

MEMO# 1202

June 8, 1989

ASSET-BACKED SECURITIES BACKED BY PERSONAL PROPERTY

- 1 - June 8, 1989 TO: MARKETING COMMITTEE NO. 17-89 RE: ASSET-BACKED SECURITIES BACKED BY PERSONAL PROPERTY

There appears to be a proliferation of offerings of what have been collectively referred to as asset-backed securities. The Institute has been examining these offerings, particularly those backed by credit card loans and other types of personal property, to determine whether they should be considered investment companies and therefore subject to registration under the Investment Company Act of 1940. The Institute believes that there are strong legal grounds for arguing that these offerings should be registered under the Act. However, we are uncertain as to whether our members have a business concern in this area. There appear to be only slight differences, for example, between a closed-end fund or unit investment trust investing in a portfolio of GNMA (asset-backed) securities and a trust invested in a portfolio of consumer revolving credit card accounts or consumer auto loans. Several of these latter trusts have been offered to the retail markets in \$1,000 units. The purpose of this memorandum is to ask the members of the Marketing Committee for their evaluation of the potential competitive effects of the sale of products backed by credit card loans and other types of personal property on sales of shares of traditional investment companies, so that the Institute can determine whether or not to take legal action. These issues will be discussed at the Committee's upcoming meeting on Friday, June 23.

Asset-Backed Securities Asset-backed securities (sometimes referred to as structured financings) generally are nonredeemable debt obligations issued by a trust that represent a fractional, undivided interest in, or are secured by, a pool of financial assets, nonpublicly traded debt securities or publicly traded mortgage certificates. The most popular type of asset-backed - 2 - security is the collateralized mortgage obligation (CMO), which is a corporate bond backed by mortgage notes or mortgage-backed securities, such as GNMA, FNMA and FHLMC certificates. A recent report by Moody's Investors Service indicates that \$72 billion in CMOs had been issued by the end of 1988. Other asset-backed securities are backed by various types of personal property. The two largest classes of these securities as of the end of 1988 were automobile loan issues (\$20.5 billion) and credit card loan issues (\$11 billion). Citicorp recently began a \$500 million offering that involves the packaging of credit card loans from its Visa and MasterCard holders. According to the attached Wall Street Journal article, previous Citicorp credit card-backed securities were offered primarily to institutional investors, but this current offering is specifically targeted to the small investor and involves \$1,000 certificates. Sears has made similar offerings involving credit card receivables and auto loans. Prospectus summaries concerning these offerings are attached. Other categories of asset-backed securities include those backed by boat loans, computer leases, tax-exempt leases, and open accounts receivable. Issuers of Asset-Backed Securities as

Investment Companies To the extent that they offer interests in pools of securities, issuers of asset-backed securities would fall within the definition of an investment company under the Act unless they could qualify under one of the Act's exceptions from the definition. Under the current position of the SEC, some issuers of asset-backed securities are excepted from the definition under a provision that states that an issuer will not be considered an investment company if it (1) does not issue redeemable securities, and (2) is engaged in certain businesses. One of these businesses is the purchasing or otherwise acquiring of mortgages and other liens on and interests in real estate. Another is the business of purchasing or acquiring credit card and other receivables. The Institute believes that the SEC's position is vulnerable to legal attack because it goes far beyond what Congress intended in including this exception in the 1940 Act. According to a well-recognized academic expert on the 1940 Act, the provisions on which the SEC relies in excepting asset-backed securities were meant only to except companies engaged in active businesses, like factors and mortgage bankers, and not passive pools that simply contain the assets listed in the exception. The Institute is therefore considering whether to take action to obtain a judicial determination of the scope of these exceptions.

Information to Be Provided By the Marketing Committee As noted above, the Institute has concluded that there is a - 3 - legal basis for challenging the SEC's treatment of securities backed by credit card loans and other types of personal property. Earlier this year, the Institute asked a group of members from the SEC Rules and Unit Investment Trust Committees whether they felt that the Institute should challenge the SEC's treatment of asset-backed securities. Their preliminary reaction was that collateralized mortgage obligation (CMO) offerings generally do not create a competitive problem; securities backed by credit card loans and other receivables would create a competitive problem, but to their knowledge these types of securities were not being offered to small investors. (As set forth above, these types of securities are now being offered to small investors.) The Institute needs the Marketing Committee's views on whether these investments are viable competitors to traditional investment companies, in order to help the Institute determine whether or not to take legal action. James S. Riepe
Chairman, Marketing Committee Attachments

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