**

[266] *See* Medidentic Mortgage Investors (pub. avail. May 23, **1984).**

[267] *See, e.g.,* American Home Finance Corp. (pub. avail. Apr. **9,1981)** (GNMA certificates). The term "whole pool certificate" means a certificate that represents the entire ownership interest in a particular pool of mortgage loans. A "partial pool certificate" is a certificate that represents less than the entire ownership interest in a particular pool of mortgage loans.

Agency partial pool certificates that represent less than the entire ownership interest in a pool of mortgages ("partial pool certificates") have not been considered to be qualifying interests.[268] The rationale is that an investor in partial pool certificates obtains greater diversification and is subject to a different prepayment risk than an investor who purchases the underlying mortgages directly. An investment in partial pool certificates is viewed as being more like an investment in the securities of the issuer, rather than an investment in the underlying mortgages. Partial pool certificates are considered to be a real estate related asset for purposes of meeting the twenty-five percent portion of the "primarily engaged in" test, however. Similarly, residual interests are not qualifying interests for purposes of subparagraph (C),[269] although they may be considered to be real estate related assets.

b. Section 3(c)(1)

Many financings rely on section 3(c)(1). This section, known as the "private investment company" exception, excepts any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than 100 persons. In addition, the issuer may not make, or propose to make, a public offering.[270] Thus, sponsors that wish to offer publicly securitized credit in the United States cannot rely on this exception.

2. Exemptive Relief

Some structured financings have obtained exemptive relief from the Commission under section 6(c), the general exemptive provision of the Act.[271] Most of the exemptive orders concern CMOs and REMICs whose assets consist

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[268] *See* Nottingham Realty Securities, Inc. (pub. avail. Apr. 19, 1984).

[269] *See, e.g*, M.D.C. Holdings (pub. avail. May 5, 1987). While agency whole pool certificates are deemed to be qualifymg interests, it is the position of the Division that whole pool (or partial pool) certificates issued by private issuers are not qualifymg interests under section 3(c)(5)(C). A no-action position has not been requested regarding private residential mortgage loans held by the issuer under funding agreements (*i.e.*, promissory notes secured by mortgage loans or mortgage Certificates). Nevertheless, these assets are not generally considered to be qualifying interests for purposes of section 3(c)(5)(C). Some issuers investing primarily in partial pool certificates and other real estate related assets have received exemptive relief. See *infra* note 272 and accompanying text.

[270] For a more detailed discussion of section 3(c)(1), see Chapter 2.

[271] 15 U.S.C. § 80a-6(c).

primarily of partial pool certificates and other mortgage-related assets that are not qualifying interests under section **3(c)(5)(C)**.[272] In this regard, the legislative history of **SMMEA** indicates that Congress expected the Commission to provide appropriate administrative relief if the Investment Compan Act unnecessarily hindered development of the secondary mortgage market.[273] The Commission has issued approximately 125 orders under section 6(c) exempting structured financings backed by mortgage-related **assets**.[274]

In general, the orders have required, among other things, that (i) the securities be rated in the top two categories by at least one rating agency; (ii) substitution of the assets be limited quantitatively and qualitatively; (iii) the assets be held by an independent trustee, qualified under the Trust Indenture Act, who has a first priority perfected security or lien interest 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 payments of principal and interest. These conditions have been imposed to ensure the safety and adequacy of the assets, to guard against self-dealing by sponsors, and to address concerns about capital structure. Many of the conditions parallel requirements imposed by the rating agencies as a condition of receiving a rating in the top two categories. The exemptive orders also have imposed conditions limiting the sale of residual interests.

Another type of structured financing that has received exemptive relief is the sale of federal government loans. Pursuant to the Omnibus Reconciliation

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[272] In addition to CMOs and REMICs, exemptive orders have been issued to special purpose corporations organized by home builders that wish to issue, among other things, bonds secured by pledges of mortgage loans on single family residences constructed by the builders, called "builder bonds." **See, *e.g.*,** American Southwest Financial Corp., et al., Investment Company Act Release No. **12771** (Oct. **29, 1982), 47** FR **50594** (Notice of Application) and **12844** (Nov. **23, 1982), 26** SEC Docket **1251** (Order).

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

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

Acts of 1986[275] and 1987,[276] the federal government sold portions of the loan portfolios of certain government agencies. Most of these sales could not be completed without exemptive relief from the Investment Company Act, although some were excepted under section 3(c)(5). A total of seven financings either received exemptions under sections 6(c) and 6(e) from most provisions of the Act, including the registration requirement,[277] or registered as closed-end mana ement investment companies and received exemptions from much of the Act?' The conditions imposed were similar to those for mortgage-related financings, requiring, among other things, that (i) the debt obligations be rated in at least one of the two highest rating categories; (ii) the residual interests be privately placed with a maximum of 100 sophisticated and experienced investors; and (iii) the pool of assets be fixed, except for limited substitutions.[279]

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[275]Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (1986).

[276]Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987). The objectives of the loan asset sales program were to reduce the government's cost of administering credit programs by transferring administrative responsibility to the private sector; improve loan origination and documentation; determine the actual subsidy of a federal credit program; and reduce the budget deficit in the year of sale. See OMB Guidelines on Loan Asset Sales, reprinted *in* GENERAL ACCOUNTING OFFICE, LOAN ASSET SALES: OMB POLICIES WILL RESULT IN PROGRAM OBJECTIVES NOT BEING FLJLLY ACHIEVED, App. II (Sept. 1986).

[277]Generally, the issuer agreed to be subject to section 26 (15 U.S.C. § 80a-26) (with certain exceptions), which applies to unit investment trusts; section 36 (15 U.S.C. § 80a-35), which subjects certain affiliated persons of an investment company, including a depositor of a unit investment trust, to liability for breaches of fiduciary duty involving personal misconduct; section 37 (15 U.S.C. § 80a-36), which makes it a crime for any person to steal or embezzle any funds or assets of a registered investment company; and sections 38 through 53 (15 U.S.C. §§ 80a-37 to -52) (often referred to as the "jurisdictional" sections of the Act) to the extent necessary to enforce compliance with sections 26, 36, and 37.

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

[279]The only other exemptive order issued by the Commission with respect to structured finanangs involved trusts established by the Government of Israel to facilitate the financing of its housing program for Soviet refugees. Each trust was to issue non-redeemable pass-through certificates backed by a single promissory note, the payment of which would be 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 (Notice of Application) and 18069 (Mar. 28, 1991), 48 SEC Docket 943 (Order).

B. Effects of the Regulatory Structure

As a practical matter, the Act today treats similar types of structured financings very differently. Some structured financings are subject to prohibitive conditions imposed by the Act, while others are exempted from the Act entirely.

Structured financings that are excepted by section 3(c)(5) or that have obtained exemptions may be sold publicly or privately in the United States, overseas, or both. Financings that do not fit within section 3(c)(5) or that are unable to obtain an exemption either must be privately placed in the United States or sold overseas. Each may be problematic for the sponsor. For example, private placements prevent sponsors from diversifying and expanding their investor bases and ensuring a liquid secondary market for the securities. The success of international offerings has been mixed.

The differing regulatory treatment affects the development of the structured finance market. The most widely accepted types of structured financings are those that are sold on the domestic public market, while those structured financings whose distribution is limited to private placements or overseas offerings have lagged in development. Many United States investors that may wish to purchase these securities are prohibited from doing so, even though the securities may be highly rated by a rating agency, because the securities are not offered publicly. Thus, today the Act distorts the market by enforcing a distinction that does not reflect the economic reality that any asset with a relatively predictable cash flow, whether it may be classified as a "commercial" instrument or a "financial" instrument, may be securitized.

The attempt by market participants to fit financings into section 3(c)(5) is understandable, but unproductive, consuming much time of sponsors, underwriters, and their counsel, as well as the time of the Commission and its staff. **A** preferable alternative is to develop a coherent approach to the treatment of structured financings under the Investment Company Act. Such an approach must take into account the unique operation of the industry and also address any investor protection concerns resulting from the pooling of securities.

V. The Reform of the Treatment of Structured Finance

In determining how the Investment Company Act should treat private sector structured finance, it is important to recognize that the purpose of structured finance is quite different from that of most investment companies. Structured finance primarily is a financing technique that integrates the capital markets with borrowers seeking access to those markets; the sponsors of asset securitizations are seeking a source of financing. In contrast, investment companies are intended to provide the advantages of professional management, diversification, and economies of scale to investors.

Nevertheless, the fundamental issue is whether structured financings in fact present opportunities for abuse similar to those presented by registered investment companies. We conclude that all structured financings, regardless of the nature of their underlying assets, theoretically present the opportunities for abuses similar to those that led to the enactment of the Investment Company Act. The industry, however, has been remarkably free of abusive practices, due primarily to the requirements thus far imposed by the market itself.

Based on this record, we recommend that the Commission adopt an exemptive rule to permit all structured financings to offer their securities publicly in the United States without registering under the Investment Company Act, provided that the financings meet certain conditions that would codify present industry practice. The conditions would limit the scope of the rule to issuers that invest in assets that have scheduled cash flows; primarily hold the assets to maturity (*i.e.,* have limited portfolio management); issue nonredeemable securities; issue publicly only debt or debt-like securities rated in the top two investment grades, the payment of which depends on the cash flows of the underlying assets; and whose assets are held by a qualified trustee. In addition, we recommend that the Commission seek public comment on whether section 3(c)(5) should be amended so that all structured financings are subject to the same requirements for exemption.

In this section, we analyze the potential for abuse in structured financings in light of the structural and operational differences between investment companies and structured financings, the actual experience over the last two decades, options for rationalizing the treatment of structured finance under the Act, and the outlines of the exemptive rule we recommend. We also discuss whether section 3(c)(5) should be amended.

A. The Potential for Abuse in Structured Financings

Because structured financings have some of the principal features of registered investment companies -- that is, they are issuers of securities and hold pooled financial assets -- the key question is whether those financings share with traditional investment companies the potential for the types of abuses that led to the enactment of the Investment Company Act. These abuses include opportunities for self-dealing and overreaching by insiders, inaccurate valuation of assets, excessive leverage, and inadequate protection of assets.

1. Overreaching and Self-Dealing by Insiders

One of the most significant concerns addressed by the Investment Company Act is overreaching and self-dealing by investment company insiders. The Commission's 1940 Investment Trust Study documented numerous instances in which investment companies were managed for the benefit of their sponsors and affiliates to the detriment of investors. For example, the "dumping" by sponsors of worthless or unmarketable securities into investment companies was prevalent. Accordingly, the Act and the rules,thereunder prohibit or restrict most transactions with insiders?''

Structured financings present a number of opportunities for analogous forms of self-dealing and overreaching. For example, a sponsor could engage in a form of dumping by selling to a special purpose issuer assets of insufficient credit quality and amount to produce adequate cash flows to make full and timely payment on the fixed income securities sold to the public.[281]

Self-dealing and overreaching by insiders after the initial deposit of assets also could harm investors. For example, a sponsor could substitute inferior assets for the assets originally placed in the pool, thereby jeopardizing payments to investors. In the case of structured financings backed by revolving credit card receivables and asset-backed commercial paper programs, similar abuses could arise, because a sponsor may sell additional assets to the issuer after the financing first offers securities to the public.

In addition, the servicer often reinvests idle cash in short-term investments when there is a timing mismatch between the collections from the underlying assets, and distributions to investors.[282] Absent appropriate restrictions, a servicer, particularly if it is the sponsor or an affiliate, might reinvest the cash in

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[280] *See* Chapter 12.

[281] Of course, section 17(a) (15 U.S.C. § 80a-17(a)), the Investment Company Act's prohibition on principal transactions with insiders, does not apply to the initial deposit of securities into a UIT, a transaction which is analogous to the transfer of assets to a special purpose issuer in a structured financing.

[282] *See* supra note 112 and accompanying text.

the sponsor's own risky securities, thereby benefitting the sponsor at the expense of investors, should the sponsor default.

Finally, the potential for other types of self-dealing exist where the sponsor or its affiliate acts as servicer. Perhaps the most serious type is where the sponsor/servicer has other dealings with the obligors on the assets in the pools, which decrease its incentive to service the debt properly.[283] For example, in a structured financing backed by credit card accounts receivable, the sponsor owns the accounts from which the receivables are generated and typically continues to service them through and beyond the course of the financing. If the sponsor is also a retailer, it may alter the accounts' terms (*e.g.,* interest rate charged, credit limit, minimum payment schedule), in order to generate additional receivables from the accounts, or to preserve its relationship with its customers. Because the receivables generated from the accounts are continually sold to the issuer during the "interest only" period of the transaction,[284] the amended terms could prevent timely payment to investors. *Also,* in acting as servicer, the sponsor may commingle collections on the assets with its own funds, thereby subjecting investors to the risk of the sponsor's insolvency.

On the other hand, the nature of the securities issued in most structured financings alters and to some extent reduces the concerns about self-dealing. Losses on the assets in the pool are borne first by parties other than fixed-income investors, such as the holder of the residual interest and the servicer.[285] Thus, self-dealing affects fixed-income investors only to the extent it completely erodes the cash flow cushion provided by those with more junior interests in the pool.

2. Inaccurate Valuation of Assets

Before 1940, investment companies often valued their portfolios inaccurately, resulting in unfair and discriminatory practices in the pricing of their securities. The Act now generally requires that investment companies value their assets at market value.

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[283]Of course, for many financings, the fact that the sponsor services the assets is desirable because the sponsor is familiar not only with the type of business from which the underlying assets were generated, but also with many of the characteristics of the specific assets.

[284]*See supra* note 157 and accompanying text.

[285]Because the holders of residual interests are almost invariably sophisticated institutional investors, they presumably are able to evaluate the risk of self-dealing, inaccurate valuation of assets, excessive leverage, and inadequate protection of assets.

In a structured financing, the valuation of the assets (albeit on a cash flow basis) is critical because payments on the fixed-income securities sold to public investors depend primarily or entirely on those assets. Because structured financings primarily issue unredeemable fixed-income securities whose payment is derived solely or primarily from the cash flow on the underlying assets, and are evaluated by investors and others on that basis, continuous valuation of assets on a market value basis is not as critical. Arguably, however, the sponsor may misvalue assets used in structured financings, resulting in a structured finance issuer holding assets whose cash flow has little relationship to the securities issued in the financing.

3. Excessive Leverage

Prior to 1940, some investment companies were highly leveraged, issuing large amounts of "senior securities," in the form of debt or preferred stock. This often resulted in the companies being unable to meet their obligations to the holders of these securities. This risk was exacerbated when equity holders redeemed their shares. Excessive issuance of senior securities also greatly increased the speculative nature of the common stock of the companies. In response, the Act limits the issuance of senior securities by management investment companies.[286]

In theory, leverage concerns are somewhat applicable to structured financings, given the degree of leverage used in virtually all structured financings. Financings could be established with assets that would not produce the cash flows needed to meet the obligations to the investors of the fixed-income securities. The effect of leverage on residual interest holders in structured financings is not truly an Investment Company Act concern, however, since those investors invariably are extremely sophisticated investors, not the type of investor the Act was intended to protect.[287] Moreover, because structured financings do not issue redeemable securities, there is no threat of redemption or repurchases of equity that could endanger senior security holders.

4. Protection of Assets

In numerous instances prior to 1940, the assets of investment companies were not adequately protected. In many cases, controlling persons of investment

[286] *See* **Investment Company Act § 18/15 U.S.C. § 80a-18. For a general discussion of the Act's limits on leverage, see Chapter 11.**

[287] There **is no requirement that residual investors be sophisticated, however.**

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,

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[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;
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> (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;
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> **(3)** the issuer does not issue any redeemable securities;
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> **(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

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[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?[314] 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]

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[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?[318] We conclude that relying on the agencies will provide a very

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[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

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[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]

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[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

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[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)