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.

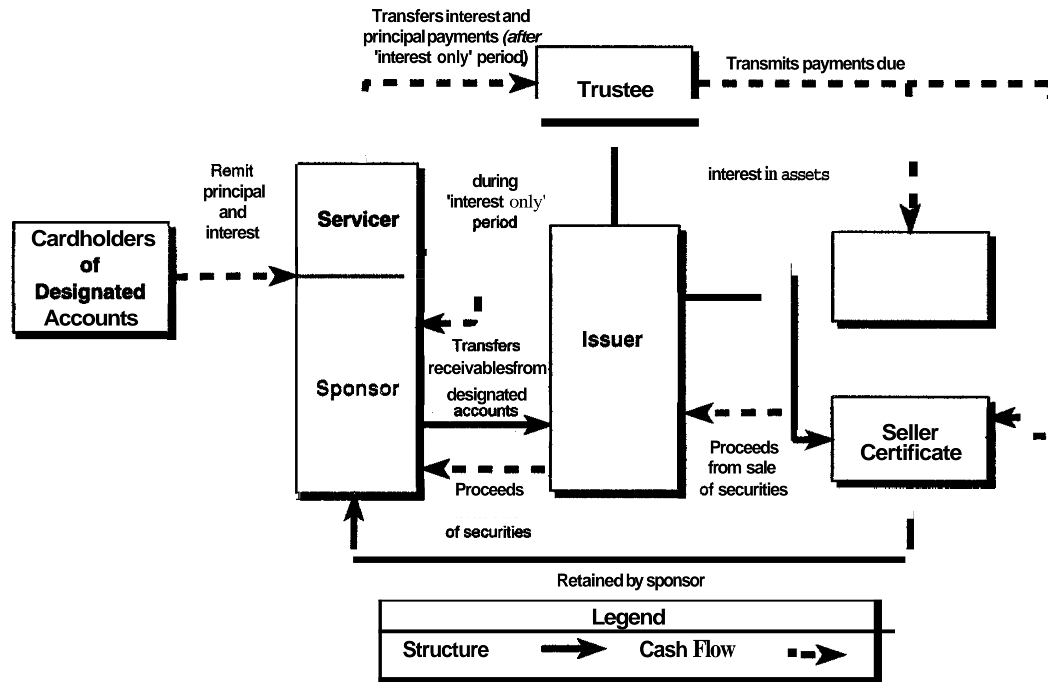
[154] *Id.* at 15.

[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-

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[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.

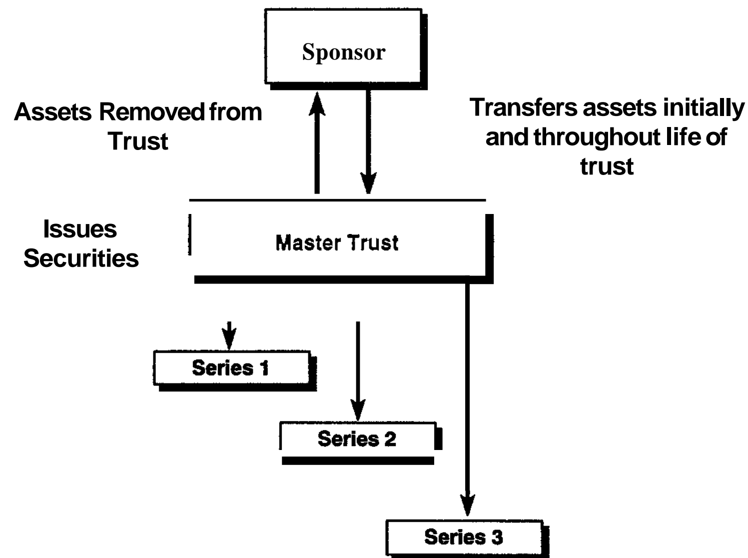
[173]For example, under Citibank's master trust structure, receivables from new credit card accounts may be sold to the trust on a daily basis. Other receivables that may be added on a periodic basis include those arising from accounts acquired from other credit card issuers, accounts of a type that 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 & POORS **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?'' 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

''*See e.g., Start-up Companies Pose Risk,* STANDARD & POORS 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

[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

[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.

[212]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

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[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 *infra* 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

[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

[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?' 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]

[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.**