

control zones that do not underlie the continental control area have no upper limit. A control zone may include one or more airports and is normally a circular area with extensions as necessary to include instrument approach paths.

4. Section 71.607 is revised to read as follows:

**§ 71.607 Jet route descriptions.**

Each jet route description can be found in subpart M of FAA Order 7400.7A (incorporated by reference, see § 71.1).

5. Section 71.609 is revised to read as follows:

**§ 71.609 Area high route descriptions.**

Each area high route description can be found in subpart M of FAA Order 7400.7A (incorporated by reference, see § 71.1).

Issued in Washington, DC, on November 18, 1992.

Harold W. Becker,

Manager, Airspace-Rules and Aeronautical Information Division.

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## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 270

[Release No. IC-19105; File No. 87-12-92]

RIN 3235-AF47

### Exclusion From the Definition of Investment Company for Structured Financings

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission is adopting a new rule, rule 3a-7 under the Investment Company Act of 1940 (the "Act"), to exclude issuers that pool income-producing assets and issue securities backed by those assets ("structured financing") from the definition of "investment company." The rule permits structured financings to offer their securities publicly in the United States without registering under the Act and complying with the Act's substantive requirements. Rule 3a-7 removes an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy, including the small business sector.

**EFFECTIVE DATE:** November 27, 1992.

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**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission is adopting a new rule, rule 3a-7, under the Investment Company Act of 1940 (15 U.S.C. 80a) (the "Act"). Rule 3a-7 excludes from the definition of "investment company" under section 3(a) of the Act (15 U.S.C. 80a-3(a)) structured financings that meet the rule's conditions. The adoption of rule 3a-7 implements the recommendation made in chapter 1 of the Division of Investment Management's report, *Protecting Investors: A Half Century of Investment Company Regulation*.<sup>1</sup> In addition, the Commission is announcing that it is not pursuing any legislative changes to section 3(c)(5) (15 U.S.C. 80a-3(c)(5)) at this time.

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#### I. Background

Structured finance is a technique whereby income-producing assets, in most cases, illiquid, are pooled and converted into capital market instruments. In a typical 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 pooled assets. 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.

<sup>1</sup> Division of Investment Management, SEC, *The Treatment of Structured Finance Under the Investment Company Act*, *Protecting Investors: A Half Century of Investment Company Regulation* (1992). The report concluded a two-year examination of the regulation of investment companies and certain other pooled investment vehicles.

A servicer, which often is the sponsor or an affiliate of the sponsor, is the primary administrator of the pool, collecting payments on the underlying assets when due and ensuring that funds are available so that investors are paid in a timely manner. In most cases, an independent trustee, usually a large commercial bank, monitors the issuer's fulfillment of its obligations.

Since its inception in the 1970's, structured finance has grown tremendously, becoming one of the dominant means of capital formation in the United States. Nevertheless, the growth and development of this market has been constrained in some degree by the Act.

Structured financings fall within the definition of investment company under section 3(a), but cannot operate under the Act's requirements.<sup>2</sup> Many private sector sponsored financings<sup>3</sup> have avoided regulation under the Act by relying on section 3(c)(5), which generally exempts from the definition of investment company any person who is not engaged in the business of issuing redeemable securities and who is primarily engaged in one of the finance businesses enumerated in the section. In addition, the Commission has issued more than 125 orders exempting other structured financings, primarily those involving mortgage-related assets, from the Act.<sup>4</sup> Financings that cannot rely on section 3(c)(5) or obtain an exemption must sell their securities in private placements in reliance on section 3(c)(1),<sup>5</sup> the "private" investment company exception, or outside the United States.

As a practical matter, the Act treats similar types of structured financings very differently, depending solely on the assets securitized.<sup>6</sup> Some sectors of the

<sup>2</sup> For example, the limitations of section 18 on the issuance of senior securities and the prohibitions of section 17 on transactions involving affiliates conflict with the operation of structured financings. 15 U.S.C. 80a-18, -17.

<sup>3</sup> Most structured financings sponsored by the federal government and government sponsored enterprises are exempted from the Act 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).

<sup>4</sup> Structured financings that have received orders may continue to rely on them or may rely on rule 3a-7.

<sup>5</sup> 15 U.S.C. 80a-3(c)(1).

<sup>6</sup> For example, most structured financings backed by consumer receivables are excepted from the Act under section 3(c)(5). Structured financings backed by general purpose loans, however, are not excepted and cannot be sold publicly in the United States, even though the financing may be similar to those qualifying for an exception or receiving exemptive relief.

economy, including small business, generally are unable to use structured financings as sources of capital, and many United States investors are denied the opportunity to purchase sound capital market instruments.

On May 29, 1992, the Commission proposed rule 3a-7, which was intended to exclude virtually all structured financings from the definition of investment company, subject to certain conditions.<sup>7</sup> These conditions generally would have required issuers to (i) issue primarily fixed-income securities, with payment thereon based on the cash flow derived from the pooled assets; (ii) offer to the public only highly rated fixed-income securities; (iii) hold to maturity substantially all of the financing's assets, with limited exceptions; and (iv) deposit assets, cash flows, and other property not needed for the financing's operation in a segregated account maintained by an independent trustee.<sup>8</sup> The proposed conditions were intended to reflect the structural and operational distinctions between registered investment companies and structured financings and incorporate investor protections currently imposed by the market itself. They also sought to accommodate future innovations in the structured finance market, consistent with investor protection.

## II. Discussion

### A. Rule 3a-7

The Commission received forty-two comment letters addressing proposed rule 3a-7.<sup>9</sup> All but two agreed that

<sup>7</sup> Exclusion from the Definition of Investment Company for Certain Structured Financings, Investment Company Act Release No. 18736 (May 29, 1992), 57 FR 23980 (June 5, 1992) [hereinafter "Proposing Release"].

<sup>8</sup> See *id.*, section II.A.2.

<sup>9</sup> The commenters were Advanta Corp.; the American Bankers Association; the American Bar Association's 1940 Act Structured Finance Task Force ("ABA Task Force"); Brown & Wood; Cadwalader, Wickersham & Taft; Chemical Bank; Chase Manhattan Corp.; Citibank N.A. ("Citibank"); Cleary, Gottlieb, Steen & Hamilton; Cravath, Swaine & Moore, on behalf of Salomon Brothers Inc. ("Salomon Brothers"); Davis Polk & Wardwell; Dean Witter Financial Services Group Inc. ("Dean Witter"); Debevoise & Plimpton, on behalf of The New York Life Insurance Company; Farella, Braun & Martel; Fidelity Management & Research Company ("FMR"); Financial Security Assurance ("FSA"); First Chicago Corp. ("First Chicago"); General Motors Acceptance Corp.; Investment Company Institute ("ICI"); Kirkland & Ellis; Kutak Rock; Latham & Watkins, on behalf of Sears, Roebuck and Co. and Sears Receivables Financing Group, Inc. ("Sears"); Lehman Brothers; Locke Purnell Rain Harrell; Mayer, Brown & Platt; MBNA America Bank N.A. ("MBNA"); Merrill Lynch & Co. ("Merrill Lynch"); Mortgage Bankers Association of America Inc. ("MBA"); NationsBank Corp.; New York State Bar Association; North American Securities Administrators Association, Inc. ("NASAA"); Orrick, Herrington & Sutcliffe; Public Securities

structured financings should be excluded from regulation under the Act. Although the commenters generally considered the proposal to be a positive step toward the removal of barriers to the use of structured financings, most argued that it was unnecessarily restrictive and, in some respects, inconsistent with the current operations of many structured financings. The rule, as adopted, has been modified to address the commenters' concerns.<sup>10</sup>

### 1. Scope of the Rule

Rule 3a-7 excludes from the definition of investment company any issuer who is engaged in the business of acquiring and holding eligible assets (and in activities related or incidental thereto) and who does not issue redeemable securities. The rule has been modified from the proposal in several respects to ensure that most structured financings, regardless of their underlying assets, can rely on the exclusion and engage in practices necessary to their operation.<sup>11</sup>

First, paragraph (b)(1) defines the term "eligible assets" as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure servicing or timely distribution of proceeds to the security holders." This definition is based on the definition of "asset-backed security" in the recently adopted revisions to Form S-3 under the Securities Act of 1933 ("Securities Act").<sup>12</sup>

Association ("PSA"); Residential Funding Corp ("RFC"); Rogers & Wells; Securities Industry Association ("SIA"); Stroock & Stroock & Lavan; Sullivan & Cromwell; Thacher Proffitt & Wood; White & Case; and Willkie Farr & Gallagher.

<sup>10</sup> In adopting rule 3a-7, the Commission disagrees with the arguments made by the ICI and NASAA that structured financings are investment companies and should be regulated under the Act. See Letter from the ICI to Jonathan G. Katz, Secretary, SEC 4-6 (Aug. 4, 1992), File No. S7-12-92 (hereinafter ICI Comment Letter); Letter from NASAA to Jonathan G. Katz, Secretary, SEC 5 (Aug. 5, 1992), File No. S7-12-92 (hereinafter NASAA Comment Letter). Structured financings are fundamentally different from investment companies in operation and purpose. Notwithstanding its size and rapid growth, the structured finance market has been virtually free of abuse. Requiring regulation based on theoretical concerns would only disrupt an increasingly important form of finance.

<sup>11</sup> One commenter suggested the proposed rule be clarified to permit issuers to hold only one eligible asset. Letter from Salomon Brothers to Jonathan G. Katz, Secretary, SEC 11 (Aug. 4, 1992), File No. S7-12-92 (hereinafter Salomon Brothers Comment Letter). Such clarification is unnecessary since the rule as proposed did not exclude this type of structure.

<sup>12</sup> These amendments expanded the benefits of rule 415 under the Securities Act, the so-called shelf registration rule, to offerings of investment grade asset-backed securities. As adopted, Form S-3 defines "asset-backed security" as "a security that is primarily serviced by the cashflows of a discrete

Paragraph (b)(1) replaces proposed paragraph (b)(1), which would have defined eligible assets to mean obligations that have scheduled cash flows, and other assets that serve solely to support the credit of the securities.<sup>13</sup> Many commenters were concerned that the proposed definition did not encompass all of the types of assets that can be securitized.<sup>14</sup> Commenters also noted that the proposed definition appeared not to include assets commonly used to support the liquidity of the securities and the creditworthiness of the assets being securitized.<sup>15</sup> Finally, many commenters

pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the securityholders." See Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992), 57 FR 46970 (Oct. 29, 1992).

<sup>13</sup> Proposed paragraph (b)(1) defined eligible assets as "obligations that require scheduled cash payments, such as notes, bonds, debentures, evidences of indebtedness, certificates of deposit, leases, installment contracts, interest rate swaps, repurchase agreements, guaranteed investment contracts, accounts receivable, chattel paper, cumulative preferred stock, guarantees, annuities, and participations or beneficial interests in any of the foregoing; and other assets that serve solely to support the credit of the issuer's securities, such as letters of credit, guarantees, and cash collateral accounts."

<sup>14</sup> Some commenters, for example, expressed concern that the proposed requirement of scheduled cash payments would exclude revolving assets (such as credit card accounts receivables, revolving home equity loans, and dealer warehouse receivables) because the cash payments on such assets vary according to current loan balances. See, e.g., Letter from Cadwalader, Wickersham & Taft to Jonathan G. Katz, Secretary SEC 4-5 (Aug. 3, 1992), File No. S7-12-92 (hereinafter Cadwalader, Wickersham & Taft Comment Letter); Letter from ABA Task Force to Jonathan G. Katz, Secretary, SEC 2 (Aug. 4, 1992), File No. S7-12-92 (hereinafter ABA Task Force Comment Letter). Mortgage pass-through certificates also may not have met the definition since they are equity interests, not obligations, and their payments depend heavily on unscheduled prepayments. Letter from Stroock & Stroock & Lavan to Jonathan G. Katz, Secretary, SEC 4 (Aug. 4, 1992), File No. S7-12-92 (hereinafter Stroock & Stroock & Lavan Comment Letter).

<sup>15</sup> See, e.g., Letter from Mayer, Brown & Platt to Jonathan G. Katz, Secretary, SEC App. 21 (Aug. 3, 1992), File No. S7-12-92 (hereinafter Mayer, Brown & Platt Comment Letter); Letter from Brown & Wood to Jonathan G. Katz, Secretary, SEC 10 (July 20, 1992), File No. S7-12-92 (hereinafter Brown & Wood Comment Letter). For example, liquidity and credit support may be provided through the use of facilities such as asset purchase and secondary marketing arrangements. See Letter from Citibank to Jonathan G. Katz, Secretary, SEC 9 (Aug. 4, 1992), File No. S7-12-92 (hereinafter Citibank Comment Letter). Also, commenters noted that private mortgage insurance, title insurance, and casualty insurance, all of which are frequently used to support the credit of the underlying assets would not have met the proposed definition. See, e.g., Cadwalader, Wickersham & Taft Comment Letter, *supra* note 14, at 6.

stated that assets that are "ancillary" or "incidental" to eligible assets, such as collateral securing a securitized asset, might not have been eligible assets under the proposed definition.<sup>16</sup> Consequently, they feared that proposed paragraph (b)(1) would have precluded many financings from relying on the rule.

As modified, paragraph (b)(1) encompasses any self-liquidating asset which by its terms converts into one or more cash payments within a finite period of time. Accordingly, virtually all assets that can be securitized (*i.e.*, which produce cash flows of the type that may be statistically analyzed by rating agencies and investors) will meet the definition of eligible asset.<sup>17</sup> In addition, the definition includes credit and liquidity arrangements that support the payment of the securities and the underlying assets, and ancillary or incidental assets which are necessary in the course of servicing the underlying assets or to assure the distribution of cash flow and/or proceeds to security holders.<sup>18</sup>

<sup>16</sup> See, e.g., ABA Task Force Comment Letter, *supra* note 14, at 3; Letter from Merrill Lynch to Jonathan G. Katz, Secretary, SEC 9-10 (Aug. 4, 1992), File No. S7-12-92 (hereinafter Merrill Lynch Comment Letter). Other examples of ancillary or incidental assets include proceeds from eligible assets, equity securities received in reorganizations or bankruptcies of obligors on eligible assets, short-term reinvestments, and property obtained upon the lease default of a third-party lessee.

<sup>17</sup> In this regard, one commenter suggested that the Commission adopt the standard used in the proposed amendments to Form S-3 because it more accurately reflected market practices. See Citibank Comment Letter, *supra* note 15, at 2-3. For similar reasons, other commenters suggested that the Commission define "eligible assets" to include "assets that by their terms convert into cash over a finite period of time," borrowing the terminology used in Regulation S under the Securities Act (17 CFR 230 § 903(c)(4)) to define "assets" for that rule's provisions relating to asset-backed securities. See, e.g., ABA Task Force Comment Letter, *supra* note 14, at 2-4; Brown & Wood Comment Letter, *supra* note 15, at 9. One commenter, however, stated that standard, which is used in both Regulation S and Form S-3, still would not reach some assets that can be securitized. See Stroock & Stroock & Lavan Comment Letter, *supra* note 14, at 4-5. Another commenter suggested that the standard was ambiguous. See Mayer, Brown & Platt Comment Letter, *supra* note 15, at App. 18.

Although the definition of eligible assets is intended to be broad, it is impossible to devise a definition of eligible assets that will include all types of assets that can be securitized. Accordingly, issuers, or other parties on their behalf, may request the Division of Investment Management take a non-action position with respect to the holding of specified assets that do not meet the definition of "eligible assets," provided such assets meet the intent of the definition.

<sup>18</sup> Thus, for example, although common stock generally would not be an eligible asset because it does not produce cash flows that can be analyzed statistically, issuers could hold common stock, for example, that was involuntarily obtained through a work-out because the common stock would be an ancillary or incidental asset.

Paragraph (b)(1) does not include a list of assets that would meet the definition of eligible assets. The proposed paragraph had included a non-exclusive list of eligible assets to provide guidance to sponsors of financings seeking to rely on the rule. Almost all commenters suggested additional assets for the list,<sup>19</sup> even though some cautioned that the list proposed was so inclusive that it might be interpreted as being exclusive.<sup>20</sup> Such an interpretation could cause confusion and ultimately impede the evolution of the structured finance market, thereby outweighing the intended benefits of including a list in the definition. Paragraph (b)(1), as adopted, is intended to include all of the assets provided as examples in the proposed paragraph, in addition to those discussed in connection with the comments received on the proposed provision.<sup>21</sup>

In addition, the rule permits an issuer to engage in activities that are related or incidental to the business of acquiring and holding eligible assets. The release proposing rule 3a-7 ("proposing release")<sup>22</sup> had explained that only issuers whose *sole* business is to hold a pool of eligible assets would be able to rely on the rule. A few commenters suggested that this interpretation could preclude current practices, since an issuer's activities during the operation of a financing is not limited to acquiring and holding eligible assets.<sup>23</sup> Accordingly, the rule, as adopted, provides issuers with the flexibility to engage in related or incidental activities.

Finally, the rule retains the proposed requirement that issuers issue only non-redeemable securities. The Commission has decided, however, to delete the reference to debt securities payable upon fourteen days' demand. While precluding issuers from acting in a manner similar to mutual funds, this

<sup>19</sup> These assets included numerous types of financial derivative products, franchise fees, cash, credit-card receivables representing cash advances, insurance policies, reserve funds, liquidity and maturity facilities, and lines of credit.

<sup>20</sup> See, e.g., Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 15 (Aug. 6, 1992), File No. S7-12-92 (hereinafter Cleary, Gottlieb, Steen & Hamilton Comment Letter).

<sup>21</sup> See *supra* notes 14-16 & 18-19 and accompanying text.

<sup>22</sup> Proposing Release, *supra* note .

<sup>23</sup> For example, an issuer may engage in such activities as filing registration statements, returning defective assets to the sponsor, and through the servicer as its agent, servicing the assets. See, e.g., Letter from Kirkland & Ellis to Jonathan G. Katz, Secretary, SEC 11 (Aug. 4, 1992), File S7-12-92 (hereinafter Kirkland & Ellis Comment Letter).

approach also codifies industry practice.<sup>24</sup>

## 2. Conditions

(i) *Securities based on underlying cash flows.* Paragraph (a)(1) requires the issuer to issue fixed-income securities or other securities that entitle their holders to receive payments that depend primarily on the cash flow from eligible assets. Paragraph (a)(1) differs from the proposal to reflect the inclusion of interest-only ("IO") securities, principal-only ("PO") securities, and "any other securities with similar characteristics" in the definition of "fixed-income securities" in paragraph (b)(2). Proposed rule 3a-7 would have excluded these securities from the definition of fixed-income securities, thereby effectively precluding issuers relying on the rule from selling such securities to the general public. The Commission noted in the proposing release that sales of IO and PO securities to unsophisticated investors may raise suitability concerns, but requested comment on whether this restriction would be appropriate.<sup>25</sup>

<sup>24</sup> Several commenters questioned whether the proposed rule would preclude financings from issuing certain types of securities, or from conducting repurchases in certain specified situations. See, e.g., ABA Task Force Comment Letter, *supra* note 14, at 26-32 (e.g., secondary market "tender option bonds," "Dutch Auction" floater/inverse floater programs); Citibank Comment Letter, *supra* note 15, at 3 (e.g., securities that commence amortization over time at the holder's option). Another commenter that the prohibition on issuing redeemable securities would adequately serve to differentiate financings from open-end management investment companies ("mutual funds"), making the restriction on the issuance of short-term demand notes unnecessary. Letter from SIA to Jonathan G. Katz, Secretary, SEC 14 (Aug. 13, 1992), File No. S7-12-92 (hereinafter SIA Comment Letter). Still two other commenters expressed concern that the proposed rule implicitly would permit the issuance of securities with a demand feature of greater than fourteen days, which in turn could promote investor confusion between structured financings and mutual funds and provide opportunities for abuse. Letter from FMR to Jonathan G. Katz, Secretary, SEC 2 (July 31, 1992), File No. S7-12-92 (hereinafter FMR Comment Letter); ICI Comment Letter, *supra* note 10, at 17-19.

Publicly offered financings rarely, if ever, issue redeemable securities. Numerous no-action positions have addressed the definition of redeemable security in the context of section 3(c)(5). See, e.g., California Dentists' Guild Real Estate Mortgage Fund II (pub. avail. Jan. 4, 1990) (a security that may be presented to the issuer by the holder is not a redeemable security if substantial restrictions are placed on the right of redemption). Counsel concerned about whether a security would be a redeemable security under rule 3a-7 may examine these no-action positions for guidance.

<sup>25</sup> The Commission also noted that financings that offer IO and PO securities arguably may represent a type of complex capital structure that the Act was intended to address. See Proposing Release, *supra* note 7, at n.74 and accompanying text.

Although a few commenters supported the restriction, most opposed it.<sup>26</sup> Opponents argued, among other things, that it would be inappropriate for the Commission to impose suitability requirements in a rule whose purpose is to exclude structured financings from the definition of investment company.<sup>27</sup> In addition, they pointed out that the restriction was unnecessary, given the suitability requirements imposed on broker-dealers under the Securities Exchange Act of 1934.<sup>28</sup> Commenters also argued that the restriction was illogical because IO and PO securities often are less volatile than other types of securities that could be sold to the general public under the proposed rule.<sup>29</sup> The Commission agrees with these commenters, and paragraphs (a)(1) and (b)(2) have been modified accordingly.<sup>30</sup> Nothing related to the Commission's adoption of this rule should be deemed to limit the duties of broker-dealers to observe suitability requirements.<sup>31</sup>

Finally, paragraph (a)(1) requires issuers to issue fixed-income securities or other securities which entitle security holders to receive payments that depend primarily on the cash flow from eligible assets. The proposed paragraph would have required issuers to issue primarily fixed-income securities with payment thereon dependent on the cash flow from eligible assets.

Several commenters expressed concern regarding the proposed requirement that an issuer primarily issue fixed-income securities. Commenters pointed out that the requirement could unnecessarily restrict the ability of issuers to rely on the rule where, for example, the value of non-fixed income obligations (e.g., residual interests) exceeded the value of the issuer's fixed-income securities.<sup>32</sup> Accordingly, final paragraph (a)(1) permits the issuance of both fixed-income securities and other securities, provided payment on these obligations is based primarily on cash flows from the underlying asset pool.<sup>33</sup>

Commenters also suggested that the proposed provision governing payments based on cash flows be modified to permit securities to be paid from collections from cash collateral accounts and other forms of credit enhancements, and to permit asset-backed commercial paper programs that use liquidity facilities to rely on the rule.<sup>34</sup> The provision tying payments to cash flows is intended to include payments obtained in any manner other than from the market value or fair value of the eligible assets.<sup>35</sup> As such, and in light of the broad definition of eligible assets in paragraph (b)(1), modification of this requirement is unnecessary.

In addition, in some financings, residual interests are paid, in part, out of the proceeds from the disposition of

eligible assets.<sup>36</sup> To address this practice, final paragraph (a)(1) requires the issuance of securities primarily backed by the cash flows from eligible assets.<sup>37</sup>

(ii) *Nature of the Securities Sold to the Public.* Under paragraph (a)(2) of the final rule, fixed-income securities that are rated, at the time of initial sale, in one of the four highest long-term debt categories or an equivalent short-term category by at least one nationally recognized statistical rating organization, or "rating agency," may be sold by the issuer and any underwriter without restriction.<sup>38</sup> Other fixed-income securities may be sold only to accredited investors as defined in rule 501(a)(1), (2), (3), and (7) under the Securities Act<sup>39</sup> and to entities in which all of the equity owners qualify as such investors ("institutional accredited investors"). Finally, all other securities, such as residual interests, could be sold only to "qualified institutional buyers" as defined in rule 144A under the Securities Act<sup>40</sup> and to persons involved in the organization or operation of the issuer and their affiliates.

The final rule, as a condition to the availability of the exemption, retains a rating requirement for securities sold to the general public. Virtually all commenters supported this approach.<sup>41</sup>

<sup>26</sup> Compare FMR Comment Letter, *supra* note 24, at 7; NASAA Comment Letter, *supra* note 10, at 2-3 (supporting restriction) with, e.g., ABA Task Force Comment Letter, *supra* note 14, at 6; Brown & Wood Comment Letter, *supra* note 15, at 10-11 (opposing restriction).

<sup>27</sup> See Cadwalader, Wickersham & Taft Comment Letter, *supra* note 14, at 10.

<sup>28</sup> See, e.g., *id.*; Letter from Lehman Brothers to Jonathan G. Katz, Secretary, SEC 2 (Aug. 18, 1992) File No. S7-12-92.

<sup>29</sup> See, e.g., ABA Task Force Comment Letter, *supra* note 14, at 5. Commenters also argued that investors should not be precluded from using IO and PO securities for hedging purposes, see, e.g., Stroock & Stroock & Lavan Comment Letter, *supra* note 14, at 13; and that the definitions of IO securities, PO securities, and "other securities with similar characteristics" are vague. See, e.g., Cleary Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at 5, 7-8.

<sup>30</sup> The definition of fixed-income securities is intended to encompass the various types of debt and debt-like securities currently offered by structured financings. The definition is not intended, however, to include residual interests structured as debt securities where a large portion of the investor's return is contingent. Based on language suggested by commenters, paragraph (b)(2) also has been modified to remove ambiguities and to delineate other methods currently used to calculate interest on asset-backed securities. See, e.g., Brown & Wood Comment Letter, *supra* note 15, at 8; ABA Task Force Comment Letter, *supra* note 14, at 8.

<sup>31</sup> As noted in the Proposing Release, the Federal Financial Institutions Examination Council adopted a supervisory policy statement that includes restrictions governing the trading of IO and PO securities by national banks due to the volatility of these instruments. Comptroller of the Currency, Administrator of National Banks, Supervisory Policy Statement on Securities Activities, Banking Circular No. 228 (Rev.) (Jan. 10, 1992). Likewise, the National Association of Insurance Commissioners is drafting a proposal limiting insurance company purchases of these securities.

<sup>32</sup> See, e.g., Kirkland & Ellis Comment Letter, *supra* note 23, at 12.

<sup>33</sup> The requirement that the issuer primarily issue these securities has been rendered unnecessary since final paragraph (a)(1) now covers all securities (i.e., securities the payment on which primarily depends on cash flows) issued by structured financings.

<sup>34</sup> See, e.g., Kirkland & Ellis Comment Letter, *supra* note 23, at 12; Mayer, Brown & Platt Comment Letter, *supra* note 15, at App. 2. Asset-backed commercial paper programs issue commercial paper on an ongoing basis and are backed by a diversified pool of assets, with assets added to the pool throughout the life of the program. Asset-backed commercial paper programs generally contain a variety of relatively short-term assets, such as credit card receivables, automobile lease receivables, and short-term money market instruments.

<sup>35</sup> As mentioned in the Proposing Release, *supra* note 7, at n.65, this paragraph is intended to preclude structured financings using a "market value" structure from relying on rule 3a-7, since market value transactions present issues that differ from financings using the cash flow structure.

<sup>36</sup> These financings are not structured as market value transactions, even though payment of their residual interests may depend, in part, on the market value of the disposed assets.

<sup>37</sup> Similarly, financings whose fixed-income securities are paid, in part, from funds obtained through the disposition of assets that, for example, do not conform to a representation or warranty would be able to satisfy the provision.

<sup>38</sup> As in the case of the proposed rule, the rating agency may not be an affiliated person of the issuer or of any person involved in the organization or operation of the issuer, such as the financing's sponsor, servicer, trustee, and provider of credit support.

<sup>39</sup> 17 CFR 230.501(a)(1), (2), (3), (7). These investors generally include banks, savings and loan associations, registered broker-dealers, insurance companies, registered investment companies, business development companies, small business development companies, state and local government employee benefit plans with total assets in excess of \$5 million, certain employee benefit plans regulated under the Employee Retirement Income Security Act of 1974, corporations, business trusts, partnerships, and charitable organizations with total assets in excess of \$5 million, and private business development companies. *Id.*

<sup>40</sup> 17 CFR 230.144A.

<sup>41</sup> See, e.g., Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at 17-18. Only two commenters, neither of which participates in the structured finance industry, opposed the use of a rating standard. ICI Comment Letter, *supra* note 10 at 14-17 [suggesting as an alternative limiting the sale of securities issued in structured financings to accredited investors]; NASAA Comment Letter, *supra* note 10, at 3-4.

The rating requirement is incorporated in the rule as a means of distinguishing structured financings from registered investment companies. The Commission wishes to emphasize that, although ratings generally reflect evaluations of credit risk, the rating requirement is not intended to address investment risks associated with the credit quality of a financing.

The involvement of rating agencies represents one of the most significant attributes of the structured finance market. This is because structured financings enable issuers to generate capital by converting often illiquid, unrated assets into marketable *rated* securities. As discussed in the proposing release, rating agency evaluations tend to address most of the Act's concerns regarding abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage.<sup>42</sup> Rating agencies have been successful in analyzing the structural integrity of financings, without impeding the development of the structured finance market. Indeed, ratings appear to have been a major factor in investor acceptance of structured financings.

The proposed rule would have limited securities sold to the public to those rated in one of the two highest categories. Most commenters favored a rating in one of the four highest categories (*i.e.*, an investment grade rating), which has been incorporated in the final rule.<sup>43</sup>

Investment grade financings have virtually the same structural safeguards. As several commenters noted, the difference between obligations rated in one of the two highest categories and those receiving an investment grade

rating generally does not reflect a diminution in the structured protections attending the financing. Rather, variances within the investment grade category tend to reflect differences in the credit quality of the obligation. In addition, consistent with the intent of the rule, the investment grade standard is more likely to accommodate a greater number and newer types of securitizations, such as financings involving small businesses.<sup>44</sup>

The final rule clarifies that the rating may include those assigned long-term debt obligations or an equivalent short-term rating, as appropriate to the obligation's maturity.<sup>45</sup> While most financings issue long-term debt, newer structures, such as asset-backed commercial paper programs, issue short-term obligations. By permitting reliance on either a long-term or a short-term rating, the final rule reflects the varying types of structures. The final rule also recognizes that a particular rating category may include a sub-classification or gradation (such as a plus or minus) to indicate relative standing within that category.

As in the case of the proposed rule, the final rule requires securities to be rated by only one rating agency. Almost all commenters favored this approach. Unlike evaluations of credit quality, rating agencies are highly unlikely to disagree as to the fundamental structural and operational integrity of a financing. Mandating ratings from more than one rating agency could increase substantially the costs of structured financings, without any commensurate benefit to public investors.<sup>46</sup>

In addition, like the proposed rule, the rating requirement applies only at the time a security is sold by the issuer or any underwriter acting on its behalf.<sup>47</sup> In

the event of a rating downgrade, secondary market transactions in securities sold to the public would not jeopardize the issuer's continued reliance on the rule.<sup>48</sup> The final provision clarifies that the rating requirement applies solely to initial sales by the issuer or any underwriter.<sup>49</sup> The rating requirement thus would not apply at the time of remarketing procedures used by some financings to periodically set the interest rate on the financing's fixed-income securities.

Under the final rule, fixed-income securities that do not meet the rating requirement (including unrated obligations) may be sold to institutional accredited investors. Any securities, without regard to type or rating (*e.g.*, residual interests), may be sold to qualified institutional buyers as defined in rule 144A under the Securities Act and to persons involved in the organization or operation of the issuer and their affiliates. As proposed, securities not meeting the rule's rating requirement or qualifying as fixed-income securities ("non-conforming securities") could have been sold only to qualified institutional buyers and to affiliated persons of the issuer.

Most commenters indicated that limiting sales of non-conforming securities to qualified institutional buyers would be too restrictive, particularly with respect to sales of lower and unrated fixed-income securities. Several commenters recommended the two-tier approach incorporated in the final rule.<sup>50</sup>

respective securities are sold to the appropriate class of investors.

<sup>42</sup> Several commenters suggested that the rating requirement apply at the time securities are issued, as opposed to the time of actual sale. These commenters expressed concern that an underwriter could cause an issuer to lose the exemption where a rating downgrade occurred prior to the underwriter's sale of its allotment. *See, e.g.*, Cadwalader, Wickersham & Taft Comment Letter, *supra* note 14, at 13-14. The Commission believes it is appropriate to require that the structural safeguards attending an investment grade rating be assured at the time securities are first sold to the public. As discussed *infra*, issuers may maintain the continued availability of the exemption by, for example, requiring underwriters to sell downgraded securities to sophisticated investors or to persons involved in the financing as specified in subparagraphs (a)(2)(i) and (ii).

<sup>43</sup> In some structures, securities are sold by the issuer and its underwriters at different times (*e.g.*, master trusts) or on an ongoing basis (*e.g.*, asset-backed commercial paper programs). The rating requirement applies to all such sales (regardless of the similarity or dissimilarity of the securities involved), not just to the first sale in any series of sales.

<sup>44</sup> *See, e.g.*, ABA Task Force Comment Letter, *supra* note 14, at 13. Some commenters also recommended a subjective standard that would reach persons with significant experience in the

One commenter recommended that the rating requirement apply to only one class, or "tranche," of an issuer's securities. Brown & Wood Comment Letter, *supra* note 15, at 4. The Commission did not follow this approach, out of a concern that the structural safeguards achieved through the rating process accompany all securities sold to unsophisticated investors. Since the vast majority of financings offer to the public only obligations rated investment grade, the rating requirement should not materially affect the structured finance market.

<sup>42</sup> Proposing Release, *supra* note 7, sections I.B. and II.A.2.(ii). *See also* text accompanying note 78 *infra*.

<sup>43</sup> Only one commenter suggested that a rating in any category would be sufficient for securities sold to the general public. Letter from Debevoise & Plimpton, on behalf of The New York Life Insurance Company, to Jonathan G. Katz, Secretary, SEC 8-17 (Aug. 4, 1992), File No. S7-12-82. Because financings rarely, if ever, sell securities rated below investment grade to persons other than sophisticated investors, such an approach would be contrary to current industry practice. In addition, lower-rated securities may present the types of investor protection concerns, most notably with respect to leverage, addressed by the Investment Company Act.

<sup>44</sup> The investment grade standard also is consistent with the Commission's recent amendments to Form S-3. *See* Sec. Act Rel. 6864, *supra* note 12.

<sup>45</sup> Short-term ratings generally cover securities with a maturity of one year or less. Because a rating agency's long-term ratings generally do not correspond to those assigned short-term debt, a short-term rating in one of the four highest categories may not equate to the investment grade standard contemplated by the rule. Accordingly, short-term obligations must receive a rating equivalent to investment grade. Depending on the rating agency, an equivalent short-term rating may represent the third or fourth highest short-term category.

<sup>46</sup> Counter to the intent of the rule, the costs associated with requiring two ratings also could be a barrier to the use of small and more innovative financings.

<sup>47</sup> To provide greater flexibility, the final rule applies solely to sales—and not to offers—by the issuer and its underwriters. Issuers, for example, would be permitted to offer residual interests and investment grade fixed-income securities pursuant to the same registration statement, so long as the

Commenters pointed out that a large number of institutional accredited investors that do not meet the definition of qualified institutional buyers routinely purchase non-investment grade fixed-income securities. By contrast, residual interests typically are sold only to very highly sophisticated investors, *i.e.*, those meeting the qualified institutional buyer test.

Non-conforming securities typically are not marketed to natural persons, who generally are not in a position to conduct their own due diligence analyses prior to investing. Accordingly, the rule retains the proposed exclusion of natural persons from the category of sophisticated investors eligible to purchase non-conforming securities.

Commenters also favored expansion of the proposed provision governing sales of non-conforming securities to affiliated persons of the issuer, pointing out that, in many financings, the issuer does not have any affiliates.<sup>51</sup> The intent of the proposed provision was to codify the current practice of distributing non-conforming securities to persons involved in the financing, such as the sponsor or other provider of securitized assets. Accordingly, the final rule clarifies that non-conforming securities may be sold to persons involved in the operation or organization of the financing (excluding agencies rating the structure) and their affiliates.<sup>52</sup>

As in the case of securities offered to the public, the final rule applies to the sale of non-conforming securities by the issuer or its underwriters.<sup>53</sup> To prevent the sale and resale of non-conforming securities to public investors, the issuer and its underwriters must exercise reasonable care to ensure that non-conforming securities are not sold or resold to persons other than those specified in subparagraphs (a)(2) (i) and (ii). Such reasonable care may include,

structured finance market. Such an approach may introduce unnecessary complexities in evaluating an investor's status under the rule.

<sup>51</sup> See, *e.g.*, Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at 18. Issuers, for example, typically are established as independent entities to avoid the risk that insolvency on the part of the financing's sponsor will affect payments to investors.

<sup>52</sup> This approach also addresses the intermediate step used in some financings where, prior to rating, securities are issued by a third party (*e.g.*, a special purpose corporation) to the entity that ultimately will issue securities in reliance on the rule.

To preserve their independence from the transaction, any agency rating the issuer's obligations could not purchase non-conforming securities. As indicated in the Proposing Release, *supra* note 7 at n.94, a trustee could purchase non-conforming securities (as well as rated obligations) so long as the trustee remains unaffiliated with the financing.

but is not limited to, contractual restrictions on sale and resale, the placement of cautionary legends on certificated securities, inquiry to determine if the investment is made by the entity or on behalf of others, and appropriate disclosure.<sup>54</sup>

(iii) *Acquisition and disposition of eligible assets.* Paragraph (a)(3) permits an issuer to acquire additional eligible assets or to dispose of eligible assets during the operation of the financing, provided three conditions are satisfied.<sup>55</sup> Paragraph (a)(3) differs significantly from the proposed provision, in response to suggestions made by commenters.

Proposed paragraph (a)(3) would have required an issuer to hold substantially all eligible assets to maturity, subject to four limited exceptions.<sup>56</sup> The provision sought to ensure that any changes in a financing's assets would not adversely affect the issuer's outstanding fixed-income security holders, and that the underlying asset pool would not be "managed" to the same extent and in the same manner as a management investment company.<sup>57</sup> At the same time, the provision was intended to permit financings to operate without undue impediments and to codify current practices. The Commission requested comment on whether proposed paragraph (a)(3) would achieve its intended purposes, and whether an alternative approach would be more appropriate.

One commenter stated that proposed paragraph (a)(3) satisfactorily balanced the need for flexibility while ensuring that financings would not act like management investment companies.<sup>58</sup>

<sup>53</sup> While limiting the type of investor eligible to purchase non-conforming securities, the rule would not restrict the offering mechanism employed. As in the case of securities offered to the public, issuers and underwriters would be free to sell non-conforming securities through private placements or public offerings.

<sup>54</sup> These steps parallel those set forth in Regulation D with respect to the resale of privately placed securities. See 17 CFR 230.502(d).

<sup>55</sup> Assets that do not meet the definition of eligible assets are not subject to these conditions.

<sup>56</sup> The four exceptions would have permitted the issuer to (i) substitute eligible assets for other eligible assets of the same type and of the same or higher credit quality; (ii) substitute pursuant to a defeasance mechanism government securities for eligible assets, provided such government securities produce cash flows similar to those expected from the replaced asset; (iii) acquire additional eligible assets that do not result in a downgrading in the rating of the issuer's outstanding fixed-income securities; and (iv) dispose of eligible assets in connection with the issuer's termination.

<sup>57</sup> The "management" of structured financings is significantly different from that of management investment companies. For example, in a structured financing, the servicer (unlike most investment advisers of management investment companies) generally has very limited discretion and must

Two other commenters argued that the proposed provision was not restrictive enough and would permit structured financings that acquire and remove assets on an ongoing basis (*e.g.*, asset-backed commercial paper programs) to be managed in a manner similar to management investment companies.<sup>59</sup>

Most commenters, however, argued that proposed paragraph (a)(3) was too restrictive, since it was inconsistent with the operation of many financings. For example, commenters noted that the proposal could cause particular difficulties for financings backed by credit card receivables<sup>60</sup> and asset-backed commercial paper programs.<sup>61</sup> It also would preclude financings from engaging in common activities that do not in any sense parallel typical "management" of registered investment company portfolios, including selling assets where documentation is defective or for nonconformity with representations and warranties, disposing of assets in default or in imminent default, and removing excess credit support.<sup>62</sup>

follow specific guidelines established prior to the issuance of the financing's securities. Also, unlike mutual funds, the acquisition or disposition of assets in a structured financing rarely affects the payment of the outstanding securities held by the general public. Finally, the acquisition or disposition of assets in a structured financing generally does not occur for the sole purpose of achieving gains or decreasing losses resulting in market value changes.

<sup>58</sup> Letter from Chemical Bank to Jonathan G. Katz, Secretary, SEC 3-4 (Aug. 3, 1992), File No. S7-12-92 (hereinafter Chemical Bank Comment Letter).

<sup>59</sup> See NASAA Comment Letter, *supra* note 10, at 4-5; ICI Comment Letter, *supra* note 10, at 6-13. The ICI specifically argued that these types of structured financings should not be able to rely on the rule. *Id.*, at 12-13. In addition, another commenter stated that the asset management limitations should be made more restrictive to increase investor protection. FMR Comment Letter, *supra* note 24, at 4-5.

<sup>60</sup> Credit card financings are backed by current and future receivables generated by specified credit card accounts; the balance of the pool fluctuates as new receivables are generated and existing amounts are paid. To accommodate the fluctuating balance, a seller (sponsor) certificate is issued to absorb the variations in the balance of the pool, thereby enabling the principal balance of the investor certificates to be maintained at a fixed level for a stated term. Proposed paragraph (a)(3) would have prohibited the disposal of assets not needed to pay the investor certificates if the seller's interest becomes disproportionately large, causing unnecessary economic burdens on the seller. Arguably, such burdens could limit the number of these financings eligible to rely on the rule. See, *e.g.*, ABA Task Force Comment Letter, *supra* note 14, at 10-17.

<sup>61</sup> Asset-backed commercial paper programs maintain the credit quality of their assets and the liquidity of their securities primarily through the disposition of assets. Such dispositions would have been prohibited under the proposal. See Citibank Comment Letter, *supra* note 15, at 9.

Paragraph (a)(3), as adopted, effectuates the intent of the proposed provision, but uses a different approach derived from the suggestions of commenters. The paragraph provides virtually all structured financings, including those that require a significant degree of asset acquisitions and dispositions, the flexibility to engage in current practices without raising concerns that they could engage in portfolio management practices resembling those employed by mutual funds. Paragraph (a)(3)(i) permits an issuer to acquire additional assets or dispose of eligible assets (regardless of whether other assets are substituted for the removed assets) only if that action complies with the terms and conditions set forth in the agreements, indentures, or other instruments pursuant to which the issuer's securities are issued.<sup>63</sup> Typically, the types (and, in some instances, the credit quality) of assets that a financing may acquire, and the conditions under which an issuer may add or remove assets, are identified specifically in the financing's operative documents at the initiation of the financing. Accordingly, paragraph (a)(3)(i) merely codifies industry practice.<sup>64</sup>

Paragraph (a)(3)(ii) permits assets to be acquired or disposed of during the operation of the financing, if such action does not result in a downgrading of the rating of the financing's outstanding fixed-income securities. This provision is similar to proposed paragraph (a)(3)(iii) except that it applies to both the acquisition and disposition of

eligible assets.<sup>65</sup> By precluding actions that result in a rating downgrade, paragraph (a)(3)(ii) is intended to ensure that any changes in the financing's assets will not adversely affect the financing's outstanding fixed-income security holders.<sup>66</sup>

Finally, paragraph (a)(3)(iii) does not allow the acquisition or disposition of eligible assets primarily for the purpose of recognizing gains or preventing losses resulting from market value changes. This condition prohibits an issuer from purchasing eligible assets with the hope of realizing capital gains through resale after such assets have appreciated in value. It also will prevent an issuer from disposing of assets, regardless of the reason for their acquisition, primarily to obtain a profit.<sup>67</sup> Issuers, however, would be permitted to retain any profits obtained through the disposition of assets, provided the assets were not removed for the primary purpose of obtaining that profit.<sup>68</sup>

<sup>63</sup> Proposed paragraph (a)(3)(iii) would have applied only to the acquisition of eligible assets. Two commenters suggested changes to the proposed paragraph that effectively would have prevented asset-backed commercial paper programs and other types of financings from relying on the rule. See ICI Comment Letter, *supra* note 10, at 13; PMR Comment Letter, *supra* note 24, at 4. Many other commenters, however, suggested maintaining the provision, either as proposed or in the form adopted. See, e.g., Letter from Dean Witter to Jonathan G. Katz, Secretary, SEC 10-11 (Aug. 14 1992), File No. S7-12-92 (hereinafter Dean Witter Comment Letter).

<sup>64</sup> The provision also addresses, in part, one concern raised by the ICI—the danger of self-dealing by affiliates. See ICI Comment Letter, *supra* note 10, at 6-8. The rating agency evaluations address most of the Act's concerns about abusive practices, including self-dealing and overreaching by insiders. Any addition or removal of assets by insiders that could result in investor harm would result in a downgrading of the outstanding fixed-income securities. In addition, the involvement of an independent trustee, as required by the rule, also will alleviate this concern.

<sup>65</sup> In the Proposing Release, *supra* note 7, the Commission specifically requested comment on whether it would be appropriate to include a general prohibition on the trading of assets for profit. Several commenters supported this approach. See, e.g., Letter from the American Bankers Association to Jonathan G. Katz, Secretary, SEC 4 (Aug. 4, 1992), File No. S7-12-92; Mayer, Brown & Platt Comment Letter, *supra* note 15, at App. 5-6; Stroock & Stroock & Lavan Comment Letter, *supra* note 14, at 7-12. A few commenters suggested that such a prohibition was vague and unworkable. See, e.g., Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at n.11; Salomon Brothers Comment Letter, *supra* note 11, at 7. Paragraph (a)(3)(iii) has been drafted in a way designed to address these commenters' concerns.

<sup>66</sup> For example, an issuer may sell eligible assets that do not conform to a representation or warranty. Similarly, an issuer may sell eligible assets in excess of required levels where the assets were acquired for credit enhancement and are sold because they are no longer needed to ensure payment of the fixed-income securities. An issuer, however, may not obtain an eligible asset for the primary purpose of enabling residual holders to benefit from market appreciation upon any subsequent sale.

Some commenters, while favoring the requirement that issuers hold substantially all assets to maturity, suggested amendments to the proposed exceptions, or the addition of new exceptions, intended to reflect industry practice. This approach would require a lengthy, detailed list of exceptions, which could, in effect, frustrate the development of other types of financings.<sup>69</sup>

The Commission also declined to impose an objective limitation on the number of portfolio transactions. In the proposing release, the Commission requested comment on whether proposed paragraph (a)(3) should be replaced with a condition requiring that a specified percentage (e.g., sixty percent) of the aggregate amount of pooled assets be held to maturity. Commenters responded that such a restriction is arbitrary and would unduly limit flexibility.<sup>70</sup>

(iv) *The Independent Trustee.* Paragraph (a)(4) retains the requirement that the trustee not be affiliated with the issuer or with any person involved in the organization or operation of the issuer.<sup>71</sup> The Commission declined to adopt the suggestion made by two commenters that the rule permit the trustee to be affiliated with some of the parties involved in the financing's operation.<sup>72</sup> Adoption of this suggestion could result in the trustee monitoring the activities of an affiliate. The rule, however, does not prevent a trustee from assuming the duties of servicer if the primary servicer is unable to perform its duties, or to perform other duties with respect to the operation of the financing.<sup>73</sup> The rule, however, would not allow a trustee to provide credit enhancement in support of the issuer's securities.

Paragraph (a)(4) also retains the requirement that the trustee execute an agreement stating that it will not resign

<sup>69</sup> Based on suggestions from commenters, at least 14 additional exceptions would need to be included in the rule for structured financings to operate in accordance with current industry practice. Of course, it is impossible to determine the other exceptions that would be required to address future innovations in the structured finance market.

<sup>70</sup> See, e.g., Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at n.11.

<sup>71</sup> Paragraph (a)(4) also retains the proposed requirement that the trustee be a bank that meets the requirements of section 26(a)(1) governing trustees of unit investment trusts. See 15 U.S.C. 80a-26(a)(1).

<sup>72</sup> See Letter from RFC to Jonathan G. Katz, Secretary, SEC 5 (Aug. 3, 1992), File S7-12-92 (trustee should be allowed to be affiliated with subservicers of the assets) (hereinafter RFC Comment Letter); Chemical Bank Comment Letter, *supra* note 58, at 5 (trustee should be allowed to be affiliated with the underwriter and placement agent).

<sup>63</sup> See, e.g., Citibank Comment Letter, *supra* note at 8-9; Letter from First Chicago to Jonathan G. Katz, Secretary, SEC 5-6 (July 28, 1992), File No. S7-12-92 (hereinafter First Chicago Comment Letter); Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at 11.

<sup>64</sup> Several commenters included a similar requirement in their suggested changes to proposed paragraph (a)(3). See, e.g., Kirkland & Ellis Comment Letter, *supra* note 23, at 18; Salomon Brothers Comment Letter, *supra* note 11, at 6.

<sup>65</sup> This requirement is not intended to prevent an issuer (or any party acting on its behalf) from having any discretion with respect to its assets. Issuers often have discretion with respect to routine, perfunctory matters that do not affect the payment of the fixed-income securities. In addition, issuers often have some discretion in connection with the disposition or acquisition of their assets, provided such actions meet predetermined guidelines set forth in the operative documents.

The Commission also is aware that in several circumstances financings have had to sell or acquire assets in ways that were not anticipated at the time the financing was established. In these cases, the operative documents were amended, with both investor and rating agency concurrence. Paragraph (a)(3)(i) would permit the continuation of this practice.

until the structured financing has been completely liquidated or until a successor trustee has been designated. Unlike the proposed paragraph, however, paragraph (a)(4) does not require the agreement to provide that the sponsor or its agent keep a record of the financing's security holders. The Commission eliminated this requirement in response to commenters' concerns that it would, in effect, prohibit the issuance of bearer securities, which are used frequently in international offerings.<sup>74</sup>

Paragraph (a)(4) also requires the issuer to take reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in eligible assets that principally generate the cash flow needed for payment on the fixed-income securities. It also would require that cash flows from eligible assets be deposited periodically in a segregated account maintained or controlled by the trustee.

Proposed paragraph (a)(4) would have required all property of the issuer at the time the financing is established, and all subsequently acquired property (including cash flows) to be transferred to the trustee within a reasonable time of receipt. This would have prohibited servicers from commingling the financing's cash flows with its own. The Commission proposed this requirement as a means to ensure the safekeeping of the issuer's assets.

Virtually all commenters argued that the proposed requirement, if interpreted literally, was inconsistent with industry practice, and would be so impractical and expensive to implement that it could eliminate the economic benefit of structured financings as a finance alternative.<sup>75</sup> Commenters generally explained that, under industry practice, whether a trustee takes physical possession of any of the issuer's assets depends on a number of factors. Often a trustee may not take possession of the assets because their transfer to the trustee is too burdensome, the servicer needs the assets for servicing purposes, or the asset itself is incapable of physical possession.<sup>76</sup> In addition, whether a servicer commingles the financing's cash flow with its own assets and, if so, how long, may depend on the type of the asset securitized, and the capability of the servicer's computer

systems to track the cash flow.<sup>77</sup> Commenters argued that the fact that the trustee may not physically hold the assets does not place the assets at risk, because the rating agencies closely evaluate the servicer's creditworthiness and capability to perform its responsibilities, and require the financing be operated in a manner that would minimize any risk to the safekeeping of the assets.<sup>78</sup>

Accordingly, some commenters argued that since requirements assuring the safekeeping of the assets vary from transaction to transaction, it is difficult to devise a standard for all structured financings without impeding industry practice.<sup>79</sup> These commenters suggested that the Commission delete any requirement with respect to the safekeeping of the assets.<sup>80</sup> Other commenters, however, suggested as an alternative that the rule require only that an issuer take actions necessary for the trustee to have a perfected security interest or an ownership interest in the assets.<sup>81</sup>

In recognition of the importance of safekeeping of assets under the Investment Company Act, the Commission has determined to require safekeeping of assets, but in a way that it believes is consistent with industry practice. Paragraph (a)(4) requires that an issuer take *reasonable* steps to provide the trustee with perfected

security interests or ownership interests. The rule does not require that a perfected security interest be a *first* security interest. This requirement applies only to assets that *principally* provide the cash flow needed for payments on the fixed-income securities; thus, perfected or ownership interests in ancillary assets are not required.<sup>82</sup>

With respect to cash flows, paragraph (a)(4) requires that they periodically be deposited in a segregated account, consistent with rating agency requirements. Thus, possession of cash flows by the servicer for periods of time would be permitted where a rating agency has determined that the risk of loss therefrom is minimal.

Finally, paragraph (a)(4) excludes asset-backed commercial paper programs from its requirements. Several commenters noted that these programs ordinarily operate without a trustee.<sup>83</sup> Commenters argued that requiring a trustee would not be practical and would do little to add to investor protection, due to the short-term of the securities, the short-term nature of the assets underlying these programs, the multi-seller structures used in such programs, and the roles of providers of credit and liquidity facilities.<sup>84</sup> Upon reflection, the Commission agrees requiring a trustee for commercial paper programs would be costly and would not add to investor protection.<sup>85</sup>

#### B. Amending Section 3(c)(5)

In the proposing release, the Commission requested comment on whether section 3(c)(5) should be amended, either to include other financing activities, or to prevent structured financings from continued reliance. Two commenters suggested that the section be expanded to exclude other financing techniques from the

<sup>74</sup> See, e.g., Dean Witter Comment Letter, *supra* note 14, at 20-21, 24.

<sup>75</sup> For example, in a structured financing backed by automobile loans, security interests would be required to be perfected in the loans, but not in the automobiles themselves.

The Commission recognizes that under the Uniform Commercial Code, possession may be required to create a valid security interest for certain instruments, e.g., mortgage notes. Accordingly, perfection may be lost when the trustee is required to deliver to the servicer assets needed for the operation of the financing, e.g., servicing. The provision has been drafted to permit trustees to continue this practice. See ABA Task Force Comment Letter, *supra* note 14, at 24.

<sup>76</sup> Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at 21; Kirkland & Ellis Comment Letter, *supra* note 23, at 7.

<sup>77</sup> See, e.g., Letter from Karen J. Kirchen, General Group Counsel, Citibank, to Marianne K. Smythe, Director, Division of Investment Management, SEC 4 (Sept. 25, 1992), File No. S7-12-92.

<sup>78</sup> See, e.g., Dean Witter Comment Letter, *supra* note 65, at 6 (the loan documentation for boat, automobile, and recreational vehicle loans generally is not transferred to the trustee, absent a compelling business reason for doing so, because of the enormous administrative and financial burden it would place on the originator of the assets); SIA Comment Letter, *supra* note 24, at 19 (assets needed for servicing purposes); Merrill Lynch Comment Letter, *supra* note 16, at 7 (some assets, such as credit card receivables and book-entry securities, exist only as computer entries).

<sup>79</sup> See First Chicago Comment Letter, *supra* note 62, at 7-8 (in a financing backed by credit card account receivables, commingling is unavoidable when the servicer has rights to the monthly excess funds attributable to finance charge receivables that exceed the amount needed to pay investors); ABA Task Force Comment Letter, *supra* note 14, at 23 (discussing computer capabilities).

<sup>80</sup> See, e.g., Mayer, Brown & Platt Comment Letter, *supra* note 15, at App. 14-15; Letter from Sears to Jonathan C. Katz, Secretary, SEC 5-8 (Aug. 14, 1992), File No. S7-12-92. For example, the rating agencies generally permit a servicer with an equal or higher rating as the financing's fixed-income securities to commingle the financing's cash flows with its own assets. In instances where the servicer does not possess the appropriate rating, the rating agencies may devise an alternative arrangement to permit the servicer to commingle assets without jeopardizing investor protection. See Dean Witter Comment Letter, *supra* note 65, at 5.

<sup>81</sup> See, e.g., Brown & Wood Comment Letter, *supra* note 15, at 18; Stroock & Stroock & Lavan Comment Letter, *supra* note 14, at 19.

<sup>82</sup> See, e.g., Stroock & Stroock & Lavan Comment Letter, *supra* note 14, at 19.

<sup>75</sup> Several commenters requested clarification on this issue. See, e.g., RPC Comment Letter, *supra* note 72, at 5.

<sup>76</sup> See Cleary, Gottlieb, Steen & Hamilton Comment Letter, *supra* note 20, at 19-20.

<sup>77</sup> See, e.g., Citibank Comment Letter, *supra* note 15, at 9-10; Dean Witter Comment Letter, *supra* note 65, at 2-6.



Act.<sup>86</sup> One commenter suggested that the section be narrowed to apply only to active businesses.<sup>87</sup> Most commenters, however, argued that it would be inappropriate to narrow the scope of section 3(c)(5), at least until both the market and the Commission gains experience with rule 3a-7.<sup>88</sup> Commenters also pointed to the difficulty of drafting an amendment that would exclude structured financings without inadvertently preventing traditional factoring vehicles from relying on the section.<sup>89</sup> In light of these comments, the Commission has decided not to pursue any legislative changes to section 3(c)(5) at this time.

In addition, the Commission's Division of Investment Management has decided not to withdraw at this time its no-action position with respect to the treatment of whole pool agency certificates under section 3(c)(5)(C).<sup>90</sup> The Commission announced in the proposing release that this position would be withdrawn upon adoption of rule 3a-7. Commenters strongly urged reconsideration of this decision. In particular, commenters argued that whole pool certificates should be considered to be interests in real estate because holders of such certificates receive payment streams that reflect payments on the underlying mortgages.<sup>91</sup> Moreover, they argued that withdrawal

of this position could cause real estate investment trusts and mortgage bankers that hold whole pool agency certificates to become subject to the Act.<sup>92</sup>

### III. Cost/Benefit Analysis

The rule will reduce a number of unnecessary costs by permitting certain types of structured financings to be sold in public offerings, rather than in private placements. This should reduce costs for issuers and allow investors access to a greater variety of financings. The rule also would mean that issuers of certain types of mortgage-related securities no longer would have to apply to the Commission for individual exemptive orders. This should reduce costs both for the issuers and for the Commission.

### IV. Summary of the Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis in accordance with 5 U.S.C. 604 regarding adoption of rule 3a-7. The Analysis explains that the rule is intended to reduce an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy, including the small business sector. The Analysis explains that current law has constricted the development of the structured finance industry. It states that the costs of compliance with rule 3a-7 will be minimal because the proposal essentially codifies industry practice. A copy of the Final Regulatory Flexibility Analysis may be obtained by contacting Rochelle G. Kauffman, Esq., or Elizabeth R. Krentzman, Esq., both at Mail Stop 10-6, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

### V. Effective Date

Rule 3a-7 is effective upon publication in the Federal Register. Pursuant to 5 U.S.C. 553(d)(1), immediate effectiveness is appropriate because rule 3a-7 is purely exemptive in nature. It excludes structured financings from the definition of investment company, thereby permitting structured financings to offer their securities publicly in the United States without registering under the Act. The rule is intended to remove an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy. The benefits of the rule to both sponsors of financings and to potential investors should be available at the earliest possible time.

<sup>86</sup> See e.g., Brown & Wood Comment Letter *supra* note 15, at 20.

<sup>87</sup> See e.g., ABA Task Force Comment Letter *supra* note 14, at 27.

### VI. Statutory Authority

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

### VII. Text of Adopted Rule

#### List of Subjects in 17 CFR Part 270

Investment Companies, Reporting and recordkeeping requirements, Securities

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

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

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

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

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

#### § 270.3a-7 Issuers of Asset-Backed Securities.

(a) Notwithstanding section 3(a) of the Act, any issuer who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets (and in activities related or incidental thereto), and who does not issue redeemable securities will not be deemed to be an investment company: *Provided That:*

(1) The issuer issues fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets;

(2) Securities sold by the issuer or any underwriter thereof are fixed-income securities rated, at the time of initial sale, in one of the four highest categories assigned long-term debt or in an equivalent short-term category (within either of which there may be sub-categories or gradations indicating relative standing) by at least one nationally recognized statistical rating organization that is not an affiliated person of the issuer or of any person involved in the organization or operation of the issuer, except that:

(i) Any fixed-income securities may be sold to accredited investors as defined in paragraphs (1), (2), (3), and (7) of rule 501(a) under the Securities Act of 1933 (17 CFR 230.501(a)) and any entity in which all of the equity owners come within such paragraphs; and

<sup>88</sup> The Proposing Release, *supra* note 7, requested comment on whether rule 3a-7 should specify other duties for trustees in addition to those proposed. For example, the release questioned whether any portion of the Trust Indenture Act's requirements should be made applicable to financings that are not subject to that Act. Most commenters argued that specifying additional duties for the trustee would be unnecessary, given the lack of abuse in the structured finance market. See, e.g., Cadwalader, Wickersham & Taft Comment Letter *supra* note 14, at 21. The Commission has determined not to specify any additional duties for the trustee.

<sup>89</sup> Letter from MBNA to Jonathan G. Katz, Secretary, SEC 7 (Aug. 4, 1992), File No. S7-12-92; Letter from New York State Bar Association to Jonathan G. Katz, Secretary, SEC 5 (Aug. 3, 1992), File No. S7-12-92. Neither commenter submitted specific language.

<sup>90</sup> ICI Comment Letter, *supra* note 10, at 20-22.

<sup>91</sup> See, e.g., ABA Task Force Comment Letter, *supra* note 14, at 33; Cadwalader, Wickersham & Taft Comment Letter, *supra* note 14, at 21-22.

<sup>92</sup> See, e.g., Letter from Sidley & Austin, on behalf of the Commercial Finance Association, to Jonathan G. Katz, Secretary, SEC (Aug. 5, 1992), File No. S7-12-92; Citibank Comment Letter, *supra* note 15, at 11.

<sup>93</sup> The Division has taken the position that issuers holding whole pool certificates issued by the Government National Mortgage Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation can rely on section 3(c)(5) since such certificates are interests in real estate. See, e.g., American Home Finance Corp. (pub. avail. Apr. 9, 1981). See also Proposing Release, *supra* note 7, at nn 44-45 and accompanying text.

(ii) Any securities may be sold to qualified institutional buyers as defined in rule 144A under the Securities Act (17 CFR 230.144A) and to persons (other than any rating organization rating the issuer's securities) involved in the organization or operation of the issuer or an affiliate, as defined in rule 405 under the Securities Act (17 CFR 230.405), of such a person;

*Provided*, That the issuer or any underwriter thereof effecting such sale exercises reasonable care to ensure that such securities are sold and will be resold to persons specified in paragraphs (a)(2) (i) and (ii) of this section;

(3) The issuer acquires additional eligible assets, or disposes of eligible assets, only if:

(i) The assets are acquired or disposed of in accordance with the terms and conditions set forth in the agreements, indentures, or other instruments pursuant to which the issuer's securities are issued,

(ii) The acquisition or disposition of the assets does not result in a downgrading in the rating of the issuer's outstanding fixed-income securities; and

(iii) The assets are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes; and

(4) If the issuer issues any securities other than securities exempted from the Securities Act by section 3(a)(3) thereof (15 U.S.C. 77c(a)(3)), the issuer:

(i) Appoints a trustee that meets the requirements of section 26(a)(1) of the Act and that is not affiliated, as that term is defined in rule 405 under the Securities Act (17 CFR 230.405), with the issuer or with any person involved in the organization or operation of the issuer, which does not offer or provide credit or credit enhancement to the issuer, and that executes an agreement or instrument concerning the issuer's securities containing provisions to the effect set forth in section 26(a)(3) of the Act;

(ii) Takes reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in those eligible assets that principally generate the cash flow needed to pay the fixed-income security holders, provided that such assets otherwise required to be held by the trustee may be released to the extent needed at the time for the operation of the issuer; and

(iii) Takes actions necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited

periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the outstanding fixed-income securities.

(b) For purposes of this section:

(1) *Eligible assets* means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

(2) *Fixed-income securities* means any securities that entitle the holder to receive:

(i) A stated principal amount; or

(ii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to a fixed rate or to a standard or formula which does not reference any change in the market value or fair value of eligible assets; or

(iii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to auctions among holders and prospective holders, or through remarketing of the security; or

(iv) An amount equal to specified fixed or variable portions of the interest received on the assets held by the issuer; or

(v) Any combination of amounts described in paragraphs (b)(2) (i), (ii), (iii), and (iv) of this section;

*Provided*, That substantially all of the payments to which the holders of such securities are entitled consist of the foregoing amounts.

By the Commission.

Dated: November 19, 1992.

Margaret H. McFarland,

Deputy Secretary.

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## INTERNATIONAL TRADE COMMISSION

### 19 CFR Part 207

#### Implementing Regulations for the U.S.-Canada Free-Trade Agreement

**AGENCY:** International Trade Commission.

**ACTION:** Final rules.

**SUMMARY:** The Commission is amending subpart G of part 207 of its Rules to conform the Commission's regulations with amendments to the U.S.-Canada Free-Trade Agreement Implementation Act of 1988 (FTA Implementation Act) contained in section 134 of the Customs and Trade Act of 1990 (hereinafter "technical amendments"). The Commission's amendments modify and

finalize the Commission's interim regulations that were previously issued in an effort to conform the Commission's rules with the FTA Implementation Act, as amended.

The substantive amendments to subpart G clarify the requirements imposed on a person retaining access to proprietary information under a protective order issued during the administrative proceeding and clarify the categories of people whom the panel may determine are entitled to have access to privileged information.

**DATES:** Effective date: December 15, 1992.

**FOR FURTHER INFORMATION CONTACT:** Abigail A. Shaine, Esq., Office of the General Counsel, U.S. International Trade Commission, telephone (202) 205-3094. Hearing impaired persons are advised that information on the matter can be obtained by contacting the Commission's TDD Terminal on 202-205-1810.

#### SUPPLEMENTARY INFORMATION:

##### Background.

On Friday, December 30, 1988, the Commission published in the *Federal Register*, the interim rules with a request for comments 53 FR 53248 (December 30, 1988), which rules were amended at 54 FR 36289 (September 1, 1989). These rules govern procedures for filing a Notice of Intent To Commence Judicial Review (§ 207.92), for granting access to proprietary information (§ 207.93), for governing access to privileged information when a panel orders the Commission to grant such access (§ 207.94), and for imposing sanctions for violations of the administrative protective orders (APO) (§§ 207.100 through 207.120.) No comments were received from the public on these rules.

On August 20, 1990, technical amendments were made by section 134 of the Customs and Trade Act of 1990, (Pub. L. 101-382) (August 20, 1990), to the FTA Implementation Act, (Pub. L. 100-449) (September 28, 1988). The U.S. and Canadian Governments also have amended the Rules of Procedure for Article 1904 Rules.

On August 6, 1992, the Commission published in the *Federal Register* amended interim rules with a request for comments. The Commission amended these rules to conform the Commission's regulations with amendments to the FTA Implementation Act and to the amended Article 1904 Rules.

The Commission received only three comments during the period allowed for public comment. One person commented that the interim rules did not allow for a