

MEMO# 4275

November 23, 1992

SEC ADOPTS 1940 ACT EXEMPTION FOR ASSET-BACKED ARRANGEMENTS

November 23, 1992 TO: BOARD OF GOVERNORS NO. 83-92 SEC RULES MEMBERS NO. 63-92 UNIT INVESTMENT TRUST MEMBERS NO. 60-92 CLOSED-END FUND MEMBERS NO. 48-92 RE: SEC ADOPTS 1940 ACT EXEMPTION FOR ASSET-BACKED ARRANGEMENTS

The Securities and Exchange Commission has adopted a new rule, Rule 3a-7, under the Investment Company Act of 1940, which excludes from the definition of "investment company" asset-backed arrangements meeting certain conditions. In its comment letter on the proposed rule, the Institute had urged the Commission to narrow the conditions that an issuer satisfy under the exemption, particularly with respect to the degree of portfolio management that would be permitted. However, the Commission has adopted a more liberal rule than initially proposed. The Rule will become effective upon publication in the Federal Register. A copy of the Commission's release is attached. As adopted, Rule 3a-7 excludes from the Act an issuer who is engaged in the business of acquiring and holding "eligible assets", as defined under the Rule, and who does not issue redeemable securities. In addition, the Rule imposes the following conditions: (1) issuers must issue fixed-income securities or other securities that entitle their holders to receive payments that depend primarily on the cash flow from eligible assets, including interest-only ("IOs") and principal-only ("POs") securities; (2) only fixed-income securities that, at the time the security is sold by the issuer, have been rated "investment grade" (in one of the four highest long-term rating categories) or an equivalent short-term rating by at least one rating agency may be sold to the public without restriction; fixed-income securities that are not rated or are rated below "investment grade" may be sold only to "accredited investors", as defined under the Securities Act of 1933, and to entities in which all of the equity owners qualify as such investors; all other securities, such as residual interests, may be sold only to "qualified institutional buyers", as defined in Rule 144A under the Securities Act, and to persons involved in the organization or operation of the issuer and their affiliates; (3) issuers may acquire additional assets or dispose of eligible assets only if that action (a) complies with the terms and conditions set forth in the agreements, indentures, or other instruments pursuant to which the issuer's securities are issued; (b) does not result in a downgrading of the rating of the issuer's outstanding fixed-income securities; and (c) is not done primarily for the purpose of recognizing gains or preventing losses resulting from market value changes; and (4) except with respect to asset-backed commercial paper programs, (a) the issuer cannot appoint a trustee that is affiliated with the issuer or with any person involved in the organization or operation of the issuer; (b) the trustee must execute an agreement stating that it will not resign until the arrangement has been completely liquidated or until a successor trustee has been designated; and (c) the issuer must take reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in eligible

assets that principally generate the cash flow needed for payment on the fixed-income securities. On a related matter, the Commission has decided not to pursue any legislative changes to Section 3(c)(5) under the Investment Company Act, which has been interpreted to exempt from the Act a number of structured financings, including most mortgage-backed arrangements. Amy B.R. Lancellotta Associate Counsel Attachment

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.