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Jeffrey B. Tevis
University of the Pacific; McGeorge School of Law

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INTRODUCTION

With its recent adoption of Rule 144A[1] and Regulation S,[2] the Securities and Exchange Commission (SEC) has attempted to substantially increase the liquidity of United States private secondary trading markets and to respond positively to the internationalization of financial markets.[3] The impetus behind these

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* B.A. 1969, M.A., 1971, J.D., 1975. University of Maryland; LL.M. 1991 Georgetown University. The author was formerly a senior business analyst with the Federal National Mortgage Association, Washington, D.C. The views expressed in this article are the author's, and do not necessarily reflect those of the association. The article is a revised version of a paper previously prepared by the author in conjunction with his master of laws degree.

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1. *See infra* notes 100-170 and accompanying text (discussing Rule 144A).

2. *See infra* notes 171-257 and accompanying text (discussing Regulation S).

3. Internationalization or, alternatively, globalization, refers generally to the growing market for cross-border securities offerings and investments. The term encompasses the following activities: Cross-listing of securities issued in one country on the exchange of another country; trading in foreign securities through foreign brokers; opening a country's securities market to foreign brokers and dealers who service both foreigners and nationals; forming contractual or other legal relationships between exchanges in different countries; 24-hour trading, involving shifting control of trading to associates in other countries and time zones; trading in multinational securities offerings; investing in international mutual funds; and selling and purchasing cross-national stock index derivative instruments. UNITED STATES CONG., OFFICE OF TECHNOLOGY ASSESSMENT, *Trading Around The Clock: Global Securities Markets And Information Technology -- Background Paper*, OTA-BP-CIT-66, at 29-35 (July 1990) [hereinafter OTA Paper].

Factors responsible for globalization include the following: Reduced communications costs stemming from advances in information systems technology; increasing world trade and interdependence of national economies; foreign financing of government budgets; dominant presence of institutional investors intent on diversifying portfolios and hedging risks; financial market deregulation; and growth in the number of offshore securities issues. *Id.* at 25-28.

measures is an increasing willingness on the SEC's part to allow certain classes of investors to fend for themselves by limiting the domestic and extraterritorial application of disclosure-oriented U.S. securities statutes and regulations. Underlying the SEC's stance is a growing sensitivity to the cost of regulation insofar as regulation

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Obstacles to further globalization include the following: Absence of liquidity in smaller markets; government policies discouraging foreign participation in national markets; exchange controls; the structure of the relationship between the banking and securities industries; differing procedures for clearance and settlement; informal government-sanctioned trade barriers; differences in corporate organization; and variations in capital adequacy standards, accounting practices, and regulatory regimes. *Id.* at 28-29. Under one view, conflicting regulatory regimes may be the most significant impediment to global market integration. *See* Warren, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185, 186 (1990) (stating that "regulatory disharmony" may be the major barrier to market integration); Note, *Barriers to the International Flow of Capital: The Facilitation of Multinational Securities Offerings*, 20 VAND. J. TRANSNAT'L L. 81, 84 (1987) (asserting that variations among nation-states' securities regimes are perhaps the greatest hindrance to capital market internationalization). *See also* Mahoney, *Regulation of International Securities Issues*, REG. CATO. REV. OF BUS. & GOV'T 62, 63 (Spring 1991) (stating that U.S. securities laws are "one of the most vexing" obstacles to international investment diversification); Perell, Kiernan & Sommer, *Regulation S and Rule 144A: A Non-U.S. Issuer's Perspective*, INT'L FIN. L. REV., at 13, 14 (Supp. Sept. 1990) (arguing that U.S. securities laws are the principal barrier to U.S. investors seeking to diversify portfolios and a cause of erosion of the preeminence of U.S. capital markets). *But see* French & Poterba, *Investor Diversification and International Equity Markets*, 81 AM. ECON. REV. 222, 224 (May 1991) (noting that portfolio patterns indicate investors' belief that returns on domestic equity will be substantially higher than returns in foreign markets; asserting that "incomplete," or "underdiversification" of equity holdings may be attributable to investor choice based on perceived risk differentials rather than variations among "national institutional constraints"). For additional discussion regarding internationalization, see generally U.S. GEN. ACCT. OFFICE, REPORT ON INT'L SEC. MARKETS (Apr. 14, 1989) (citing development of capital adequacy regulations, clearance and settlement procedures, and necessity for U.S. regulators to "coordinate" U.S. approach to international securities regulation as foremost challenges to internationalization); STAFF OF SEC, REPORT TO SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS AND HOUSE COMM. ON ENERGY AND COMMERCE (July 27, 1987) (identifying, *inter alia*, regulatory policy issues raised by market globalization) [hereinafter SEC STUDY]; Policy Statement on the Regulation of International Securities Markets, Int'l Series Release No. 1, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,341 (Nov. 23, 1988) (outlining goals of global market system and identifying regulatory issues posed by internationalization of securities markets; citing "harmonization" of international securities regulation as a central principle); Cox & Michael, *The Market For Markets: Development of International Securities and Commodities Trading*, 36 CATH. U.L. REV. 833 (1987) (reviewing the economics underlying development of securities markets and market linkages); Grundfest, *Internationalization Of The World's Securities Markets: Economic Causes And Regulatory Consequences*, 4 J. FIN. SERVICES RES. 349 (1990) (discussing dual challenges of internationalization of securities markets: identifying and acting collectively in areas where cooperation may be beneficial, *e.g.*, coordinating registration and accounting requirements; and avoiding harmonization of regulatory regimes where competition may be preferable).

affects the cost of capital,[4] and thereby, the competitive position of U.S. issuers and securities markets relative to their foreign counterparts.[5]

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4. A firm's cost of capital is central to the decision to undertake a project. Cost of capital is defined as that level of real pre-tax rate of return which meets the firm's after-tax cost of funds and tax obligations. McCauley & Zimmer, *Explaining International Differences in the Cost of Capital*, FRBNY Q. REV., Summer 1989, at 7, 24-25. Cost of capital is satisfied when revenues meet the cost of equity, weighted by its proportion of the firm's capital; the effective cost of debt, similarly weighted; and income taxes, net of tax credits, and depreciation, discounted by the firm's after-tax cost of funds. *Id.* at 15. *See generally* Blackwell & Kidwell, *An Investigation of Cost Differences Between Public Sales and Private Placements of Debt*, 22 J. FIN. ECON. 253 (1988). Based on a study of public utilities' market choice decisions with respect to raising debt, the authors conclude that market selection is determined by which method -- public offering or private placement -- results in the lowest transaction costs. *Id.* at 273.

5. *See* McCauley & Zimmer, *supra* note 4, at 7, 24-25 (explaining that U.S. and U.K. firms' higher cost of capital than Japanese and German firms' attributable to differences in savings rates, industrial policy, and close relationship between banks and industry). *Cf.* Ando & Auerbach, *The Cost of Capital in Japan: Recent Evidence and Further Results*, 4 J. JAPANESE & INT'L ECON. 323, 324-25 (1990) (stating that lower cost of capital in Japan explained in part by extraordinary growth of Japanese land values and relatively high degree of equity cross-ownership among Japanese firms); Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 99 (1990) (observing that differences in burdens imposed by respective regulatory systems may account for portion of "large" U.S.-Japan cost of capital disparities; discussing generally "political agency problems" of how legislative and corporate management interests act as constraining influences on potential changes in U.S. capital market regulation aimed at cost of capital reduction and increased institutional investor monitoring of management); Poterba, *Comparing the Cost of Capital in the United States and Japan: A Survey of Methods*, FRBNY Q. REV., Winter 1991, at 20, 30 (differential in cost of equity in U.S. and Japan is "single most important explanation" for evident cost of capital differences). *But cf.* Frankel, *The Japanese Cost of Finance: A Survey*, 20 FIN. MGMT. 95, 123-24 (Spring 1991) (asserting that increases in real interest rates and decline of stock market in Japan in 1990 resulted in Japanese cost of capital being "approximately" equal to U.S. cost). In addition to variations in savings rates, differences in industrial organization and the existence of national industrial policy permit Japanese and German firms to reduce their cost of capital below that of U.S. and U.K. firms through greater use of lower risk debt. *See* McCauley & Zimmer, *supra* note 4, at 7.

The efficacy of "industrial policy" and whether or to what extent such a policy should be adopted by the U.S. has been a matter of considerable controversy. Part of the disagreement stems from the lack of consensus on the meaning of the term. *Compare* C. PRESTOWITZ, TRADING PLACES: HOW WE ALLOWED JAPAN TO TAKE THE LEAD (1988) *and* R. REICH, TALES OF A NEW AMERICA (1987) *and* L. THUROW, THE ZERO-SUM SOLUTION (1985) (all sources favoring adoption of various forms of industrial policy) *with* THE POLITICS OF INDUSTRIAL POLICY (C. Barfield & W. Schambra eds. 1986) (discussing political aspects of industrial policy in critical terms) *and* R. LAWRENCE, CAN AMERICA COMPETE? (1984) *and* Schultz, *Industrial Policy: A Dissent*, BROOKINGS REV. 3 (Fall 1983) (both sources arguing that proponents misconceive government's role and its ability to successfully devise and implement policy).

Government policy which seeks to promote competitiveness must be informed by a realistic assessment of the new meaning global economic integration has given to the term "national competitiveness." Reich, *Who Is Us?*, 68 HARV. BUS. REV. 53 (Jan./Feb. 1990) (asserting quality of U.S. workforce -- not necessarily U.S. owned and based corporations -- is basis of American

Historically, U.S. securities markets have been recognized as the world's most innovative. One example of the financial products which have given rise to such reputation is the asset-backed security (ABS).[6] Securitization[7] of financial assets began in 1970 with the Government National Mortgage Association guaranteed pass-through certificate, the "Ginnie Mae."[8] Since then, automobile loans, credit card receivables, and a host of other assets have been packaged as securities and sold by the private sector.[9] Theoretically, any source of cash flow can be securitized and traded in the form of a security. However, there are practical difficulties associated with securitizing assets such as commercial mortgages, which stem from their lack of standard features and special risk characteristics.[10] The fact that such assets are generally the subject of negotiated agreements makes it difficult to create homogeneous securities comprised of instruments with similar contractual rights and cash flow characteristics.[11] Despite such obstacles,[12] the demand for lower cost, more flexible sources of financing, in conjunction with the development of increasingly sophisticated computer modeling techniques and database management systems, resulted in a burgeoning growth of the

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of U.S. workforce -- not necessarily U.S. owned and based corporations -- is basis of American competitiveness).

6. *See infra* notes 19-68 and accompanying text (discussing asset-backed securities).

7. "Securitization" or, alternatively, "structured financing," is the process by which cash flows from debt instruments or receivables are combined in a single pool. *See infra* notes 19-42 and accompanying text (describing process of securitization). The combined cash stream is then allocated among, and used to fund payments on, newly created securities in accordance with specified (principal and interest) payment schedules. *Id.*

8. The Government National Mortgage Association (GNMA) is a unit of the U.S. Department of Housing and Urban Development. 12 U.S.C. § 1717(a)(2) (1988). Mortgage backed securities which are issued by private firms but guaranteed as to principal and interest by the Association are referred to as "Ginnie Maes." *See infra* note 23 and accompanying text (discussing introduction of GNMA securities).

9. *See infra* notes 69-97 (market for non-real estate and real estate related ABSs).

10. *See infra* note 12 (Shenker & Colletta -- a discussion of commercial mortgage securitzation).

11. *Id.*

12. *See* Shenker & Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers* in *Symposium-New Financial Products, The Modern Process of Financial Innovations, and the Law*, 69 TEX. L. REV. 1369, 1396-1403 (1991) (describing initial, creative use of securitization to finance commercial real estate through capital markets, rather than in traditional mortgage lending market).

wide volume of $93.8 billion in 1986, the market reached $158 billion in 1989 and is projected to increase to $175.5 billion in 1990, a rise of eleven percent.[13]

This Article explores the potential impact of Rule 144A and Regulation S on the nature of, and markets for, asset-backed securities. Parts I and II outline ABS structures and trading markets.[14] Part III reviews the principal elements of Rule 144A and certain related regulatory developments.[15] Part IV describes Regulation S.[16] Part V considers some of the potential effects of these new regulations on ABS secondary market trading.[17] The Article concludes that securitization in the Rule 144A and Regulation S environment may result in financial fraud which will act as one of the catalysts in the forthcoming reassessment of the bases of U.S. securities laws in the era of global markets.[18]

As Rule 144A and Regulation S begin to be utilized, they may be viewed as welcome, if overdue, developments for issuers and investors alike in the movement toward deregulation and increased capital and trading market efficiencies. Despite this Article's conjectures, firm conclusions about the overall efficacy of Rule 144A and Regulation S, and their effects on ABS markets in particular, await experience and empirical study.

I. ASSET-BACKED SECURITIES

A. Background

Securitization, also referred to as structured financing, involves pooling homogeneous groups of assets and using the combined cash flow to fund payments on various types of securities which

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13. MOODY'S INVESTOR SERVICES, INC., STRUCTURED FINANCE: ANNUAL REPORT 1989 REVIEW AND 1990 OUTLOOK, Jan. 1990, at 5 [hereinafter MOODY'S ANNUAL REPORT]. Moody's anticipates that the *Structured Finance: Annual Report 1990 Review and 1991 Outlook* will be released during the second quarter of 1991.

14. *See infra* notes 19-99 and accompanying text.

15. *See infra* notes 100-170 and accompanying text.

16. *See infra* notes 171-257 and accompanying text.

17. *See infra* notes 258-349 and accompanying text.

18. *See infra* notes 350-360 and accompanying text.

are sold to investors.[19] The process of securitization involves structuring the security with the emphasis on tax and accounting considerations, assessment of credit risk and agency ratings, financing strategy, and tracking, reporting and servicing support.[20] Securitization can be seen as an outgrowth of the commercial paper market which developed as corporate borrowers sought lower cost,

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19. *See, e.g.*, K. LORE, MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET § 1, at 3-6 (1991 ed.); C. PAVEL, SECURITIZATION: THE ASSET ANALYSIS AND DEVELOPMENT OF LOAN-BASED ASSET-BACKED SECURITIES MARKETS 1 (1989); Asset Finance Group, The First Boston Corp., *Overview of Assets and Structures*, THE ASSET SECURITIZATION HANDBOOK 21, at 35-36 (P. Zweig ed. 1989) [hereinafter Asset Finance Group, The First Boston Corp.]; Barmat, *Securitization: An Overview*, THE HANDBOOK OF ASSET-BACKED SECURITIES 3, at 4 (J. Lederman ed. 1990) [hereinafter Barmat]; Boemio & Edwards, *Asset Securitization: A Supervisory Perspective*, 75 FED. RES. BULL. 659, at 659-61 (Oct. 1989).

Securitization has been described as a type of financial intermediation that involves, on a general level, the purchase and sale of financial claims. Cumming, *The Economics of Securitization*, FRBNY Q. REV., Autumn 1987, at 11-12. In contrast to traditional financial intermediation, securitization attempts to match borrowers and savers through recourse to the financial markets. *Id.* This is done by issuance of bonds, commercial paper and asset-backed securities. *Id.* Although financial intermediaries originate debt, the financial markets are used to place the debt with ultimate holder-investors. *Id.* A further distinction relates to disintermediation, which involves displacement of banks and thrifts from traditional lending by other businesses, or direct lending between firms in the same economic sector, *e.g.*, trade credit, as opposed to financial market transactions. *Id.* Unlike disintermediation, securitization entails a permanent change in the forms of claims and types of claim holders. *Id.* However, both securitization and disintermediation involve a shift away from intermediation by depository institutions. *Id. Compare, e.g.*, Shenker & Colletta, *supra* note 12, at 1373-80 (noting that the term "securitization" has no distinct legal meaning; stating that no uniform, satisfactory definition of securitization exists; describing various uses of the term; and defining securitization as the sale of equity or debt instruments representing ownership interests in an income stream from an asset or pool of assets, in a manner which reallocates underlying risks and which, in effect, increases the marketability of the underlying assets), *with* T. FRANKEL, SECURITIZATION: STRUCTURAL FINANCE, FINANCIAL ASSET POOLS AND ASSET-BACKED SECURITIES at xlvi, § 5 at 172-73 (1991) (securitization "seems to lack legal infrastructures") *and id.* § 1.2 at 6-7 (securitization may involve "substitution of securities for loans," the sale of portions of large loans known as "loan participants," and the sale of securities (i.e. ownership interests) in an asset pool, which securities are traded in a secondary market through financial intermediaries).

20. Barmat, *supra* note 19, at 6-14. *See* Shenker & Colletta, *supra* note 12, at 1376-80 (securitization process involves asset selection, segregation, equity (pass-through instruments) or debt (pay-through or asset-backed bond structures) choice, and risk and resale considerations); Koflowitz, *Making the Right Mortgage-Backed Securities Software Moves*, 7 WALL STREET J. COMPUTER REV. at 32 (discussing requirements of ABS issuers and investors relative to limitations of currently available software). *See generally* L. KARCHER, PROCESSING MORTGAGE-BACKED SECURITIES (1989) (describing, *inter alia*, ABS operations processing cycle and clearance procedures).

more flexible financing alternatives to traditional bank loans.[21] The roots of securitization also lie in the federal policy of increasing the supply of residential mortgage credit by stimulating the development of the secondary mortgage market.[22] This policy objective has been pursued since the creation of the Federal National Mortgage Association (FNMA) in 1938, and more recently, through the establishment of the Government National Mortgage Association (GNMA) in 1968, and the Federal Home Loan Mortgage Corporation (FHLMC) in 1970.[23] By accelerating the process of disintermediation, securitization has been a significant force in restructuring the financial services industry.[24]

Several factors have been driving structured finance. From the commercial lender's perspective, securitized debt frequently has a lower total cost than whole loans. For example, it has been estimated that the issuance and administrative costs associated with collateralized mortgage obligations (CMOs),[25] average

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21. J. ROSENTHAL & J. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 40 (1988); Acheson & Halstead, *Trends in Securitization -- Private and Public*, 6 CONTINENTAL BANK J. OF APPLIED CORP. FIN. 52, 53-54 (Fall 1988). Securitization's origins can be traced back to the 19th century and beyond in the form of mortgage-backed bonds, and mortgage participation certificates. Shenker & Colletta, *supra* note 12, at 1380-82. *See* T. FRANKEL, *supra* note 19, § 2.1 at p. 29.

22. LORE, *supra* note 19, § 1 at 19-23, 27-31, 69-71.

23. *Id.* § 2 at 1-46. In 1970, the GNMA began guaranteeing securities (pass-through certificates) collateralized by pools of mortgages created by private originators. *Id.* § 2 at 19-25, 39-42. GNMA securities ("Ginnie Maes") are technically issued by these originators. *Id.* The FNMA and FHLMC provide liquidity to the secondary mortgage market by purchasing conventional, VA, and FHA loans. *Id.* The FNMA and FHLMC issue pass-through securities similar to Ginnie Maes: mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs), respectively. *See infra* note 25 (defining CMO). The FNMA and FHLMC are Congressionally-chartered corporations. Ownership of the organizations, which are variously referred to as government sponsored enterprises (GSEs) or government-related agencies, was transferred to private shareholders in 1968 (FNMA) and 1989 (FHLMC). *See* LORE, *supra* note 19, § 2 at 10-13, 16-20. Since non-real estate-related securities developed out of MBS and CMO structures and because the MBS and CMO markets are orders of magnitude larger than the non-real estate-related markets, a distinction is usually drawn between MBSs/CMOs and asset-backed securities (ABSs). For ease of exposition in this Article, the term ABS will be used generally to refer to MBSs, CMOs, and non-real estate-related asset-backed securities unless otherwise indicated.

24. Cumming, *The Economics of Securitization*, 12 FRBNY Q. REV., at 13-14, 21-23; Shenker & Colletta, *supra* note 12, at 1389-92.

25. A collateralized mortgage obligation (CMO) is a bond secured by a mortgage pool. That portion of cash flow from the pool which represents repayments of principal is paid out sequentially into one or more classes (tranches) of the bonds. Interest is generally paid currently or accrues on

approximately twenty-five basis points annually for the duration of the bond.[26] A comparable bank-held residential mortgage portfolio has intermediary costs, such as equity costs, income taxes, reserves, and insurance, of approximately one hundred-fifty basis points.[27]

Debt which has been securitized is made more liquid: it may be valued and transferred more efficiently in secondary markets than individual loans or loan participations.[28] Such debt also has the advantage of being diversified because it represents a pool of loans, the repayment of which depends on the performance of many borrowers.[29] Securitization unbundles the credit and interest rate risks associated with traditional debt and, by restructuring the debt, more efficiently allocates these risks among those willing and able to bear it.[30]

With respect to the entities which initially owned the assets (originators), the sale of the assets to vehicles created for the purpose of issuing securities collateralized by the assets removes the assets from the originators' balance sheets.[31] The ability to remove assets is particularly attractive to depository institutions because the amount of equity capital required to support balance sheet assets is thereby reduced, and the resulting increase in available capital permits expansion and diversification, as well as

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the respective outstanding balances of all tranches. Glossary, THE ASSET SECURITIZATION HANDBOOK, *supra* note 19, at 558. Each bond class has a specified maturity and coupon date. Boemio & Edwards, *supra* note 19, at 662. *See infra* notes 56-60 and accompanying text (discussing CMOs).

26. Bryan, *Introduction* to THE ASSET SECURITIZATION HANDBOOK, *supra* note 19, at 11.

27. *Id. See* L. BRYAN, BREAKING UP THE BANK: RETHINKING AN INDUSTRY UNDER SIEGE 82-84 (1988) (stating that bank subsidiaries of holding companies rated single-A or less have saved approximately 1.5% in direct financing costs by securitizing loans, *e.g.*, credit card receivables, in comparison with direct issue costs); Kopff & Lent, *Management Challenges in the Age of Securitization*, THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 19, at 156 (noting that BBB-rated firm funding portfolios may save up to 60 basis points by collateralizing security with consumer receivables instead of funding with corporate debt).

28. For a comprehensive analysis of securitization and loan participations see T. FRANKEL, *supra* note 19, at Pt. III (Loan Participations).

29. PAVEL, *supra* note 19, at 13-14.

30. ROSENTHAL & OCAMPO, *supra* note 21, at 6-12; Shenker & Colletta *supra* note 12, at 1393-95. *But see* Forsyth, *infra* note 333 (discussing apparent misallocation of risks in CMO market).

31. PAVEL, *supra* note 19, at 16-17; Goldberg, Burke, Gordon, Pinkes & Watson, *Asset Securitization and Corporation Financial Health*, THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 19, at 179 [hereinafter Goldberg]; Kopff & Lent, *supra* note 27, at 156-57.

greater control of asset-liability ratios.[32] Securitization is thus significant since it reduces financial intermediaries' traditional role.[33] Structured financing has expanded sources of credit by making it practical and cost effective for originators to place debt directly with investors. In addition, credit enhancement devices, such as letters of credit, surety bonds, and over collateralization, which may be required to obtain an investment grade rating for an offering, often result in ABSs having a higher rating than that of the originator.[34] In such instances, the originator's cost of capital (net of securitization expenses) is lower than it would have been had it issued the debt directly.[35]

Securitization has been a source of origination and servicing fee income for asset originators. Structured financing has generated additional underwriting compensation and trading commissions for the major investment banking houses,[36] although income from the non-real estate-related ABS markets has been more volatile than that from MBSs.[37] Apart from federal agency and GSE guarantees behind the vast majority of securitized residential real estate debt, banks and insurance companies with the requisite underwriting

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32. PAVEL, *supra* note 19, at 16-17; Goldberg, *supra* note 31, at 179; Kopff & Lent, *supra* note 27, at 156-58. *See* ROSENTHAL & OCAMPO, *supra* note 21, at 219 (examining how securitization may be used as a device to liquify assets, reduce leverage, and improve credit, thereby deterring hostile takeovers).

33. Goldberg, *supra* note 31, at 178. *See* Starobin, *Bypassing Banks*, NAT'L J., Mar. 9, 1991, at 554 (discussing marketplace shift from commercial banks to non-bank providers of financial services).

34. Asset Finance Group, The First Boston Corp., *supra* note 19, at 27-30; Bryan, *supra* note 26, at 17-18.

35. Asset Finance Group, The First Boston Corp., *supra* note 19, at 27-30; Barmat, *supra* note 19, at 5; Bryan, *supra* note 26, at 17-18, 27-30; Kopff & Lent, *supra* note 27, at 156. *See* Asset Finance Group, The First Boston Corp., *supra* note 19, at 25-26 (outlining considerations bearing on the decision to securitize). High quality loans are relatively less expensive to securitize. There is a concern that this reduced securitization expense may result in a flight of such assets from depository institutions and undermine the capital adequacy guidelines. Boemio & Edwards, *supra* note 19, at 661-62; Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks: Leverage Measure, 12 C.F.R. app. § 225 (1991). *But see* Shenker & Colletta, *supra* note 12, at 1395 n.124 (despite foregoing, on balance incentives to securitize should encourage institutions to adapt higher underwriting standards).

36. Bryan, *supra* note 26, at 18. For rankings of investment banks in public underwritings and private offerings of asset-backed securities, see Tables 1 and 2, *infra*, at pages 155 and 156.

37. Dannen, *The Failed Promise of Asset-Backed Securities*, 23 INSTITUTIONAL INVESTOR, Oct. 1989, at 261-64.

skills have profited from guaranteeing the credit risks associated with non-real estate-related ABSs.[38] With regard to borrowers, as competition among lenders stimulated by securitization increases, reduction in the cost of funds may be expected, resulting in more flexible lending terms.[39] Investors have profited from the securities' high credit ratings, yields, and liquidity.[40] Asset-backed securities have also become an important tool for investor portfolio management[41] because their cash flows can be structured to meet specific investor requirements.[42]

B. Structure and Principal Types of Asset-Backed Securities

Although the basic concept of the ABS is relatively straightforward, such instruments have evolved from their origins in the secondary mortgage market into a variety of complex

38. Credit underwriting assumes knowledge and skills which may be lacking because the process is relatively novel and complex. In 1985 Ticor Mortgage Insurance Company filed for bankruptcy as a result of the default by Equity Programs Investment Corporation (EPIC) on its MBSs. ROSENTHAL & OCAMPO, *supra* note 21, at 17-18. Ticor was overexposed as principal guarantor and had conducted an inadequate initial credit review. *Id. See* Note, *The Private Mortgage Insurer's Action for Rescission for Misrepresentation: Limiting a Potential Threat to Private Sector Participation in the Secondary Mortgage Market*, 47 WASH. & LEE L. REV. 589, 599-601 (1990) (describing the EPIC default and arguing generally for limitation on insurers' right to rescind for misrepresentation in insurance application in cases where applicant has sold loan on secondary market) [hereinafter Note, *The Private Mortgage Investor's Action*]. *See also* Batte, *War Stories From The Due Diligence Zone*, 51 MORTGAGE BANKING, Mar. 1991, at 47, 49 (describing mortgage servicing deficiencies, including computer system under-use and "many serious investor compliance violations" among "good cross-section" of mortgage banking industry); MOODY'S ANNUAL REPORT, *supra* note 13, at 5-6 (noting increasing complexity of ABSs and trend toward higher risks and adverse pressure on credit standards due to heightening competition among underwriters, trustees, attorneys, accountants, and collateral credit enhancers); T. FRANKEL, *supra* note 19, § 3.4 at 94 (existing regulation of participants in securitization process "inadequate"); STANDARD & POOR'S CORP., *Asset-Backed Securitization*, STANDARD & POOR'S CREDIT REV., Mar. 1989, at 3-10 (discussing ABS rating process and related instrument and market risks).

39. PAVEL, *supra* note 19, at 15; ROSENTHAL & OCAMPO, *supra* note 21, at 12; Bryan, *supra* note 26, at 18-19. Reductions in cost of funds have been estimated to be on the order of 100 basis points or more. *Id.*

40. L. BRYAN, *supra* note 27, at 81. Some ABS issues have been structured to offer yields of 20 basis points more than highly liquid comparable investments. *Id.*

41. *See generally* W. SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS (1970); R. BREALEY & S. MYERS, PRINCIPALS OF CORPORATE FINANCE (1988) (both sources analyzing how portfolio theory has led to reduction in firm-specific risk through diversification).

42. L. BRYAN, *supra* note 27, at 70, 73-74, 81-82; Goldberg, *supra* note 31, at 179.

investment vehicles. The securities are the subject of extensive analysis in a sizable body of literature and research reports.[43] The primary forms of the asset-backed security are described below.

Asset-backed securities can be structured as pass-through instruments, pay-through bonds, or asset-backed bonds. Assuming the present value of an asset's future cash flow can be ascertained, the choice of structure depends on asset cash flow characteristics, such as prepayment, delinquency, and default rates. The entity owning the assets must also consider whether to transfer or retain ownership. In this regard, the decreased balance sheet burden resulting from a sale must be weighed against the consequences of recognizing gains or losses on the sale.[44] Detailed construction

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43. *See, e.g.*, sources cited *supra* notes 19 and 21. *See also* L. BRYAN, BANKRUPT: RESTORING THE HEALTH AND PROFITABILITY OF OUR BANKING SYSTEM Pt. III, § 8 (1991) (discussing, *inter alia*, implications of securitization for future structure of banking industry); EDSON & JACOBS, SECONDARY MORTGAGE MARKET GUIDE (1991) (describing legal aspects of secondary mortgage market); J. HENDERSON & J. SCOTT, SECURITIZATION (1988) (describing process and development of securitization in the U.S. and United Kingdom); J. WALMSLEY, THE NEW FINANCIAL INSTRUMENTS 227-70 (1988) (describing securitization process and growth of real estate-related ABSs); THE HANDBOOK OF FIXED INCOME SECURITIES Pt. 4 (F. Fabozzi 3d ed. 1991) (discussing mortgage-backed and asset-backed securities); 5 THE LIBRARY OF INVESTMENT BANKING, MORTGAGE AND ASSET SECURITIZATION (R. Kuhn ed. 1990) (comprehensive treatment of real estate-related securitization and asset-based finance); CALIFORNIA DEPT. OF REAL ESTATE, A REVIEW OF SECONDARY MORTGAGE MARKET ACTIVITIES, INST. CALIF. REAL EST. RES. (June 1990) (describing development of secondary mortgage market and surveying recent developments); Parks, *The ABCs of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance*, J. ACCT., Apr. 1991, at 41; Shaw, *Developments in Securitized Markets: Selected Legal Considerations Relating to Asset-Backed Securities*, in PRAC. L. INST., TWENTY-SECOND ANN. INST. ON SEC. REG. (1990), at 247 (surveying recent developments). *See also Changes in Our Financial System: Globalization of Capital Markets and Securitization of Credit: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 203 (1987) (including, *inter alia*, various views of ramifications of securitization on the current and future structure of U.S. financial system) *reprinted in* U.S. CODE CONG. & ADMIN. NEWS (1987).

44. Barmat, *supra* note 19, at 6-7. Whether or not the entity sells the assets to a limited purpose vehicle, it must be insulated from the bankruptcy of the seller. Sellers usually retain some interest in the assets and frequently have servicing rights. *See* Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607, 608-27 (1990) (discussing asset title transfer by originator-seller and related seller bankruptcy issues).

It is important to note at the outset that a thorough analysis of whether a particular asset-backed arrangement involves a "security" under banking law and under securities law must be conducted. Additional determinations must be made as to the identity of the issues and underwriter of, and dealer in, the securities, and whether the securities are equity or debt. T. FRANKEL, *supra* note 19, at §§ 7.7-7.14, § 8, §§ 11-13. It would not be on overstatement to describe the current state of the law in this area as unsettled, convoluted and frequently contradictory.

and precise terms of the securities are determined on the bases of computer matrices and pricing and yield factors.[45]

Pass-through ABSs represent direct, undivided fractional interests in a pool of assets such as mortgage or credit card receivables.[46] The asset portfolio is held in a grantor trust (usually formed by the asset owner) which issues certificates evidencing ownership to investors.[47] The owner sells the assets, removing them from the balance sheet, to the trust, which is deemed to be created by the investors. In return, the owner receives the proceeds from certificate sales and, frequently, fees for servicing the assets as well. In order to preserve the non-taxable status of the trust, principal and interest payments received by the trust, less trust expenses, must be passed through directly to investors on a pro rata basis.[48] The trust acts as a static conduit for the cash flows received and subsequent distributions to investors cannot be modified, for example, by issuing additional classes of certificates having different maturities, interest rates, or payment schedules.[49] Since title to the assets is held by the trust, investors bear prepayment and default risks.[50]

Pay-through instruments, in comparison with pass-through securities, are more flexible and market-sensitive. Pay-through bonds constitute debt of the issuer which is secured by a pool of assets, and are pledged as collateral for the payment of principal and interest on the bonds.[51] Payments of bond principal and

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45. LORE, *supra* note 19, § 3 at 6-21; T. FRANKEL, *supra* note 19, § 2.7 at 57 n.2.

46. PAVEL, *supra* note 19, at 4-6; Kunz, *Securities Laws Considerations*, THE ASSET SECURITIZATION HANDBOOK, *supra* note 19, at 348-49; Murray & Hadaway, *Mortgage-Backed Securities: An Investigation of Legal and Financial Issues*, 11 J. CORP. L. 203, 207-08 (1986).

47. PAVEL, *supra* note 19, at 4-6; Barmat, *supra* note 19, at 7-8; Kunz, *supra* note 46, at 48-49.

48. Barmat, *supra* note 19, at 7-8; Kunz, *supra* note 46, at 348-49; Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 503, 508-09.

49. Kunz, *supra* note 46, at 348-49; Pittman, *supra* note 48, at 503, 508-09.

50. PAVEL, *supra* note 19, at 4-6; Barmat, *supra* note 19, at 7-8; Kunz, *supra* note 46, at 348-49; Murray & Hadaway, *supra* note 46, at 207; Pittman, *supra* note 48, at 503-05.

51. PAVEL, *supra* note 19, at 8-9; Barmat, *supra* note 19, at 8-9; Kunz, *supra* note 46, at 350-51; Watson & Joint, *Rating Asset-Backed Transactions*, THE ASSET SECURITIZATION HANDBOOK, *supra* note 19, at 228-29.

interest need not be tied to payments on the collateral.[52] Pay-through bonds are issued by a limited purpose entity established as a subsidiary of the parent asset owner.[53] Proceeds from the sale of the bonds are used to finance the contemporaneous acquisition of the assets from the parent.[54] The bonds are issued under a trust indenture pursuant to which cash flow from the collateral can be reconfigured into a single or series of bond tranches (classes) with maturities, interest rates, and payment terms different from those of the underlying assets.[55]

Pay-through bonds originated in the MBS market in 1983 and are frequently structured as collateralized mortgage obligations (CMOs).[56] Collateralized mortgage obligations are collateralized by pass-through MBSs and are generally issued in at least four classes, as follows: short-term, medium-term, long-term, and zero coupon (Z) tranches.[57] Except for the Z tranche, each tranche receives periodic interest payments.[58] All principal payments, including prepayments, are applied to retire the tranches sequentially, commencing with the earliest maturing tranche.[59] Pay-through bonds are treated as debt of the issuer, which may therefore deduct interest paid to bondholders and partially offset income received from the collateral.[60]

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52. LORE, *supra* note 19, § 3 at 14-15; ROSENTHAL & OCAMPO, *supra* note 21, at 54-58; Murray & Hadaway, *supra* note 46, at 208-10.

53. As an alternative to the limited purpose financial subsidiary of the asset owner, a special purpose ABS corporation may be formed as a subsidiary of an entity not affiliated with the asset owner. Kunz, *supra* note 46, at 349-51. Such unaffiliated entities are typically broker-dealers which underwrite ABS offerings. *Id.* The corporation finances the purchase of assets by issuing securities under a trust indenture. *Id.* The corporation offers asset owners the advantage of disposing of assets through SEC Rule 415 offering procedure as an alternative to multiple registrations. *Id.*

54. ROSENTHAL & OCAMPO, *supra* note 21, at 54-58; Kunz, *supra* note 46, at 349-50.

55. *Id.*

56. LORE, *supra* note 19, § 3 at 19-24; PAVEL, *supra* note 19, at 8-9; ROSENTHAL & OCAMPO, *supra* note 21, at 54-58; Barmat, *supra* note 19, at 8-9; Pittman, *supra* note 48, at 506-08.

57. LORE, *supra* note 19, § 3 at 19-24; ROSENTHAL & OCAMPO, *supra* note 21, at 54-58; Pittman, *supra* note 48, at 506-08. Tranche Maturities typically range from 5 through 20 years.

58. LORE, *supra* note 19, § 3 at 20-22; Pittman, *supra* note 48, at 506-07.

59. LORE, *supra* note 19, § 3 at 19-23; Pittman, *supra* note 48, at 507. Tranche maturities typically range from five through 20 years.

60. LORE, *supra* note 19, § 3 at 19-24; ROSENTHAL & OCAMPO, *supra* note 21, at 54-58; Barmat, *supra* note 19, at 8; Pittman, *supra* note 48, at 507. The Tax Reform Act of 1986 included legislation that provided issuers the option of structuring issues for accounting purposes as a sale or

Asset-backed bonds represent direct obligations of the issuer. The bonds are collateralized by a discrete asset pool pledged to secure payment of a specified percentage return, and have a fixed maturity date.[61] The assets are retained on the issuer's balance sheet and the bonds become new liabilities.[62] Principal and interest payments on the bonds may be structured in a single class (asset-backed note) or multiple classes.[63] Bond payments need not derive from or match cash flows from the pledged collateral.[64] Bond value is based on the market value of the collateral or its discounted future cash flow value.[65] Asset-backed bonds are generally overcollateralized; the collateral is evaluated periodically

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as debt financing. Act of Oct. 22, 1986, Pub. L. No. 99-514, 1986, U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2085 (1986). *See* Act of Nov. 10, 1988, Pub. L. No. 100-647, 1988, U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342 (1988). The real estate mortgage investment conduit (REMIC) legislated by the Act permits issuers to avoid dual taxation, as with CMOs, without having to structure the transaction as a debt offering. *See generally* K. LORE & K. KUSMA, MORTGAGE-BACKED SECURITIES – SPECIAL UPDATE: REMICS (REAL ESTATE MORTGAGE INVESTMENT CONDUITS) (1987) (tracing background of REMICs, REMIC rules and associated securities and tax law aspects). Multiclass ABSs may be structured as derivative instruments such as stripped securities. Interest only strips (IOs) and principal only strips (POs) represent the right to receive all the interest and principal, respectively, from the underlying asset pool's cash flow. Pittman, *supra* note 48, at 509-12. Asset-backed securities residuals represent claims on cash flows from collateral, net of all payments to investors and expenses. *Id.* Residuals result from the spread between the asset pool's weighted average interest rate and the bonds' interest rate, over collateralization, and income from investing cash flow until it is distributed to investors. *Id.* Floating rate ABSs tie investor returns to fluctuations in widely accepted interest rate indices, such as the London Inter-Bank Offering Rate (LIBOR). *Id.* Planned amortization class (PAC) and targeted amortization class (TAC) bonds attempt to achieve more definite duration by using prepayments on the underlying collateral to maintain the principal repayment schedule of the PAC tranche of the bonds. *Id.* This may, however, increase the volatility of the other classes. LORE, *supra* note 19, § 3, at 24-26; Pittman, *supra* note 48, at 509-12.

61. LORE, *supra* note 19, § 3 at 28-30; Barmat, *supra* note 19, at 7. Asset-backed bonds may be, but are infrequently, issued by special purpose entities. T. FRANKEL, *supra* note 19, § 8.4 at 294.

62. The bonds are issued directly by the company -- *ipso facto* they are the company's liability.

63. LORE, *supra* note 19, § 3 at 28; PAVEL, *supra* note 19, at 7-8; Barmat, *supra* note 19, at 7.

64. LORE, *supra* note 19, § 3 at 30; Asset Finance Group, The First Boston Corp., *supra* note 19, at 41-42.

65. Barmat, *supra* note 19, at 7. *Cf.* LORE, *supra* note 19, § 3 at 28 (comparing collateral structure of mortgage-backed bonds, which are based on collateral's market value, with pay-through bonds, which are collateralized on basis of collateral pool cash flow).

and is added to, when necessary, in the event of unanticipated prepayments, defaults or declines in market value.[66]

The ability to restructure asset cash flows allows multi-class debt instruments to be constructed to meet investor requirements regarding maturity and reduces the cost to issuers by obtaining the lowest blended yield to investors.[67] Multi-class ABSs with varying tranche maturities and coupon rates can be designed to produce a lower weighted average interest rate than the interest rate for a single maturity security.[68]

66. LORE, *supra* note 19, § 3 at 28-30 (relating to mortgage-backed bonds); PAVEL, *supra* note 19, at 7; Barmat, *supra* note 19, at 7; Pittman, *supra* note 48, at 500-01, 507 n.47. Asset-backed preferred stock and asset-backed commercial paper are issued through limited purpose vehicles. PAVEL, *supra* note 19, at 9-10; ROSENTHAL & OCAMPO, *supra* note 21, at 199-201; Asset Finance Group, The First Boston Corp., *supra* note 19, at 42-43; Hourican, *Receivable-Backed Commercial Paper*, THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 19, at 315-19.

With respect to preferred stock, the vehicles are subsidiaries of the parent asset owner which purchases consumer and trade receivables from the parent to collateralize stock dividends and redemption rights. Asset Finance Group, The First Boston Corp., *supra* note 19, at 42. Asset-backed preferred stock dividends are given favorable tax treatment in the hands of corporate investors which can utilize the 80% "dividends received" deduction. I.R.C. § 243(a) (1982). The deduction allows asset-backed preferred stock to be issued at a lower dividend rate than the interest rate on equivalent corporate debt. Haspel & Bush, *The Treatment of "Securitized" Investment Opportunities*, 5 J. TAX'N INVESTMENTS 60, 62 (1987). Overcollateralization and irrevocable letters of credit or surety bonds support the stock and can also result in ratings sufficiently high to permit issuers to borrow at interest rates below that of commercial paper. Asset Finance Group, The First Boston Corp., *supra* note 19, at 42. Asset-backed commercial paper is commonly used to finance sales of receivables. PAVEL, *supra* note 19, at 9; ROSENTHAL & OCAMPO, *supra* note 21, at 199-201; Hourican, *supra*, at 315. Asset-backed commercial paper may take the form of direct-pay on standby commercial paper. Such paper is variously supported by bank letters of credit, corporate guarantees, surety bonds and insurance policies. Asset-backed paper may also be issued as market value commercial paper, which is supported by an overcollateralized asset pool. PAVEL, *supra* note 19, at 9-10; ROSENTHAL & OCAMPO, *supra* note 21, at 200; Asset Finance Group, The First Boston Corp., *supra* note 19, at 42-43; Hourican, *supra*, at 315-19; MOODY'S ANNUAL REPORT, *supra* note 13, at 16.

67. ROSENTHAL & OCAMPO, *supra* note 21, at 55.

68. *Id.* at 56.

II. OVERVIEW OF ASSET-BACKED MARKETS[69]

Total volume of international structured offerings rose from $93.8 billion in 1986 to $158 billion in 1989.[70] In 1990, an 11.1% increase in volume to $175.5 billion is forecast.[71] Since the beginning of structured financing in the early 1970's, U.S. issuers have overwhelmingly dominated the structured financing market.[72] However, securitization, primarily real estate-related, is increasing in the U.K., Europe -- notably France -- and Australia, and non-

69. Market data concerning GNMA, FNMA and FHLMC securities is the most comprehensive and reliable. Data concerning private sector public offerings of real estate and non-real estate-related ABSs is available from fewer sources. Such data is often not truly comparable because of the absence of uniformly agreed upon definitions of various types of ABSs, among other reasons. Reliable information about ABS private placements is the most difficult to obtain. Ostensibly comparable data from different sources often show considerable disparities, in some cases making comparisons meaningless. *See* LORE, *supra* note 19, § 1 at 23-24 (stating that data concerning public and private MBS offerings by private sectors are "less definitive" than for GSEs, and that data provided by a "variety of sources . . . seldom correlate;" asserting that actual size of private sector is "somewhat illusory"). It should be added that the foregoing is doubly the case with respect to non-U.S. issuers in non-U.S. markets. This situation should improve given the level of market interest in ABSs. Duff & Phelps Credit Rating Company recently scheduled a conference in Tokyo in response to Japanese demands for more detailed market data. *See Duff & Phelps Holds Tokyo Investor Conference*, PR NEWSWIRE (Oct. 8, 1990) (LEXIS, Nexis library, Currnt file). The difficulties of obtaining accurate and comprehensive data on ABS markets mirror a similar state of affairs with respect to the information currently available concerning institutional investors and markets. *See* Brancato & Gaughan, *The Growth of Institutional Investors in U.S. Capital Markets*, INST. INVESTOR PROJECT, COLUM. CENTER FOR L. & ECON. STUD. (Nov. 1988). Data on institutional investors and markets "must be painstakingly constructed from a wide variety of sources, few of which provide consistent comparison." *Id.* at iii, *cited in* Note, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 IND. L. J. 233, 238 n.22 (1990) [hereinafter Note, *The Capital Markets in Transition*]. The implications of the lack of reliable market data generally were brought home with respect to Rule 144A by Congressman John Dingell (D-Mich.), Chairman, House Committee on Energy and Commerce. In response to the SEC's first semi-annual report on the use of Rule 144A, *see infra* note 105, Cong. Dingell charged that the Commission used anecdotal evidence rather than substantive data, and has requested that the General Accounting Office scrutinize the Commission's methodology and data quality. *Dingell: Cram It, Quinn: Expand It*, INST. INVESTOR, CORP. FIN. WEEK (Mar. 11, 1991) (LEXIS, Nexis library, Currnt file). Investment Dealer's Digest, Inc., has announced a new weekly publication, *Private Placement Letter*, which is set to report detailed data on private (including 144A) markets. *IDD Launches New Private Placement Letter -- The Weekly Chronicle of The Private and 144A Markets*, PR NEWSWIRE, Jan. 16, 1991 (LEXIS, Nexis library, Currnt file).

70. MOODY'S ANNUAL REPORT, *supra* note 13, at 5.

71. *Id.* at 3, 5-6.

72. *Id.* at 6.

U.S. markets are said to be on the verge of "explosive growth."[73] In the United States, as of February 1990, the twentieth anniversary of the first offering of a GNMA guaranteed mortgage security, in excess of $900 billion in mortgage-related securities were estimated to be outstanding.[74] The market for real estate-related pass-through securities is comprised almost entirely of direct offerings of the FNMA and FHLMC, offerings collateralized by GNMA pass-throughs and other GSE securities.[75] Nevertheless, from 1984, when the Secondary Mortgage Market Enhancement Act (SMMEA)[76] was enacted to encourage increased private sector (non-GSE) involvement in the secondary mortgage market, private offerings rose from $10 billion[77] to $71 billion in 1988.[78]

73. *Id.* at 3-6, 19-21. In 1989, U.K. mortgage-backed offerings totaled $2.9 billion, and in Australia structured financing issues amounted to $1.6 billion. *Id.* at 3, 19-21. The first asset-backed offering in France occurred in 1989. *Id.* The growth of securitization is due in large measure to the privatization movement and deregulation occurring in Europe. *Id.* at 20. Securitization of third world debt has been discussed as a means of alleviating pressures on LDEs (less developed countries) and banks' LDC loan portfolios. Puchala, *Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 137, 170-71. *But see* Leebron, *First Things First: A Comment on Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 173, 173-75, 173 (stating that securitization benefits lenders only and does not address developing countries' basic socioeconomic problems, in contrast to debt-equity swaps and the other approaches aimed at de-leveraging third world economies). *Cf.* Simpson, *The Greening of Global Investment; How the Environment, Ethics and Politics Are Reshaping Strategies*, THE ECONOMIST (Spec. Report No. 2108) (Jan. 1991) (discussing variety and relative influence of ethical considerations on investment decisions).

74. STANDARD & POOR'S CORP., *Standard & Poor's Credit Forum -- Structured Finance Turns 20*, PR NEWSWIRE (Feb. 23, 1990) (LEXIS, Nexis library, Curnt file). The $900 billion figure does not include securities collateralized by other mortgage-backed securities. *Id.* The mortgage-related securities market, including mortgage-backed pass-through securities, CMOs, REMICs, and stripped mortgage-backed pass-through securities, had an average growth rate of 25% per annum during the period 1980-89. *Id.*

75. LORE, *supra* note 19, § 1 at 12, 23; Pittman, *supra* note 48, at 539. The size of the private sector's share of the MBS market has been estimated to be in the range of 5%. *Id.*

76. Act of Oct. 3, 1984, Pub. L. No. 98-440, 1984, U.S. CODE CONG. & ADMIN. NEWS (98 Stat.) 1689 (1984). *See generally* LORE, *supra* note 19, § 1 at 59-62 (tracing background and impact of SMMEA on secondary mortgage market). *See also* Pittman, *supra* note 48, at 512-38 (analyzing in detail major SMMEA provisions).

77. *Database, Secondary Mortgage Markets* (Summer 1986). *Secondary Mortgage Markets* is a publication of the Federal Home Loan Mortgage Corporation. *Database* is a periodic supplement to that publication which contains data on the mortgage banking industry.

78. *Database, Secondary Mortgage Markets* (Spring 1989). Figures represent public issues; actual total is higher when private placements are included.

The first public offering of non-real estate-related ABSs, computer leases, occurred in 1985.[79] The two dominant non-real estate-related securitized assets, automobile loans and credit card receivables, were first marketed in 1984 and 1986, respectively.[80] As of year-end 1987, thirty-five percent of home mortgages, five percent of automobile loans, one percent of commercial mortgages, and two percent of credit card receivables had been securitized.[81] The $770 billion in securitized loans outstanding as of 1987 compared with a total of more than $4 trillion in potentially securitizable assets.[82]

For 1990, volume of U.S. domestic MBS public issues was $139.6 billion, a twenty-one percent increase over 1989 volume.[83] Asset-backed underwritings (non-real estate-related issues) totaled $40.4 billion in 1990, a seventy-two percent rise from the prior

79. Barmat, *supra* note 19, at 14.

80. L. BRYAN, *supra* note 27, at 77. With respect to the dominance of automobile loans and credit card receivables in the non-real estate related markets, see graph, *Consumer Loan-Backed Securities Trends*, *infra*, at page 162 (illustrating auto loans and credit card receivables under combined title, "Consumer Loan-Backed Securities").

81. L. BRYAN, *supra* note 27, at 77-78 (citing as sources, Federal Reserve Board and McKinsey & Company estimates).

82. *Id.* Securitizable asset classes comprising the $3.4 trillion total in 1986 are, as follows:

Consumer	$1,546	46%
Mortgages	$1.2	63%
Installment	0.4	21
Other	0.5	16
Corporate	1,836	54
Mortgages	0.5	24
Trade receivables	0.7	38
Bank loans	0.6	29
Other	0.3	14
	$3,382	100%

Id. (citing as source, McKinsey & Company analysis), *id.*, at 79. (Numbers in chart represent billions).

83. *The 1991 Corporate Sweepstakes*, INSTITUTIONAL INVESTOR, Feb. 1991, at 17. There were 4,439 domestic MBS public issues in 1990. *Id.*

year's volume.[84] As of mid-1990, the total volume of combined mortgage and non-real estate-related asset-backed debt exceeded sixty percent of the U.S. domestic debt market.[85]

Data on the U.S. private placement market shows volume rising from $15.9 billion in 1980 to $165.6 billion in 1989.[86] In 1990, however, volume fell back to $116.4 billion.[87] Private offerings represented 21.7% of the $73.3 billion in total 1980 U.S. financings.[88] By 1989, private offerings amounted to 34.9% of the $475 billion in total 1989 financings.[89] The 1990 decline in volume saw private offerings drop to 27.6% of the $437.8 billion in total 1990 corporate financings.[90]

Private placements of securitized debt grew in volume from $4.9 billion in 1984 to $12.1 billion in 1985, and reached $28.8 billion in 1987.[91] In 1989, volume dropped to $14.7 billion, and in 1990, to $12.6 billion.[92] The 1989-90 fall-off, while attributable principally to adverse economic conditions, may also have been due in part to the increasing standardization of asset-backed products and investors' growing understanding of associated

84. *Id.* at 89 (reporting IDD Information Services, Inc. data); Pratt, *Treasury Rally Sparks Strong Finish for Debt, ABS and Optimism for 1991: Merrill Lynch Strengthens Grip on Underwriting Crown*, INVESTMENT DEALER'S DIG., Jan. 7, 1991, at 17.

85. *First Half 1990 Reflects 8.7 Percent Growth in Underwriting Volumes; Mortgage-Backed Financings Slow, Asset-Backed Debt Booms*, PR NEWSWIRE (June 29, 1990) (LEXIS, Nexis library, Curmt file).

86. Pressman, *Sea Change Sweeps Private Mart in 1980s; But It Didn't Ebb and Flow with Public Market*, INVESTMENT DEALER'S DIG., Apr. 30, 1990, at 25. There were 967 private offerings in 1980 and 2,325 offerings in 1990. *Id.* Data excludes CDs and deposit notes, and is based on reports from investment banks and commercial banks acting as agents in placements; total volume is underestimated because securities placed directly with investors are not counted. *Id.* at 28.

87. *Goldman Wears Two-Tiered Crown as 1990's Top Private Placement Agent*, INSTITUTIONAL INVESTOR, CORP. FIN. WEEK supp. (Mar. 11, 1991) (LEXIS, Nexis library, Curmt file) (citing as source, Securities Data Co.). Data excludes CDs and deposit notes. *Id.*

88. Pressman, *supra* note 86, at 25.

89. *Id.*

90. Gillen, *Private Placements Plunged 27% in 1990, Hurt By Flight to Quality, ESOPs' Decline*, BOND BUYER, Mar. 8, 1991, at 3.

91. Pressman, *supra* note 86, at 26.

92. *Goldman Wears Two-Tiered Crown as 1990's Top Private Placement Agent*, *supra* note 87.

risks.[93] In contrast, the volume of public offerings of mortgage and non-real estate related ABSs has grown steadily. Issue volume in 1984 was $12.3 billion and $22.3 billion in 1985.[94] By 1990, the total volume of publicly-issued real estate- and non-real estate related ABSs had reached $180 billion.[95]

With respect to growth prospects, the United States ABS market is forecast to advance at a more moderate pace, consistent with having reached a mature stage, although the consumer loan (principally automobile and credit card receivables), commercial mortgage, and corporate debt-backed sectors should experience continued rapid increases in volume.[96] In Europe and Japan, as securitization as a corporate financing technique and related technology begin to take hold, substantial future volume growth may be expected.[97]

93. Pressman, *supra* note 86, at 26. *See* Atwater, *Criteria for Predicting Asset-Backed Issuers of the Next Decade*, AM. BANKER, June 8, 1990, Supp. 16A-17A (noting growth of structured finance in 1990's was characterized, in part, by standardization of securitized instruments among high volume issuers); Dannen, *supra* note 37, at 262-64 (stating that non-real estate-related ABS offerings are evolving into lower fee generating "commodities business" for investment bankers, reducing profit margins to level of Rule 415 shelf-registration issues). *Cf.* Tufano, *Financial Innovation and First-Mover Advantages*, 25 J. FIN. ECON. 213 (1989). Based on an examination of investment banks' profits from development of new financial products, including mortgage and non-real estate-related ABSs during the period 1974-1986, the author makes the following conclusions: New product originators do not charge higher prices during the period preceding the appearance of imitative products; originators' long run pricing is below that of rivals' imitative products; and originators' greater revenues are derived from larger number of underwritings, *i.e.*, greater market share, obtained with innovations as contrasted with sales of clones. *Id.* at 234.

94. *The 1991 Corporate Sweepstakes*, *supra* note 83, at 91-92.

95. *Id.*

96. MOODY'S ANNUAL REPORT, *supra* note 13, at 6, 20-21.

97. Harvey, *Securitization Goes International*, BANKER'S MAG., May/June 1991, at 25; MOODY'S ANNUAL REPORT, *supra* note 13, at 6, 20-21; Steves, *Going Global: MBS Markets Abroad Are Seeing a Quickening Pace of Growth. The United Kingdom and France Are Among The Front-Runners Making a Strong Move to Securitization*, 51 MORTGAGE BANKING 7, 24 (Apr. 1991); *Opportunities and Risks in Securitizing Markets*, EUROMONEY, May 1991, Supp. 7. *See* SHALE, *Security in Big Numbers*, EUROMONEY, Mar. 1991, at 37 (describing projected $50-100 billion ABS market in Japan within five years and growing banking and corporate pressures on existing legal obstacles to market's development). *See generally* STANDARD & POOR'S CORP., *International Structured Finance*, STANDARD & POOR'S CREDIT REV., Apr. 15, 1991 (reporting on current developments in global expansion of securitization outside U.S.).

To add perspective to the discussion in Part V concerning Rule 144A, Regulation S, and ABS markets, portions of MOODY'S ANNUAL REPORT, *supra* note 13, at 3, 5, 7, 10-21 are reproduced in the text, *infra*, at pages 159-173.

TABLE 1
Ranking Underwriters of Public Offerings of Mortgage-Backed and Asset-Backed Securities: January 1 to December 31, 1990
Mortgage-Backed Securities[98]

	1990		$ Volume (Millions)	# of Issues
10	1	Kidder Peabody	$ 18,783.4	639
2	2	Bear Stearns	17,375.1	516
1	3	Goldman Sachs	14,691.5	320
5	4	First Boston	12,455.0	418
3	5	Prudential Bache	12,221.5	313
4	6	Salomon Brothers	11,963.3	266
6	7	Merrill Lynch	11,047.7	392
7	8	Lehman Brothers	10,571.1	365
8	9	Morgan Stanley	5,331.8	150
11	10	Donaldson, Lufkin & Jenrette	5,202.1	278
13	11	PaineWebber	3,274.8	135
	12	J.P. Morgan Securities	3,045.7	92
12	13	UBS Securities	2,978.5	137
19	14	Normura Securities	2,892.3	118
14	15	Citicorp Securities	2,646.3	65
		Total Market Volume	**$139,606.5**	**4,439**

98. *The 1991 Corporate Sweepstakes*, *supra* note 83, at 89 (reporting IDD Information Services, Inc. data). These rankings include all firmly underwritten taxable debt issues offered during the period January 1 to December 31, 1990. Figures are reported at the net, not the principal, amount, and private placements are excluded.

TABLE 2
Ranking Underwriters of Public Offerings of Mortgage-Backed and Asset-Backed Securities: January 1 to December 31, 1990
Asset-Backed Securities[99]

1989	1990		$ Volume (Millions)	# of Issues
3	1	Merrill Lynch	10,298.1	30
1	2	First Boston	8,384.1	24
2	3	Goldman Sachs	5,655.7	12
6	4	Salomon Brothers	4,847.3	13
4	5	Dean Witter	3,984.2	9
11	6	Morgan Stanley	2,069.3	9
5	7	Chemical Securities	1,533.1	6
	8	Citicorp Securities	701.8	2
	9	J.P. Morgan Securities	649.2	2
8	10	Lehman Brothers	499.2	2
	11	Chase Securities	498.7	1
7	12	Prudential Bache	480.6	4
12	13	Bear Stearns	388.2	1
	14	Donaldson, Lufkin & Jenrette	299.2	2
	15	BT Securities	74.5	1
		Total Market Volume	**$40,363.5**	**118**

99. *The 1991 Corporate Sweepstakes*, *supra* note 83, at 89 (reporting IDD Information Services, Inc. data). These rankings include all firmly underwritten taxable debt issues offered during the period January 1 to December 31, 1990. Figures are reported at the net, not the principal, amount, and private placements are excluded.

TABLE 3
ALL PRIVATE PLACEMENTS: 1989 & 1990+

Type of Security	1990			1989		
	$ Amount (Bils)	% of Market	Number of Issues	$ Amount (Bils)	% of Market	Number of Issues
Total Volume	128.1	100.0	2,411	199.9	100.0	2,926
Debt	110.4	86.2	2,139	168.5	84.3	2,495
Equity	18.1	14.1	279	31.8	15.9	448
Foreign Issurers	21.7	16.9	366	30.8	15.4	519
U.S Issurers	106.4	84.6	2,045	169.1	84.6	2,407
Debt Categories:						
High Yield	10.9	8.5	196	31.6	15.8	349
Investment Grade	75.2	58.7	1,327	93.5	46.8	1,265
CDs and Deposit Notes	11.7	9.1	412	28.7	14.4	674
Mortgage and Asset Backed	12.6	9.8	204	14.7	7.4	207
Other Overall Categories:						
Acquisition Related	14.7	11.5	299	50.9	25.5	494
Lease Related	11.9	9.3	166	16.3	8.2	254
Plain Vanilla	69.6	54.3	1,080	77.3	38.7	1,143

\+ *Goldman Wears Two-Tiered Crown As 1990's Top Private Placement Agent*, INST. INV. CROP. FIN. WEEK., Mar. 11, 1991 (Supp.) (LEXIS, Nexis Library, Currnt file).

Prudential Bache did not participate in the private placement rankings for 1990. Dollar Amounts are principal amounts. Equal credit is given to each placement agent. These rankings reflect only what has been reported to Securities Data Co., or announced publicly. Only issues with maturities greater than one year are included. Medium-Term Note Programs, Deposit Note Programs, Revolving Credit Facilities have not been included. Plain vanilla table excludes the following types of private placements: high yield, lease related, mortgage and asset backed, acquisition related CDs and deposit notes, ESOPs, MTNs and placements with registration rights.

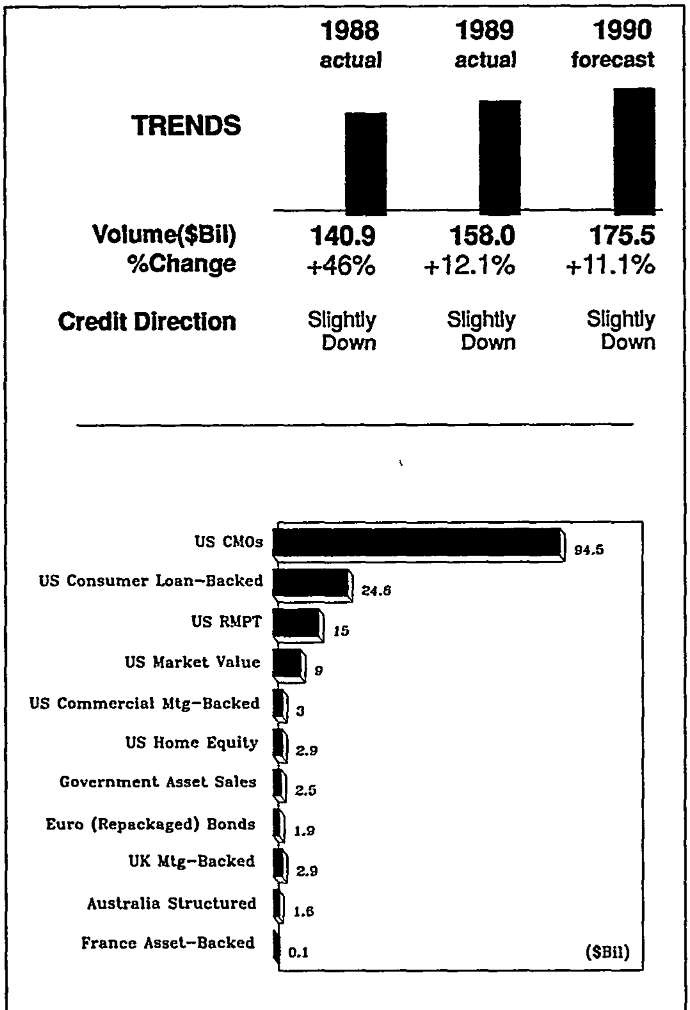
TABLE 4

RANKING AGENTS IN MORTGAGE-BACKED & ASSET-BACKED PRIVATE OFFERINGS: 1989 & 1990++

Type of Security	1990				1989			
	Dollar Amount	Rank	% of Market	# of Issues	Dollar Amount	Rank	% of Market	# of Issues
Chase Manhattan Bank	1,967.1	1	15.6	33	3,040.3	1	20.7	53
NCNB National Bank of N.C.	1,705.0	2	13.5	9	405.0	11	2.8	6
Salomon Brothers	1,416.6	3	11.2	45	972.2	5	6.6	19
Chemical Bank	1,295.5	4	10.3	17	980.2	4	6.7	13
First Boston	829.1	5	6.6	20	794.0	6	5.4	11
J.P. Morgan	810.0	6	6.4	4	2,412.0	2	16.4	18
Citicorp	773.9	7	6.1	7	424.5	10	2.9	6
Continental Bank	769.3	8	6.1	8	520.6	9	3.5	3
Morgan Stanly	535.7	9	4.2	7	293.0	13	2.0	6
Dean Witter Capital Markets	450.0	10	3.6	5	--			--
TOTALS	12,649.1		100.0	204	14,667.4		100.0	207

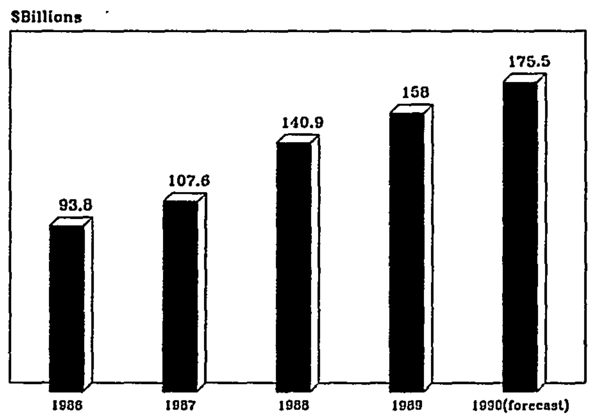
++ *Goldman Wears Two-Tiered Crown As 1990's Top Private Placement Agent*, INST. INV. CROP. FIN. WEEK., Mar. 11, 1991 (Supp.) (LEXIS, Nexis Library, Currnt file).

Prudential Bache did not participate in the private placement rankings for 1990. Dollar Amounts are principal amounts. Equal credit is given to each placement agent. These rankings reflect only what has been reported to Securities Data Co., or announced publicly. Only issues with maturities greater than one year are included. Medium-Term Note Programs, Deposit Note Programs, Revolving Credit Facilities have not been included. Plain vanilla table excludes the following types of private placements: high yield, lease related, mortgage and asset backed, acquisition related CDs and deposit notes, ESOPs, MTNs and placements with registration rights.



1989 Structured Finance Market

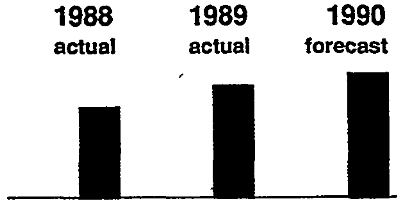
SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).



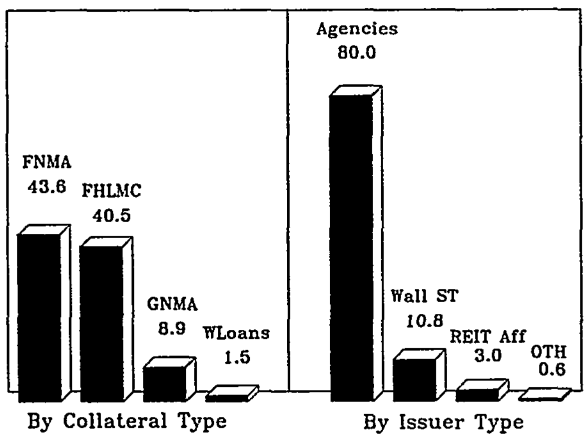
1986-1990 Total Structured Finance Market

SOURCE: Moody's Annual Report, *supra* note 13
(reprinted with Moody's permission).

CMO TRENDS



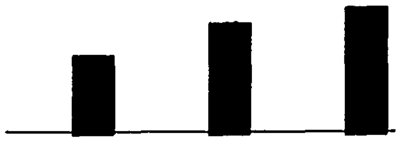
	1988 actual	1989 actual	1990 forecast
Volume($Bil)	**76.1**	**94.5**	**104.0**
%Change	+28%	+24%	+10%
Issues	292	273	243
Issuers	38	23	12
Active Bankers	19	21	19
Sector Rating	**Aaa**	**Aaa**	**Aaa**
Credit Direction	Stable	Stable	Stable



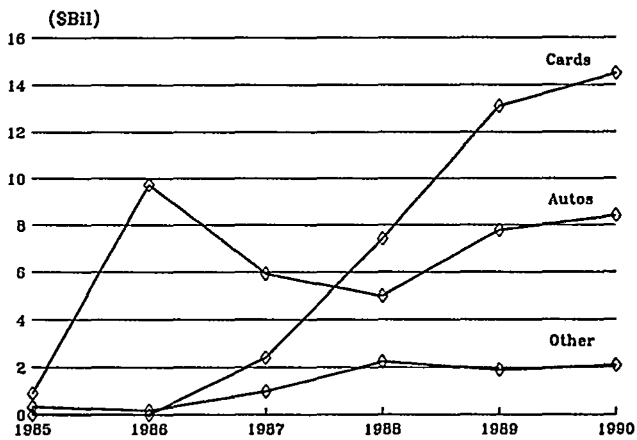
1989 Market Volume ($Bil)

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

Consumer Loan-Backed Securities TRENDS



	1988 actual	1989 actual	1990 forecast
Volume($Bil)	15.5	22.0	25.0
%Change	+58%	+41.9%	+14%
Issues	59	61	67
Issuers	36	31	35
Active Bankers	12	13	15
Sector Rating	Aa1	Aa1	Aa1
Credit Direction	Slightly Down	Slightly Down	Slightly Down

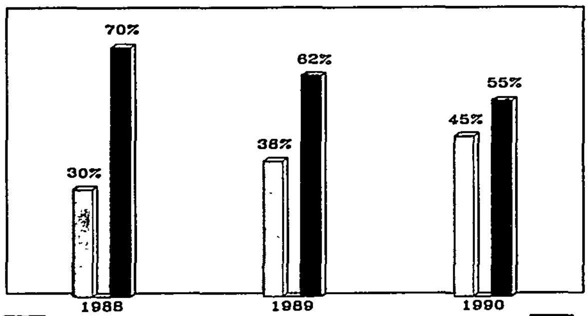


1985-1990 Consumer Loan Backed Volume

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

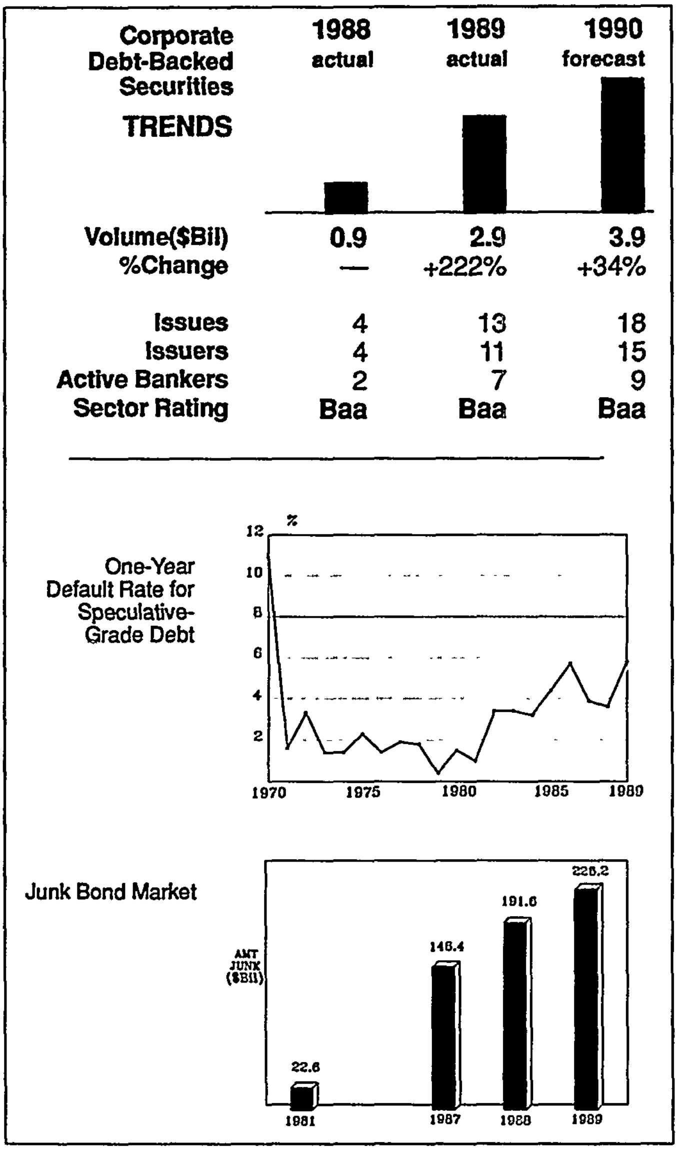
Commercial Mortgage-Backed Securities TRENDS	1988 actual	1989 actual	1990 forecast

Volume($Bil)	2.5	3.0	4.0
%Change	+92%	+20%	+33%
Issues	31	36	45
Issuers	25	30	40
Active Bankers	5	6	9
Sector Rating	Aa	Aa	Aa
Credit Direction	Slightly Down	Down	Slightly Down



Property-Specific vs. Pool Transactions
1988-1990 Percentage Share

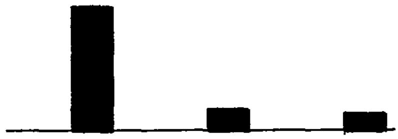
SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).



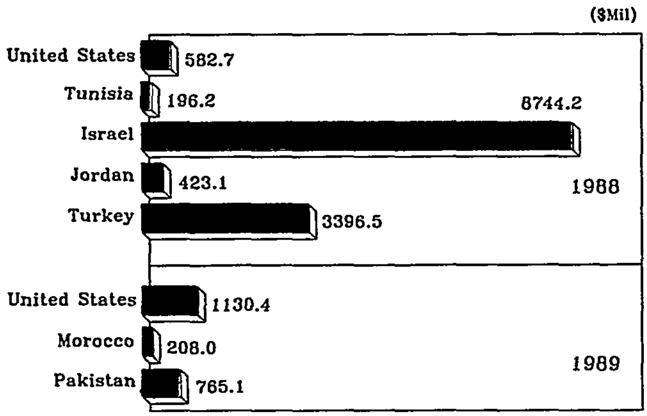
SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

Government Asset Sales

TRENDS



	1988 actual	1989 actual	1990 forecast
Volume($Bil)	13.8	2.5	2.0
%Change	+221%	-82%	-20%
Issues	9	5	5
Issuers	7	4	4
Active Bankers	6	5	5
Sector Rating	Aaa	Aa1	Aa2
Credit Direction	Stable	Slightly Down	Slightly Down

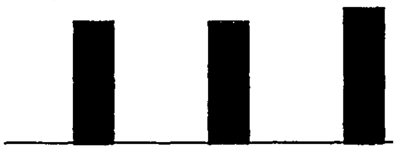


1988-1989 Market Volume by Country

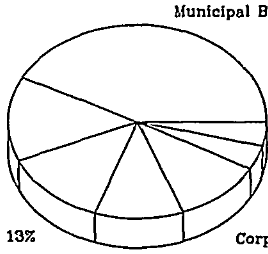
SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

Leveraged Income Funds TRENDS

	1988 actual	1989 actual	1990 forecast



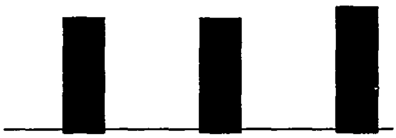
	1988 actual	1989 actual	1990 forecast
Volume($Bil)	**1.8**	**1.8**	**2.0**
%Change	0%	0%	+10%
Issues	14	14	18
Issuers	10	8	8
Active Bankers	4	7	8
Sector Rating	"aaa"	"aaa"	"aaa"
Credit Direction	Stable	Stable	Stable



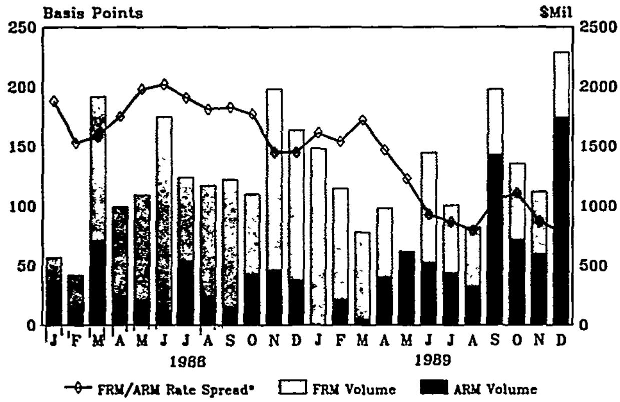
Primary Portfolio Investments
for Leveraged Income Funds

SOURCE: Moody's Annual Report, *supra* note 13
(reprinted with Moody's permission).

Residential Mortgage Pass-Throughs TRENDS	1988 actual	1989 actual	1990 forecast
Volume($Bil)	**15.1**	**15.0**	**16.5**
%Change	+65%	-1%	+10%
Issues	181	147	160
Issuers	36	32	30
Active Bankers	16	17	17
Sector Rating	**Aa2**	**Aa2**	**Aa2**
Credit Direction	Stable	Stable	Stable



Pass-Through Volume and FRM/ARM Spread
1988-1989



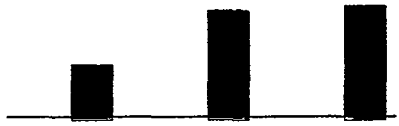
*Source: Office of Thrift Supervision

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

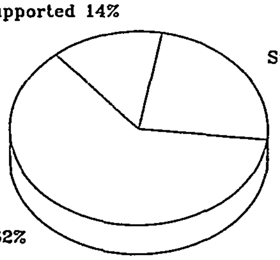
Home Equity/ Second Mortgage-Backed Securities TRENDS	1989 actual	1990 forecast
Volume($Bil)	2.9	3.5
%Change	NA	+20%
Issues	7	9
Issuers	6	7
Sector Rating	Aa1	Aa1
Credit Direction	NA	Slightly Down

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

Third Party and Market Value Commercial Paper TRENDS



	1988 actual	1989 actual	1990 forecast
Volume($Bil)	9.2	18.5	19.5
%Change	+35%	+100%	6%
Issues	70	100	110
Active Bankers	21	31	31
Sector Rating	P-1	P-1	P-1
Credit Direction	Stable	Stable	Stable

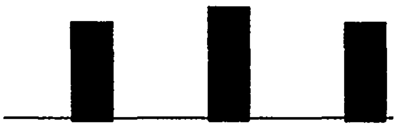


U.S. Market for Third Party and Market Value Commercial Paper

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

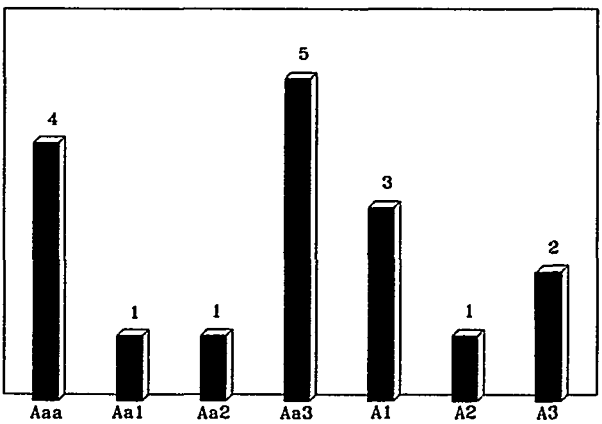
BANK-GUARANTEED EUROBOND TRENDS

	1988 actual	1989 actual	1990 forecast



	1988 actual	1989 actual	1990 forecast
Volume($Bil)	14.3	16.5	14.2
%Change	-4%	+15%	-14%
Issues	194	127	110
Issuers	189	118	105
Active Bankers	16	17	17
Sector Rating	Aaa/Aa	Aaa/Aa	Aaa/Aa
Credit Direction	Stable	Stable	Stable

REPACKAGED BONDS

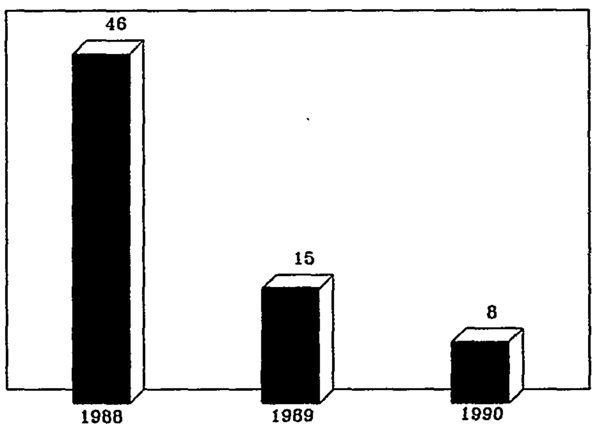


Outstanding Ratings of Repackaged Eurobonds

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

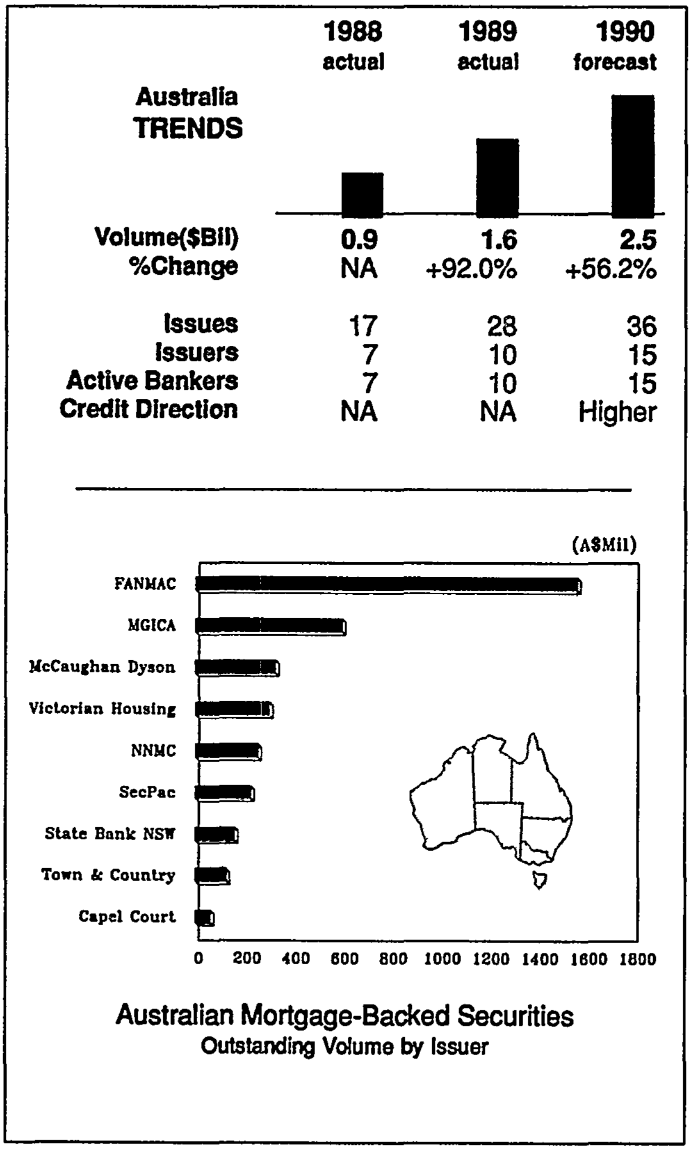
U.S. Mortgage-Backed& Collateralized Bond TRENDS

	1988 actual	**1989** actual	**1990** forecast
Volume($Bil)	**7.5**	**3.9**	**1.7**
%Change	+26%	-48%	-56%
Issues	46	15	8
Issuers	29	15	8
Active Bankers	13	7	5
Sector Rating	**Aaa**	**Aaa**	**Aaa**
Credit Direction	Stable	Stable	Stable



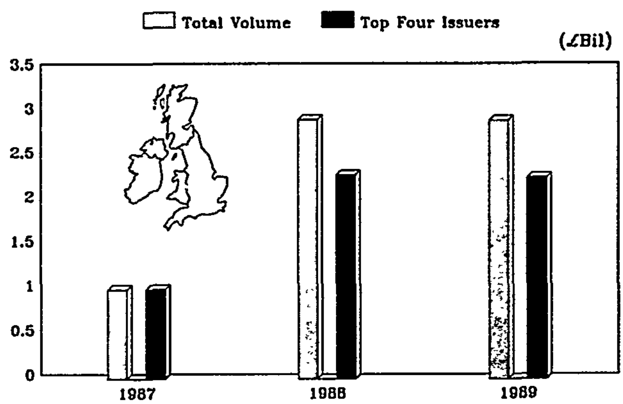
Number of Issues 1988-1990

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).



SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

United Kingdom TRENDS	1988 actual	1989 actual	1990 forecast
Volume(£Bil)	2.9	2.9	3.0
%Change	+192%	0%	+3%
Issues	16	14	15
Issuers	8	8	11
Active Bankers	4	6	5
Sector Rating	Aaa	Aaa	Aaa
Credit Direction	Stable	Stable	Stable



1987-1989 Market Concentration

SOURCE: Moody's Annual Report, *supra* note 13 (reprinted with Moody's permission).

III. RULE 144A AND RELATED DEVELOPMENTS

A. *Rule 144A*

Rule 144A[100] is an exemption for the resale of restricted securities from the section 5[101] registration requirements of the Securities Act.[102] Only resales of such securities to "qualified institutional buyers" fall within the safe harbor provided by the rule.[103] The provisions of Rule 144A are examined generally, below, with particular reference to their applicability to debt and asset-backed securities.

Rule 144A is a non-exclusive exemption from registration which may be used by persons other than the issuer. The rule may

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100. 17 C.F.R. § 230.144A (1990). Rule 144A was proposed in October 1988. Sec. Act Release No. 33-6806, 42 SEC Docket 76 (CCH) (Oct. 25, 1988), 53 Fed. Reg. 44,016 (Nov. 1, 1988), [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,335 [hereinafter Proposing Release]. The Rule attracted substantial comment and was reproposed in significantly modified form in July 1989 after a SEC hearing. Sec. Act Release No. 33-6839, 43 SEC Docket 2027 (CCH) (July 11, 1989), 54 Fed. Reg. 30,076 (July 18, 1989), [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,427 [hereinafter Reproposing Release]. On April 19, 1990, after further changes, the Commission adopted Rule 144A in final form. Sec. Act Release No. 33-6862, 46 SEC Docket 26 (CCH) (Apr. 23, 1990), 55 Fed. Reg. 17,933 (Apr. 30, 1990), [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523 (codified at 17 C.F.R. § 230.144A (1991)) [hereinafter Adopting Release]. In addition to the references to the Adopting Release, the overview of Rule 144A in Section III draws generally on the Adopting Release. The proposed and reproposed version of the rule are described in L. LOSS & J. SELIGMAN, SECURITIES REGULATION 180-87 (3d ed. 1989).

The economic policy considerations underlying Rule 144A vis-à-vis the market dominance of institutional investors and the growth of private placement activity are the subject of an extensive analysis in Note, *The Capital Markets in Transition*, *supra* note 69. The background of Rule 144A and a description of its development by one of its chief architects appears in Hanks, *Rule 144A: Another Cabbage In The Chop Suey*, 24 GEO. WASH. J. INT'L L. & ECON. 305 (1990). *See also* M. POLLOCK, RESALES OF RESTRICTED SECURITIES UNDER SEC RULES 144 AND 144A, 46-2nd C. P. S., at A-23 through A-30 (BNA 1990); Berkeley & Minarick, *New Rule 144A: Institutional Trading of Privately Placed Securities*, PRAC. L. INST., ADVANCED SEC. L. WORKSHOP, 1990, at 47; Cooper, *Rule 144A and Regulation S Under the Securities Act of 1933*, PRAC. L. INST., INSTITUTIONAL INVESTORS 353 (1990) (all sources containing detailed descriptions of Rule 144A). For a summary treatment of the Rule and comments on its adoption, see Barron, *Some Comments on SEC Rule 144A*, 18 SEC. REG. L. J. 400 (1991). For additional discussion regarding Rule 144A, see generally H. BLOOMENTHAL, 3A SECURITIES AND FEDERAL CORPORATE LAW Ch. 4A (1991); C. JOHNSON, CORPORATE FINANCE AND THE SECURITIES LAWS 353-57 (1990); T. Gilroy & E. Kaufmann, SECURITIES LAW TECHNIQUES: TRANSACTIONS, LITIGATION Ch. 39 (A.A. Sommer, Jr., ed. 1991).

101. 15 U.S.C. § 77e (1988).

102. 15 U.S.C. § 77a-77bbbb (1988) [hereinafter the Securities Act].

103. Rule 144A(d)(1); Rule 144A(a).

be seen as a partial codification of "section 4(1 1/2)" practice[104] in which non-issuer holders engage in unregistered sales in reliance on the exemptions from registration provided by section 4(1)[105] of the Securities Act for transactions by persons other than issuers, underwriters, or dealers, and by section 4(2)[106] of the Act for issuer transactions not involving a public offering. Engrafted on to section 4(1) by counsel have been the Supreme Court's criteria, first articulated in *SEC v. Ralston Purina Co.*,[107] under which the seller in a private transaction has the burden of demonstrating that the purchaser is sufficiently sophisticated to evaluate and bear a security's risk, and is acquiring it for investment purposes and not

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104. Section 4(1 1/2) has never been explicitly approved by the Securities and Exchange Commission. *See* Bloomenthal, *The SEC And Internationalization Of Capital Markets: Herein Of Regulation S And Rule 144A*, 18 DEN. J. INT'L L. & POL'Y 83, 112 n.159 (1989) (discussing the genesis of § 4(1 1/2) in the context of proposed and reproposed Regulation S and Rule 144A). *See generally* J. HICKS, RESALES OF RESTRICTED SECURITIES 475-519 (1990) (analyzing case law relating to § 4(1 1/2); Schneider, *Section 4(1 1/2) -- Private Resales of Restricted or Control Securities*, 49 OHIO ST. L. J. 501 (1988) (analyzing use of § 4(1 1/2) exemption with reference to competing policy considerations); STUDY GROUP ON RESALES OF DEBT SECURITIES, ABA COMMITTEE ON DEVELOPMENTS IN BUSINESS FINANCING, *Resale by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 BUS. LAW. 1927, 1959 (1979) (stating that § 4(1 1/2) supports "broader types" of private resales).

105. 15 U.S.C. § 77d(1) (1988). Congressman John D. Dingell (D.-Mich.) (Chairman, House Committee on Energy and Commerce) and Edward J. Markey (D.-Mass.) (Chairman, House Subcommittee on Telecommunications and Finance) have been highly critical of the SEC's adoption of Rule 144A. Letter to SEC Chairman Richard C. Breedon from Congressman John D. Dinzell Chairman, House Committee on Energy and Commerce and Congressman Edward J. Markey, Chairman, House Subcommittee on Telecommunications and Finance, *reprinted in* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,600. While supporting the policy goals underlying the rule, they have argued that the SEC has exceeded the scope of its powers in adopting Rule 144A and that the rule itself may be *ultra vires*, and resulted in the creation of a two-tiered trading market system. *Id.* at 80,695. *See* U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, *Electronic Bulls and Bears: U.S. Securities Markets and Information Technology*, OTA-CIT-469 (Sept. 1990), at 58. *Compare* Hanks, *supra* note 100, at 331 (to the extent Rule 144A is *ultra vires* because of the lack of mandated information disclosure about the issuer, then Rule 506 of Regulation D is even more so because it is less well grounded in case law). The SEC is to report to Congress on the use of Rule 144A at six-month intervals. [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,696. Cong. Dingell reacted negatively to the SEC's first report. *Dingell: Cram It, Quinn: Expand It*, *supra* note 69.

106. 15 U.S.C. § 77d(2) (1988).

107. 346 U.S. 119 (1953).

with a view towards distribution.[108] The concern with the nature of the prospective purchaser is carried forward in Rule 144A and is its central focus.

As noted above, Rule 144A is not available for transactions by issuers, which must place their securities in reliance on section 4(2), Regulation D[109], another exemption from legislation, as Regulation S.[110] Under Rule 144A, purchasers of restricted securities may resell[111] them immediately upon acquisition in private secondary markets[112] to qualified institutional buyers.

1. *Eligible Securities*

Securities eligible for resale under Rule 144A are those which are not of the same class as securities listed on a United States

108. *Id.* at 126. In *Ralston Purina,* the Court rejected the issuer's argument that the offer of its securities to "key" employees, a group which was defined to include low-level markets, was a private offering exempt under § 4(2). *Id.* at 125-26. The Court reasoned that the applicability of § 4(2) should depend on whether the offerees are sophisticated and have access to the information necessary to assess a security's merits and risks, thus obviating the need for protection under the Act. *Id.* at 124-27. Section 2(11) of the Securities Act, 15 U.S.C. § 77b(11) (1988), defines an underwriter as one who acquires securities from an issuer or affiliate of an issuer with a view to distribution, *i.e.*, a public offering.

109. 17 C.F.R. §§ 230.501-508 (1990).

110. In *Securities Industry Association,* SEC No-Action Letter, [current] Fed. Sec. L. Rep. (CCH) ¶ 79,729 (April 25, 1991) the Commission granted exemptions from Exchange Act Rule 10b-6 (antimanipulation) and Rule 10b-7 (stabilization restrictions) to allow transactions outside the United States when foreign securities are being offered and sold to QIBs in the United States pursuant to Section 4(2), Regulation D or Rule 144A. The exemptions are subject to the following conditions, among others:

(i) the non-U.S. transactions must be effected on the International Stock exchange (on the Stock Exchange Automated Quotation (SEAQ) or SEAQ International Systems), or on the Montreal, Paris, Tokyo or Toronto Stock Exchanges;
(ii) the issuer must have a minimum operating history of three years;
(iii) the exemptions are restricted to distributions in the U.S. of foreign securities whose principal market is outside the U.S.

Id.

111. Rule 144A(b). *See* Preliminary Note 7 to Rule 144A.

112. In conjunction with its adoption of Rule 144A, the SEC recently approved PORTAL, an automated trading system for restricted securities which will be operated by the National Association of Securities Dealers, Inc. *See infra* notes 160-170 and accompanying text (discussing PORTAL). The New York and American Stock Exchanges are establishing similar systems. *See infra* note 161 and accompanying text.

securities exchange or quoted in an inter-dealer quotation system.[113] With respect to debt instruments, including asset-backed securities, the Commission's position is that new issues of securities having such characteristics as interest rates, maturities, and collateral and which are "substantially identical" to those of publicly-traded securities are considered fungible and therefore ineligible for resale under Rule 144A.[114] Separate series of debt securities are considered different classes under the rule.[115]

2. *Purchasers*

Sales under Rule 144A may be made only to qualified institutional buyers (QIBs) or their agents.[116] Qualified institutional buyers are defined generally as corporations or

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113. Rule 144A(d)(3)(i). In certain quarters, one of the chief concerns associated with the formulation of Rule 144A has been the potential development of parallel public and private trading markets in the same securities. Division of Corporation Finance Summary of Commentators' Remarks (File No. 57-23-28, May 3, 1989); Hanks, *Rule 144A: Easing Restrictions On Trading Unregistered Securities*, N.Y.L.J., May 10, 1990, at 5, col. 1. The SEC's view was that restricted securities' liquidity premiums would lessen the attraction into private markets of securities trading in public markets. *Id.* at 6. The restriction of Rule 144A to non-fungible (the term fungible does not appear in the Rule, although the Commission uses it in the Adopting Release) securities reflects the position of the New York Stock Exchange, among others. *Id.* Under Rule 144A, if the value of a common stock rises above the 10% premium level of the security convertible into it, *see infra* note 115, conversions will follow resulting in the same securities being traded on public and private markets. *Id.* Because fungibility is measured at the time of issuance, parallel trading may also occur if an issuer registers securities which are currently trading pursuant to Rule 144A. *Id.* The amendment of Rule 144, *see infra* notes 147-152, to permit tacking of holding periods will accelerate the flow of restricted securities into public trading markets and should diminish the amount of parallel trading. *Id.*

114. Adopting Release, *supra* note 100, at 80,640.

115. *Id.* Equity securities are considered to be of the same class if they are substantially similar in character and confer comparable rights on holders. *Id.* Preferred securities are deemed to be of the same class if their terms are substantially identical. *Id.* Convertible securities are deemed to be both the convertible and underlying securities unless they are the subject of an effective conversion premium of no less than 10% when initially issued. *Id.* With respect to American depository receipt (ADR) shares listed on a U.S. securities exchange or on NASDAQ, the underlying shares are viewed as trading publicly and therefore, as securities of the same class as the ADRs, such underlying shares would not be eligible for resale under Rule 144A. *Id.*

116. Rule 144A(d)(1). The Division of Corporation Finance recently indicated that sellers may rely on Standard & Poor's list of QIBs. STANDARD & POOR'S CORP. (July 8, 1991) (File No. 801-3981).

partnerships owning and investing on a discretionary basis a minimum of $100 million in securities of non-affiliated entities.[117] In the case of federally insured banks and thrift institutions, such institutions are additionally required to have an audited net worth of not less than $25 million.[118] An exception to the $100 million requirement exists for Exchange Act registered broker-dealers which must own and exercise investment discretion over at least $10 million worth of securities of issuers not affiliated with the broker-dealer.[119] Broker-dealers are also classified as QIBs when acting on behalf of other such buyers in riskless principal transactions or when acting as agents on a non-discretionary basis.[120] Broker-dealer affiliates of depository institutions are not subject to the $25 million net worth requirement.[121]

Aggregation of wholly- and majority-owned subsidiary holdings is permitted for purposes of meeting the $100 million requirement on the condition that the investments are controlled by a common

117. Rule 144A(a)(1)(i). Rule 144A as initially proposed provided for three tiers of qualified buyers. Proposing Release, *supra* note 100, at 89,540-46. A qualified institutional buyer was defined as one having $100 million or more in assets (on a consolidated basis). *Id.* Two additional classes of qualified buyers were required to have a minimum of $5 million in assets and permitted to invest in securities of SEC reporting issuers or any securities subject to certain resale restrictions. *Id.* When Rule 144A was reproposed in 1989, a qualified institutional buyer was defined as an entity owning or having under management $100 million or more in securities; the second and third buyer tiers were dropped. Reproposing Release, *supra* note 100, at 80,221, 80,224.

118. Rule 144A(a)(1)(vi). The $25 million net worth requirement did not appear in the proposed and reproposed versions of the rule. The SEC is soliciting comment on the appropriateness of the requirement. Adopting Release, *supra* note 100, at 80,638, 80,642.

119. Rule 144A(a)(1)(ii). Securities held by a broker-dealer in its investment and trading accounts, such as market-making inventories, are considered to be owned by it. *Id.* Unsold public offering allotments are not deemed to be owned by the broker-dealer. *Id.* Section 4(3) of the Securities Act, 15 U.S.C. § 77d(3) (1988), exempts dealer transactions from Section 5 registration requirements except when dealers are participants in a distribution or for a specified period after the securities are first offered to the public. A dealer complying with Rule 144A will not be considered to be a participant in a distribution, and thus not be deemed to be an underwriter because the securities will not be deemed to have been offered publicly. Rule 144A(c); Adopting Release, *supra* note 100, at 80,639.

120. Rule 144A(a)(1)(iii). A riskless principal transaction is defined in Rule 144A as one in which a dealer buys a security from any person and makes a simultaneous offsetting sale to a QIB, including another dealer acting as riskless principal for a QIB. Rule 144A(a)(5).

121. Adopting Release, *supra* note 100, at 80,642.

parent.[122] The separate assets of a "family of investment companies" headed by a common investment advisor are made explicitly eligible for aggregative treatment.[123] The value of securities held is determined according to the basis of acquisition cost, except when the buyer's financial statements report holdings on a market value basis.[124]

Noteworthy with respect to calculation of the $100 million qualifying amount is the Commission's decision to exclude from the definition of security under Rule 144A only, securities issued by the United States and its instrumentalities and, *inter alia*, certificates of deposit, loan participations, and repurchase agreements.[125] The Commission's position, in conjunction with the $25 million net worth requirement for depository institutions, is designed to limit depository institution participation and exposure in Rule 144A transactions.[126] However, a more equitable restriction on depository institution transactions under Rule 144A, which would be consistent with the goal of increasing private secondary market liquidity, might be a requirement restricting such institutions' acquisitions of non-investment grade securities.

Sellers must reasonably believe that prospective purchasers are qualified institutional buyers.[127] The non-exclusive alternative sources of information for satisfying this requirement are the

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122. Rule 144A(a)(4).

123. Rule 144A(a)(1)(iv).

124. Adopting Release, *supra* note 100, at 80,644.

125. In *UNUM Life Insurance Co.*, (Nov. 21, 1990), 1990 SEC No-Act. LEXIS 1250, the Commission's staff stated explicitly its view that securities issued or guaranteed by the U.S. Department of Housing and Urban Development, FNMA, FHLMC and the Student Loan Marketing Association are excluded from the calculation of securities owned and invested on a discretionary basis under Rule 144A(a)(2). *Id.* The Staff also indicated its position that securities which must be registered under the Securities Act of 1933 and which are secured by, or represent an individual interest in a pool of mortgages or commercial receivables are eligible to be counted as securities owned and invested on a discretionary basis, even if the assets underlying the pool are issued or guaranteed by the federal government or one of its instrumentalities. *Id.*

126. In addition to the thrift industry debacle, recent concern about potential adverse developments in the U.S. banking industry suggest the SEC's concern may also be well founded with respect to banks' participation in Rule 144A transactions. *See, e.g.*, Bates, *Banks Losing Credibility, Chief Regulator Says*, L.A. Times, Oct. 24, 1990, § D, at 1, col. 5; Gonzalez, *Dark Clouds and a Deep Sleep*, L.A. Times, Oct. 26, 1990, § B, at 11, col. 3 (op. ed.).

127. Rule 144A(d)(1).

buyer's most current annual financial statements, its most recent filing with a governmental or self-regulatory organization, the latest data contained in a recognized securities manual, or the buyer's representation that it meets or exceeds the $100 million threshold.[128] Sellers are required to inform purchasers that the sale may be made in reliance on Rule 144A.[129] Qualified institutional buyers are restricted to acquiring securities under the rule solely for their own account or for the accounts of other such buyers.[130]

3. *Information Requirement*

Rule 144A does not require that any information about the issuer be disclosed except where the issuer neither reports under the Exchange Act nor files home country reports with the SEC pursuant to Rule 12g3-2(b).[131] Upon the request of prospective buyers and securities holders, non-filing issuers must furnish prospective buyers, as well as holders, a "very brief" description of the issuer's principal products and services and three years' financial statements.[132]

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128. Rule 144A(d)(1)(i)-(iv).

129. Rule 144A(d)(2).

130. Rule 144A(d)(1); Rule 144A(a)(1); Adopting Release, *supra* note 100, at 80,645. The QIB definition has been subjected to considerable criticism. Longstreth, Beekman & Rich, *Rule 144A: A Closer Look*, 4 INSIGHTS: CORP. & SEC. L. ADVISOR 16, 19-21 (Aug. 1990) [hereinafter Longstreth]; McLaughlin, *Identifying "QIBs" Under SEC Rule 144A*, N.Y.L.J. 5, col. 1 (Sept. 20, 1990).

131. Rule 144A(d)(4)(i); 17 C.F.R. § 240.12g3-2(b) (1990). Under Rule 12g3-2 a foreign issuer which has not made a public offering in the U.S. is exempt from Exchange Act, 15 U.S.C. §§ 78a-78kk (1988), registration and reporting requirements if it has fewer than 300 U.S. resident shareholders or files with the SEC and makes publicly available that information which it is required to furnish the exchange on which its securities are traded. Securities of foreign issuers exempt pursuant to Rule 12g3-2(b) had not been permitted to be traded on NASDAQ. *See* Sec. Exch. Act Release No. 34-20264 (Oct. 6, 1983), [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,435. *See generally* Hanks & Bushner, *Rule 12g3-2(b): Backdoor or Trapdoor?*, 10 INT'L FIN. L. REV. 36 (Apr. 1991) (discussing relationship of Rule 12g3-2(b) to Rule 144A and ADRs). In conjunction with the Commission's approval of the NASD's PORTAL system, *see infra* notes 160-170 and accompanying text, it has allowed foreign PORTAL-traded issuers to retain their Rule 12g3-2(b) exemption. 55 Fed. Reg. 18,781, 18,789 (May 4, 1991).

132. Rule 144A(d)(4)(i),(ii). It is on the issue of mandated information disclosure that Commissioner Fleischman dissented from the Commission's final version of Rule 144A. Adopting Release, *supra* note 100, at 80,657. He argues persuasively that such disclosure is inconsistent with the policy implicit in the rule of allowing QIBs to fend for themselves by using their bargaining

Asset-backed securities are dealt with specifically in the Release.[133] According to the SEC, under Rule 144A the servicer or trustee of the entity holding title to the assets is deemed to be the "issuer" of the securities.[134] The SEC staff has indicated that such entities are considered issuers only for the purpose of identifying the party which must disclose information in compliance with the Rule 144A(d)(4)(ii) information requirement.[135] The SEC staff considers the information requirement to be satisfied by providing a description of the securities' structure and distribution schedule, data relating to underlying asset performance, and credit enhancement.[136]

With respect to issuer-related disclosure matters generally, the effectiveness of the rule in promoting the development and liquidity of private secondary markets depends significantly on the amount of information which is demanded by prospective buyers, in addition to that which may have been previously furnished pursuant to Rule 144A or which is otherwise available. In his partial dissent from Rule 144A Commissioner Fleischman predicted that the rule's disclosure requirement would impede resales.[137] However, buyers are free to and may demand more or different information than is publicly available, regardless of Rule 144A. Thus, the extent to which buyers insist on additional information will similarly have a negative impact on market liquidity.

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power. *Id.* The effect of required disclosure will be to disproportionately encumber development stage issuers and encumber resales. *Id.* at 80,658. This concern may also be appropriate in light of the absence of any cap on the amount of information QIBs may demand. *Id.* at 80,657-61. The information requirement may be the rule's most controversial element. The exposure of issuers to the liability created by the requirement may act as a substantial disincentive for foreign issuers which might otherwise want their securities to be traded in the 144A market.

133. Adopting Release, *supra* note 100, at 80,646.

134. *Id.*

135. *Mortgage-backed and Asset-backed Securities, Securities Act Release No. 6862 - The Rule 144A Release* (Nov. 29, 1990) (1990 SEC No-Act. LEXIS 1273). The staff stated that Rule 144A's information requirement was not intended to cause any change in the analysis of an entity's issuer status under the federal securities laws for privately placed ABSs than in public offerings of such securities. *Id.*

136. Adopting Release, *supra* note 100, at 80,646.

137. *Id.* at 80,656.

4. *Resales*

As indicated above, sellers must take reasonable measures to ensure that the buyer has notice that the seller may be relying on Rule 144A.[138] Buyers may freely resell restricted securities within the confines of the rule or pursuant to another exemption from registration.[139]

5. *Investment Companies; Broker-Dealer Net Capital Requirements*

Open-end (mutual) funds are subject to stringent limitations on investments in restricted securities.[140] The SEC has traditionally viewed such securities as illiquid.[141] However, in an action which may stimulate private secondary markets, the Commission has ceded to fund directors the discretion to determine the liquidity of Rule 144A securities.[142] In this regard, the Commission has taken

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138. *Id.* at 80,646. *See* Federal Securities Regulation Subcommittee an Annual Review, *Significant 1990 Legislative and Regulatory Developments*, 43 BUS. LAW 973, 984 (1991) (stating that "reasonable steps" taken to ensure Rule 144A buyer awareness likely to become "standard disclosure" in private placement documentation").

139. Rule 144A(e). *See infra* notes 147-52 and accompanying text (discussing Rule 144, 17 C.F.R. § 230.144 (1990), which was amended concurrently with the adoption of Rule 144A to allow tacking of holding periods pursuant to the Rule 144 two- and three-year holding period requirements). Rule 144A does not address the extent of an issuer's liability, if any, for resales of its securities in violation of the rule's provisions e.g., sales to non-QIBs. Longstreth, *supra* note 130, at 16-18. *See also* sources cited *supra* note 138 (discussing, *inter alia*, Rule 144A resale liability).

140. Sections 4(2) and 5(a)(1) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-4(2), 80a-5(a)(1) (1988).

141. Investment Co. Act Release No. 40-5847 (Oct. 21, 1969), 35 Fed. Reg. 1989 (Dec. 31, 1970).

142. Adopting Release, *supra* note 100, at 80,647-48. The release lists as non-exhaustive factors bearing on liquidity determinations the following:

> (1) The frequency of trades and quotes for the security;
> (2) the number of dealers willing to purchase or sell the security and the number of other potential purchasers;
> (3) dealer undertakings to make a market in the security; and
> (4) the nature of the security and the nature of the marketplace trades (*e.g.*, the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer).

Id. See Mahoney, *supra* note 3, at 69 (stating that mutual funds may be one of the principal "unintentional" beneficiaries of Rule 144A).

the position that an illiquid security is one that cannot be disposed of within seven days at a price related to the holder's valuation of the security.[143] Should active secondary markets develop for Rule 144A non-investment grade debt consistent with portfolio theory, the Commission's view of liquidity with respect to investment company holdings may conflict with its position on liquidity vis-à-vis broker-dealer net capital requirements.

With respect to liquidity determinations pursuant to the broker-dealer Uniform Net Capital Rule,[144] it may be inferred from the Release that non-investment grade domestic and foreign corporate debt will be excluded from broker-dealer asset calculations.[145] It is reasonable to assume that the Commission will extend its interpretation of corporate debt to include asset-backed securities which are commonly issued by grantor trusts and special purpose partnerships as well as corporations. The Commission's stance is intended to minimize broker-dealer exposure in 144A markets. However, one effect of the SEC's position on net capital liquidity may be to further limit the participation of moderately-sized, and often more entrepreneurial, broker-dealers and issuers in the evolution of asset-backed markets, most particularly, development of markets for non-investment grade ABSs.[146]

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143. Investment Co. Act Release No. 40-14983 (Mar. 12, 1986), [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,972 (adopting amendments to Rule 2a-7, 17 C.F.R. § 270.2a-7 (1990)).

144. 17 C.F.R. § 240.15c3-1 (1990). *See generally* Molinari & Kibler, *Broker-Dealers' Financial Responsibility Under The Uniform Net Capital Rule -- A Case For Liquidity*, 72 GEO. L. J. 1, 18 (1983) (stating that Net Capital Rule's emphasis on liquidity is the most effective method for ensuring broker dealer stability and investor protection). The Commission recently amended the Net Capital Rule to tighten restrictions on withdrawals of equity capital. Sec. Exch. Act Release No. 34-28927, 46 SEC Docket 573 (CCH) (Feb. 28, 1991), 56 Fed. Reg. 9124 (Mar. 5, 1991), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,713 (to be codified at 17 C.F.R. § 240.15c3-1 (1991)).

145. Adopting Release, *supra* note 100, at 80,648-49.

146. *But see* Salwen & Mitchell, *SEC May Control Market In Asset-Backed Securities*, Wall St. J., June 28, 1991, at 1, col. 3 (discussing possible limitation of ABS pools to investment grade debt); L. BRYAN, *supra* note 27, at 165-167 (recent shrinkage of junk bond market related to thrift industry crisis will reduce demand for securitization of assets which are not "high quality").

B. Rule 144 Amendments

Holders of restricted securities[147] have traditionally been required to retain them for a minimum of two years before sales could be made in reliance on Rule 144.[148] Tacking the holding periods of prior holders to that of the seller generally has not been permitted.[149] With its adoption of Rule 144A, the Commission has determined to allow tacking generally, both for Rule 144A and other restricted securities.[150] The holding periods for all restricted securities run from the date they were last acquired from the issuer or an affiliate of the issuer.[151] Thus, the securities of reporting issuers can generally trade freely two years after issue, and those of non-reporting issuers and Rule 12g3-2(b) exempt foreign issuers may do so three years after the first sale.[152]

C. Regulation T Amendments

Foreign securities generally are not freely tradable on U.S. markets and, under Regulation T, had not been eligible for treatment as marginable securities.[153] The restrictions on trading of foreign securities on U.S. markets have had a negative impact on U.S. broker-dealers' net capital and have inhibited U.S. transactions in foreign securities.[154] The SEC has sought to

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147. Prior to the adoption of Rule 144A, a restricted security had been defined in Rule 144(a)(3) as a security acquired from an issuer or affiliate of an issuer in a transaction not involving a public offering. *Id.* With the advent of Rule 144A, the Rule 144 definition has been amended to include securities acquired in Rule 144A transactions. 17 C.F.R. § 230.144(a)(3)(iv) (1991).

148. Rule 144(d)(1). There is a three-year holding period for current and certain former issuer affiliates and for non-Exchange Act reporting and exempt foreign issuers. *Id.*; Rule 144(k).

149. Sec. Act Release No. 33-5223, (Jan. 11, 1972), [1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487. Previously, tacking holding periods had been permitted only where the holder acquired the security pursuant to a pledge, gift, trust, or estate. Rule 144(d)(4).

150. Rule 144(d),(k); Adopting Release, *supra* note 100, at 80,649. *See* Austin & Peters, *Resales of Securities Under Rule 144*, in PRAC. L. INST., SEC. FILINGS 1990 REV. AND UPDATE 451, 468-86 (1990); POLLOCK, *supra* note 100, at A-1 through A-22 (both sources discussing new tacking provisions and other aspects of amended Rule 144).

151. Rule 144(d)(1).

152. Karmel, *New Rules for Trading Foreign Securities*, N.Y.L.J., June 28, 1990, 3, 6, col. 1.

153. *Id.*

154. *Id.*

alleviate this situation by stating that foreign securities held in broker-dealer proprietary accounts for resale are considered liquid if they are: (1) Debt securities of a foreign issuer not traded flat or in default as to principal or interest, which were issued publicly in a principal foreign securities market by a government or multi-governmental organization; (2) debt securities of a foreign issuer not traded flat or in default as to principal or interest, which were issued publicly in a principal foreign securities market and which have been rated in one of the four top rating categories by at least two nationally recognized U.S. statistical rating organizations (NSRO); or (3) securities of a foreign issuer which were issued publicly in a principal foreign securities market and which are listed on one of the major money markets outside the United States.[155]

In recognition of the fact that foreign clearance and settlement procedures are often more lengthy than the Regulation T seven day settlement requirement for non-marginable securities,[156] the Federal Reserve Board recently amended Regulation T to provide that foreign securities purchases must be settled within seven days or on the date required by the foreign securities market, but in no event later than thirty-five days after execution.[157] The Board has also allowed broker-dealers to extend margin credit on specified foreign debt and equity securities which had previously been permitted only for exchange listed and designated NASDAQ securities.[158] Under Regulation T, foreign debt securities are eligible for margin treatment if (1) there was a principal amount outstanding of no less than $100 million on the date of initial issuance; (2) at the time the broker-dealer extends margin credit it

155. Adopting Release, *supra* note 100, at 80,648-49.

156. 12 C.F.R. § 220.8(b)(1)(i) (1990); Karmel, *supra* note 152, at 6, col. 1 (discussing Regulation T amendments).

157. 12 C.F.R. § 220.8(b)(1)(ii) (1991).

158. 12 C.F.R. § 220.2(t)(5) (1991) (relating to debt); 12 C.F.R. § 220(i),(j) (1991) (relating to equity).

reasonably believes that the issuer is not in default of principal and interest; and (3) a NSRO has rated the issue in one of the two highest rating categories.[159]

D. PORTAL[160]

In conjunction with the SEC's adoption of Rule 144A, the Commission also approved a proposal by the National Association of Securities Dealers, Inc. (NASD) to establish a computerized system for the primary placement and secondary trading of Rule 144A securities.[161] PORTAL is a screen-based quotation, trading,

159. 12 C.F.R. § 220.2(t)(5) (1991).

160. PORTAL is an acronym for Private Offerings, Resales and Trading Through Automated Linkage.

161. Sec. Exch. Act Release No. 34-27956 (Apr. 27, 1990), 55 Fed. Reg. 18,781 (May 4, 1990) [hereinafter PORTAL Release]. In its PORTAL Release, the SEC approved the NASD's new Schedule I [hereinafter the PORTAL Rules] to its Bylaws. *See* File No. SR NASD-88-23; NASD Manual 1990 Schedule I to the Bylaws (CCH) ¶¶ 1951-79. *See also* Bloomenthal, *Rule 144A and the PORTAL Market*, 12 SEC. & FED. CORP. L. REP. 145, 149-50 (describing PORTAL as a "careful . . . if not overcautious" system). *See generally* Rothwell, *The Evolution of the Portal Market*, 4 INSIGHTS: CORP. & SEC. L. ADVISOR 3 (Oct. 1990) (describing changes in PORTAL rules in response to amendments to Rule 144A; criticizing, *inter alia*, the SEC's requirement that the NASD maintain tight restrictions on exit of securities from PORTAL, in contrast to Rule 144A's lack of similar restrictions on resales outside PORTAL; and stating that the Commission's refusal to restrict Rule 144A transactions to "sealed" markets such as PORTAL may lead to unregulated leakage of restricted securities into public markets); Rothwell, *The New Market For Institutional Trading: The PORTAL Market*, in PRAC. L. INST., PRIVATE PLACEMENTS AFTER RULE 144A 131 (1990) (containing detailed description of PORTAL).

Initial response of broker-dealers and institutional investors to PORTAL has been limited. Gillen, *NASD System for Private Placement Draws Yawns From Market Participants*, BOND BUYER Dec. 14, 1990, at 3. The mediocre response is, in part, a reflection of poor market conditions generally. *See infra* notes 295-99 and 317-18 and accompanying text (market's initial response to Rule 144A). In order to encourage use, the NASD has sought SEC approval to convert PORTAL to an "open" trading system, dropping certain requirements including that NASD members prequalify with the NASD as QIBs, and permitting members to conduct Rule 144A transactions outside of PORTAL. *NASD Proposes Converting Its System For Rule 144A To Open Trading System*, SEC. REG. & L. REP. (BNA), Feb. 15, 1991, at 7.

The American and New York Stock Exchanges are establishing competing systems: SITUS (System for Institutional Trading of Unregistered Securities) and NYSE System 144A, respectively. *See Securities, NYSE Proposes Creation of New System For Buying, Selling Rule 144A Stocks*, Daily Report For Executives (BNA), Sept. 14, 1990, at A-2.

clearing, and settlement system for U.S. and foreign equity and debt securities.[162]

To become eligible for trading on PORTAL securities must be approved in accordance with PORTAL Rules, be eligible for sale pursuant to Rule 144A,[163] and be deposited with designated depository organizations.[164] In order to participate in PORTAL, investors, dealers, and brokers must comply with registration criteria.[165] Investors and dealers must be eligible to purchase Rule 144A securities by having QIB status under the rule.[166] Brokers are prohibited from executing transactions on the PORTAL market as principals.[167]

To inhibit leakage of PORTAL securities into public trading markets, securities may be transferred out of the PORTAL system only via "qualified exit transactions."[168] A qualified exit transaction is defined as: (1) A transaction registered pursuant to the Securities Act; (2) a transaction exempt from registration under Regulation S, or Rules 144A or 145; (3) a repurchase by the issuer or an affiliate; (4) a transaction exempt under Rule 144A based on counsel's opinion reviewed by the NASD in advance of the transaction;[169] or (5) a demonstrably exempt transaction resulting in the purchaser acquiring freely-tradable securities.[170]

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162. Clearance and settlement may be made in U.S. dollars and numerous foreign currencies through two designated depository institutions, the Depository Trust Company (DTC) and Centrale de Livraison de Valeurs Mobilieres S.A. Luxembourg (CEDEL). 55 Fed. Reg. 18,783-86 (May 4, 1990) (relating to foreign securities).

163. PORTAL Rules, Pt. II, § 2(a)(1). Securities can be traded in the PORTAL market without the issuer's consent. 55 Fed. Reg. 18,782 (May 4, 1990).

164. PORTAL Rules, Pt. II, § 2(a)(3). *See supra* note 162 (identifying depositories).

165. PORTAL Rules, Pt. IV (relating to investors); *id.* Pt. III (relating to dealers).

166. *Id.* Pt. IV, § 1(b)(1) (relating to investors); Pt. III, § 1(b)(1) (relating to dealers).

167. *Id.* Pt. III, § 3. All brokers and dealers must be NASD members as a condition of participating in PORTAL. *Id.* Pt. III, § 2(b) (relating to brokers); *id.* Pt. III, § 1(b)(2) (relating to dealers). PORTAL participants must be members of DTC or CEDEL and PORTAL accounts must be maintained separately from participants' other accounts at those depositories. *Id.* Pt. III, § 2(b) (relating to brokers); *id.* Pt. III, § 1(b)(3) (relating to dealers).

168. *Id.* Pt. I, § 18.

169. *Id.* Pt. I, § 18(b)(4).

170. *Id.* Pt. I, § 18(c).

IV. REGULATION S

In adopting Regulation S,[171] the SEC has attempted to rationalize the extraterritorial reach of the registration provisions of U.S. securities laws. The Commission's traditional position has been that the Securities Act's section 5 registration requirements do not apply to offers and sales of securities under circumstances which result in the securities "coming to rest abroad."[172] In numerous no-action letters over the years, the SEC staff has approved a variety of procedures[173] to ensure that securities were

171. 17 C.F.R. § 230.901-904. Regulation S was proposed by the Commission in June 1988 to replace Sec. Act Release No. 33-4708., *See infra* note 172. Sec. Act Release No. 33-6779, 41 SEC Docket 126 (CCH) (June 10, 1988), 53 Fed. Reg. 22,661 (June 17, 1988), [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,242 [hereinafter Regulation S Proposing Release]. It was reproposed one year later in revised form. Sec. Act Release No. 33-6838, 43 SEC Docket 2008 (CCH) (July 11, 1989), 54 Fed. Reg. 30,063 (July 18, 1989), [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,426 [hereinafter Regulation S Reproposing Release]. The Commission adopted Regulation S on April 19, 1990. Sec. Act Release No. 33-6863, 46 SEC Docket 52 (CCH) (Apr. 24, 1990), 55 Fed. Reg. 18,306 (May 2, 1990), [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,524 (to be codified at 17 C.F.R. § 230.901-904 (1990)) [hereinafter Regulation S Adopting Release]. In addition to references to the Regulation S Adopting Release, the text's overview of Regulation S draws generally on that Adopting Release.

Professors Loss and Seligman describe the proposed and reproposed versions of Regulation S in LOSS & SELIGMAN, *supra* note 100, at 64-76. For an overview and further discussion regarding Regulation S, see generally R. Adler, *Regulation S: The Safe Harbor For Offshore Securities Transactions*, 58 C.P.S., at A-1 through A-11, A-17 through A-20 (BNA 1991) (1990) (containing detailed descriptions of Regulation S); Berger, *Offshore Distribution of Securities: The Impact of Regulation S*, 3 TRANSNAT'L LAW. 575 (1990) (containing detailed descriptions of Regulation S); Berkeley & Minarick, *New Regulation S: Offshore Offerings*, in PRAC. L. INST., ADV. SEC. L. WORKSHOP, 99 (1990) (outlining Regulation S); Cooper, *supra* note 100, at 370-82; Jakes, *Foreign Offerings Under Regulation S*, in PRAC. L. INST., SEC. FILINGS, 1990 REV. AND UPDATE, 221 (1990). *See also* BLOOMENTHAL, 3C SECURITIES AND FEDERAL CORPORATE LAW § 15.12 (1991) (comprehensive analysis of Regulation S); JOHNSON, *supra* note 100, at 469-73 (describing applicability of Regulation S to debt offerings); Krohn, *Offerings Out of Bounds: Safe Harbors Under the SEC's New Regulation S*, 4 PROBATE & PROPERTY, Sept./Oct. 1990, at 6, 10 (Regulation S "no panacea" for developees and portfolio managers in quest for foreign capital); Perrell, Kiernan & Sommer, *supra* note 3, at 13 (Supp.), 17-21.

172. Registration of Foreign Offerings by Domestic Issuers, Sec. Act Release No. 33-4708, 1 Fed. Sec. L. Rep. (CCH) ¶ 1361-63 (July 9, 1964).

173. Procedures involved lock-up agreements among underwriters and dealers prohibiting sales to such persons. *See* Beller & Berney, *Eurobonds*, 19 REV. SEC. & COMM. REG. 39, 42-48 (1986) (includes discussion of U.S. sales restrictions concerning initial distributions of warrants, and secondary tracking and convertible securities). *See generally* Evans, *Offerings of Securities Solely to Foreign Investors*, 40 BUS. LAW. 69 (1989) (discussing, *inter alia*, lock-up procedures approved in SEC no-action letters).

offered and sold only to non-U.S. nationals and not distributed or redistributed in the United States.[174] In contrast to the prior non-U.S. national regime, under the "territorial approach"[175] of Regulation S, offers and sales of securities which occur "offshore" from the United States are not subject to section 5.[176] Additionally, Regulation S contains two non-exclusive safe harbors from registration: an issuer safe harbor[177] for offers and sales by issuers, securities professionals, and their affiliates and a resale safe harbor[178] for resales by all other persons. The availability of both safe harbors is conditioned on the existence of "offshore transactions"[179] and the absence of "directed selling efforts"[180] in the United States.[181] While Regulation S narrows the scope of section 5's registration requirements, the Commission has reaffirmed the greater reach of the federal securities anti-fraud provisions.[182]

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174. Because a security's domestic market is usually the primary market, the concern is that unregistered securities distributed offshore by U.S. issuers will flow back into the United States. SEC STUDY, *supra* note 3, at II-54.

175. Regulation S Adopting Release, *supra* note 171, at 80,665.

176. Rule 901 ("General Statement"); Rule 902(i) ("Offshore Transaction").

177. Rule 903.

178. Rule 904.

179. An "offshore transaction" is one in which the offer is not made to a person in the United States. Rule 902(j); Regulation S Adopting Release, *supra* note 171, at 80, 666-68. In order to be defined as an offshore transaction, either the offer must be made to a purchaser which is outside the United States when the buy order originates or the transaction must be carried out on a designated offshore securities market. *Id.*

180. "Directed selling efforts" are activities which are calculated or could reasonably be expected to condition the market for the Regulation S offerings. Rule 902(b); Regulation S Adopting Release, *supra* note 171, at 80,668-71. Such efforts include marketing activities in the United States calculated to induce the purchase of securities ostensibly being offered and sold outside the U.S. Rule 902(b). *Id. See infra* notes 191-96 and accompanying text (describing directed selling efforts). *See also* McLaughlin, *"Directed Selling Efforts" Under Regulation S and the U.S. Securities Analyst*, 24 REV. OF SEC. & COMM. REG. 117, 122 (1991) (stating that Regulation S should be broadly construed so that "normal" distribution of research material in the U.S., comparable to that allowed during domestic public offerings, during Regulation S offerings should not be deemed to be prohibited "directed selling efforts").

181. Rule 903(a),(b); Rule 904(a),(b).

182. According to the Commission, Regulation S does not limit the extra-territorial application of federal anti-fraud provisions, as articulated by the courts pursuant to the "conduct" and "effects" tests. Preliminary Notes 1 and 2 to Regulation S; Regulation S Adopting Release, *supra* note 171, at 80,665. The conduct and effects tests have their origins in RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF U.S. (1965). *See* ITT v. Vencap, Ltd., 519 F.2d 1001, 1018 (2d Cir. 1975) (applying conduct test); Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 990 (2d Cir. 1975), *cert.*

The General Statement[183] of Regulation S provides that offers and sales occurring outside the United States are not subject to Securities Act registration, whether or not they fall within the safe harbors.[184] Determinations that transactions are exempt under Rule 901 are made on the facts and circumstances of each case.[185]

The safe harbors of Regulation S are set forth in Rules 903 and 904, and permit registration-free distributions and secondary resales, respectively. Under the Rule 903 issuer safe harbor, offers and sales made by the issuers, underwriters, dealers, or other participants in the distribution (distributors)[186] are considered to be made outside the United States.[187] While distributors may engage in resales of securities of the same class as those being distributed, under Rule 904 distributors are prohibited from reselling the securities which are the subject of the offering until the distribution has ended, their allotments have been sold, and any applicable restricted period[188] has expired.[189] Resales under the

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denied, 423 U.S. 1018 (1975) (discussing bases for distinguishing between scope of disclosure and antifraud provisions); Schoenbaum v. Firstbook, 405 F.2d 200, *rev'd. on other grounds*, 405 F.2d 215, 2220 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 906 (1969) (applying effects test). *See* Goelzer, Mills, Gresham & Sullivan, *The Role of the U.S. Securities and Exchange Commission in Transnational Acquisitions*, 22 INT'L L. 615, 620, 641 (1988) (noting that U.S. jurisdiction is more likely to be invoked in cases involving fraud than in matters concerning registration provisions; asserting that integration of world securities markets and international currency fluctuations will lead to regulatory conflicts resulting from differences in scope of U.S. and foreign jurisdiction and substantive law). *Compare* Note, *Restricting the Jurisdiction of American Courts Over Transnational Securities Fraud*, 79 GEO. L.J. 141, 148-61, 169-71 (1990) (critically reviewing inconsistent application of conduct and effects test; arguing for restrained use of effects test as consonant with protection of U.S. investors, markets, and national political interests in global market setting). Regulation S is a safe harbor from federal registration of securities offerings. It does not limit the application of state securities laws, some of which may impose registration requirements on offshore transactions which comply with Regulation S. Preliminary Note 4 to Regulation S; Regulation S Adopting Release, *supra* note 171, at 80,665.

183. Rule 901.

184. *Id.*; Regulation S Adopting Release, *supra* note 171, at 80,665-66.

185. Regulation S Adopting Release, *supra* note 171, at 80,665-66.

186. Rule 902(c). Rule 902(c) defines as a "distributor" any underwriter, dealer, or other person participating in the distribution of securities offered or sold in reliance on Regulation S. *Id.*

187. Rule 903(a)-(c).

188. Rule 902(m) ("Restricted Period").

189. Rule 904.

Rule 904 safe harbor may be made by persons unaffiliated with or not acting on behalf of issuers or distributors, and are deemed to occur outside the United States.[190]

A. General Conditions -- Offshore Transactions; No Directed Selling Efforts

As noted above, transactions under Rules 903 and 904 must be offshore and not be the subject of directed selling efforts. In an offshore transaction, no offer or sale may be made to a person in the United States.[191] Further, either the buy order must be originated when the buyer is or the seller reasonably believes the buyer to be outside the U.S. or, regardless of the location of the person originating the buy order, the transaction must not be prearranged and must be executed through a designated offshore securities market.[192] Also, for the issuer safe harbor to be available, neither the issuer nor any distributor, affiliate, or agent may engage in directed selling efforts in the United States.[193] Similarly, the resale safe harbor is available only if the seller, its affiliates, and agents refrain from directed selling efforts in the United States. Directed selling efforts are activities within or outside the United States which could reasonably be expected to result in conditioning the market for the securities being offered in reliance on Regulation S.[194] Such activities can include

190. *Id.*

191. Rule 902(i).

192. Issuer offshore transactions must be executed on a foreign securities exchange. Rule 902(ii)(B)(1). Offshore resale transactions must be executed through a designated offshore securities market. Rule 902(ii)(B)(2); Rule 902(a) ("Designated Offshore Securities Market") identifies seventeen foreign markets. The Commission staff has designated additional markets subsequent to the adoption of Regulation S. *See Shearson Lehman Hutton, Inc.*, SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79, 498 (July 7, 1990) (Helsinki Stock Exchange); *The First Boston Corp.*, SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. ¶ 79,462 (June 14, 1990) (Stock Exchange Automated Quotation International (SEAQ), part of International Stock Exchange (ISE) of the United Kingdom and Republic of Ireland Limited).

193. Rule 903(b).

194. Rule 902(b)(1).

distribution or publication within the United States of print and broadcast advertising, recommendations, opinions,[195] and broker-dealer quotations.[196]

B. Issuer Safe Harbor

1. Category 1: Foreign Issuers with No Substantial U.S. Market Interest, Overseas Directed Offerings, and Foreign Government Offerings

The Rule 903 safe harbor distinguishes among three categories[197] of securities on the basis of nationality, Exchange Act reporting status, and the degree of U.S. market interest in the security.[198] Category 1 is set forth in Rule 903(c)(1) and is available for the following securities: (1) Foreign issuer offerings for which there is no substantial U.S. market interest (SUSMI);[199] (2) overseas directed offerings;[200] (3) offerings backed by the full

195. Advertisements concerning offerings are prohibited from appearing in publications having a "general circulation" in the United States. 902(b),(k); Rule 903(b). A "general circulation" publication is defined as one printed primarily for distribution in the U.S. or which has had an average circulation during the previous 12 months of 15,000 or more copies per issue in the United States. Rule 902(k)(1),(2). Where a foreign publication produces a separate U.S. edition that has a general circulation in the U.S., only the U.S. edition will be deemed to be a general circulation publication if the non-U.S. editions do not qualify as general circulation publications when the U.S. edition is disregarded. *Id.* Certain tombstone advertisements in publications with limited U.S. and non-U.S. aggregate circulations are excluded from the definition of directed selling efforts. Rule 902(b); Regulation S Adopting Release, *supra* note 171, at 80,668-71. *See* McLaughlin, *supra* note 180, at 122 (arguing that "normal" distribution of research material should not be construed as constituted directed selling efforts).

196. Quotations on PORTAL, *see supra* notes 160-70 and accompanying text, are not considered to be directed selling efforts under Regulation S. Regulation S Adopting Release, *supra* note 171, at 80,671 n.71.

197. Each category is subsequently referred to in the text as a separate safe harbor although they are all classes of the Rule 903 issuer safe harbor.

198. With respect to a subsidiary's debt securities which are fully and unconditionally guaranteed by the parent, the ultimate parent's status under Regulation S governs for the purposes of determining which issuer safe harbor is available. Rule 903(c)(5).

199. SUSMI is defined in Rule 902(n). *See infra* notes 209-13 and accompanying text (discussing SUSMI).

200. An overseas directed offering is defined in Rule 902(j) and includes foreign issuer offerings targeted at a single country and U.S. issuer offerings of non-convertible debt securities, ABSs, and non-participating preferred stock denominated in a foreign currency and directed at a single foreign country. Rule 902(j). *See* Rule 903(c)(4)(i),(ii) ("Non-Participating Preferred Stock and

faith and credit of a foreign government;[201] and (4) securities issued in connection with certain employee benefit plans.[202] Offers and sales of securities within the Category 1 safe harbor are not subject to any limitations,[203] save that they be made offshore and not be the subject of directed selling efforts in the United States.[204] The intent underlying Regulation S, as with Release 4708,[205] is to minimize flowback into U.S. markets of securities initially sold abroad.[206] In the SEC's view none of the aforementioned offerings are likely to result in significant flowback.[207] Among those singled out by the Commission as low risks in this regard are United States asset-backed issues directed at a single foreign jurisdiction.[208]

SUSMI in an issuer's debt securities is calculated by aggregating its "traditional" debt securities, non-participating preferred stock, and asset-backed securities.[209] An ABS is defined alternately as an ownership interest or certificate of participation in a pool of specified assets or a security, secured by assets or certificates of participation in such assets, the principal and interest

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Asset-Backed Securities").

201. Rule 903(c)(1)(iii).

202. Rule 903(c)(1)(iv).

203. For example, a U.S. person overseas at the time of the offering could purchase Category 1 securities.

204. Rule 903(a),(b).

205. *See supra* notes 172-74 and accompanying text. In release 4708, the SEC announced that it would not pursue enforcement action for failure to register public offerings in cases where securities were distributed overseas exclusively to foreign nationals in a manner designed to result in the securities "coming to rest aboard." 1 Fed. Sec. L. Rep. (CCH) ¶¶ 1361-63 (1964). *See supra* note 173 and accompanying text (for sources describing practice under Release 4708).

206. Regulation S Adopting Release, *supra* note 171, at 80671.

207. *Id.* at 80,672.

208. *See supra* note 200 and accompanying text. Regulation S Adopting Release, *supra* note 171, at 80,672.

209. Rule 902(n)(3). SUSMI in non-participating preferred stock and ABSs is determined on the same basis as debt securities. Rule 903(c)(1)(i)(B); Rule 903(c)(4)(ii); Regulation S Adopting Release, *supra* note 171, at 80,673-74. Rule 902(n)(1) defines SUSMI with regard to equity securities. SUSMI in a class of equity securities exists where, either at the commencement of the offering the securities traded publicly in U.S. markets comprised the largest market for the security, or at least 20% of the trading in the security occurred through U.S. trading facilities and less than 55% of the trading occurred through the facilities of an exchange of a single foreign country. Rule 902(n)(1). SUSMI in warrants is determined by the degree of market interest in the underlying securities at the time of exercise. Rule 903(c)(1)(i)(C).

of which is payable in relation to payments or reasonable projections of payments on specified assets or certificates of participation in a pool of specified assets.[210] SUSMI is determined at the commencement of the offering and is deemed to exist where all the issuers' debt securities are held by 300 or more U.S. persons,[211] and a minimum of both $1 billion and twenty percent of the principal amount of such debt is held by U.S. persons.[212] SUSMI in asset-backed securities is determined using the debt securities definition.[213]

Overseas directed offerings (ODOs) are offerings to residents of a single country other than the U.S. by foreign issuers or domestic issuers of non-convertible debt and ABSs denominated in non-U.S. dollar convertible foreign currency.[214]

2. *Category 2: Securities of Reporting Issuers; Debt, Asset-Backed and Non-Participating Preferred Securities of Non-Reporting Foreign Issuers*

The Category 2 safe harbor is available for reporting U.S. issuers, all foreign reporting issuers with SUSMI, and foreign issuers' debt, non-participating preferred stock, and ABSs.[215] Category 2 securities are subject to the General Conditions of Regulation S,[216] as well as specified offering and transaction

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210. Rule 903(c)(4)(ii). An ownership interest in an ABS includes servicing rights, and the receipt or right to receive timely payments pursuant to the terms of the security. *Id.* "Assets" include securities, installment sales, accounts receivable, notes, leases, contracts and other assets which by their terms convert to cash over finite periods of time. *Id.*

211. Rule 902(n)(2)(i); Rule 903(c)(4)(i),(ii). SUSMI is calculated on the basis of the *total* debt securities of the issuer, including securities of a different class than those being offered. *Id.*

212. Rule 902(n)(2). Commercial paper exempt from registration under Section 3(a)(3) of the Securities Act, 15 U.S.C. § 77c(a)(3) (1988), is excluded from the determination of SUSMI in an issuer's debt securities. Rule 902(n)(3); Regulation S Adopting Release, *supra* note 171, at 80,674 n. 920.

213. Rule 903(c)(1)(i)(B); Rule 903(c)(4)(ii).

214. Rule 902(j); Rule 903(c)(1)(i),(ii).

215. Rule 903(c)(1)(i). Rule 902(l) excludes from the definition of reporting issuers those foreign issuers filing information with the SEC pursuant to Rule 12g3-2(b) of the Exchange Act, 17 C.F.R. § 240.12g3-2(b) (1990); Rule 902(l).

216. Rule 903(c)(2).

restrictions on issuers[217] and certain other persons and transaction restrictions[218] on investors.

The transaction restrictions of Rule 903(c)(2) prohibit Category 2 securities from being offered or sold to U.S. persons[219] until after the expiration of a forty-day "restricted period,"[220] which is generally the period at the conclusion of which the securities are deemed to have come to rest in the hands of non-U.S. persons.[221] Issuers and distributors[222] must ascertain that purchasers are non-U.S. persons.[223] With respect to natural persons, status as a U.S. person is determined principally on the basis of residency within the United States.[224] An entity's status is generally determined on the basis of jurisdiction of the organization.[225] Fiduciaries with investment discretion are considered purchasers, and their location or organization in the U.S. is generally determinative.[226] An exception exists for U.S. professional fiduciaries such as broker-dealers, which exercise investment

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217. *See* Rule 903(c)(3) (specifying additional restrictions on issuers).

218. Rule 903(c)(2)-(3).

219. The Regulation S definition of "U.S. person" relates to purchasers of securities, not issuers. With respect to natural persons, U.S. residency, not citizenship, determines status as a U.S. person. Rule 902(o)(1)(i). Trusts and estates are U.S. persons if any trustee or executor is a U.S. person, except that such entities are not U.S. persons if an executor, administrator, or trustee which is not a U.S. person has sole or shared investment discretion and if certain additional factors are present. Rule 902(o)(1)(iii) (relating to estates); Rule 902(o)(1)(iv) (relating to trusts). Entities organized under U.S. laws are U.S. persons. Rule 902(o)(1)(ii). Branches or agencies of U.S. entities located abroad are generally U.S. persons, and U.S. branches or agencies of foreign entities are U.S. persons. Rule 902(o)(1)(ii). A U.S. entity which organizes an entity under foreign law specifically for the purpose of purchasing unregistered securities is not a U.S. person if organized and owned by accredited investors (as defined in Regulation D, 17 C.F.R. § 230.501(a) (1990)) which are not natural persons, trusts, or estates. Rule 902(o)(1)(viii). U.S. professional fiduciaries with discretionary control over the accounts of non-U.S. persons are not deemed to be U.S. persons. Rule 902(o)(2). The definition of directed selling efforts excludes contacts with such fiduciaries. Rule 902(b)(3). Offers and sales to them are considered to be made offshore. Rule 902(i)(3). *See generally* Regulation S Adopting Release, *supra* note 171, at 80,676-77 (discussing definition of U.S. person).

220. "Restricted period" is defined in Rule 902(m).

221. Rule 903(c)(2).

222. Rule 902(c) defines distributor as any underwriter, dealer, or other person which, pursuant to a contract, participates in the distribution of securities being offered or sold in reliance on Regulation S. Rule 902(c).

223. Rule 903(c)(1)(iv)(c).

224. *See supra* note 219 (Regulation S definition of U.S. person).

225. Rule 902(o)(l)(ii).

226. Rule 902(o)(1)(vi),(vii).

discretion over the accounts of non-U.S. persons. Such fiduciaries are deemed to be non-U.S. persons.[227] Offers and sales to U.S. professional fiduciaries are considered to be offshore and not to have been the result of directed selling efforts in the United States.[228]

The forty-day restricted period commences upon the closing date or the date of the first offer to a non-distributor, whichever is later.[229] With respect to multiclass continuous non-convertible debt offerings -- a common asset-backed structure -- a restricted period applies to each tranche.[230] A tranche's restricted period begins on the date the lead underwriter certifies that the distribution of that tranche has been completed.[231] During the restricted period, the distributor selling the securities must inform distributors, dealers, and other persons receiving compensation in connection with the securities, by confirmation or similar method, that they are subject to the same offer and sale restrictions as the selling distributor.[232]

Category 2 offering restrictions apply to the issuer, all distributors, affiliates, and agents.[233] The restrictions focus on excluding U.S. persons from offers and sales during the restricted period. Distributors must agree in writing to abide by Regulation S and must specifically assure that all offering materials and advertisements disclose that the securities are restricted.[234]

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227. Rule 902(o)(2).

228. *See supra* notes 193-96 and accompanying text (discussing directed selling efforts).

229. Rule 902(m).

230. *Id.*

231. *Id.* The restricted period for continuous offerings commences when the lead underwriter certifies that the distribution has been completed. *Id.* The restricted period for warrants commences after they have been distributed, provided that they have restrictive legends, that there are written certifications from persons exercising the warrants, and that there are procedures to prevent their exercise in the United States. *Id.*; Regulation S Adopting Release, *supra* note 171, at 80,677-78.

232. Rule 903(c)(2)(iv). Category 3 securities are subject to the same requirement. Rule 903(c)(3)(iv). *See infra* notes 235-43 and accompanying text (discussing Category 3 securities).

233. Rule 902(c); Rule 903(c)(2)(ii)-(iv).

234. *See* Rule 902(h) (defining "Offering Restrictions").

3. Category 3: Non-Reporting U.S. Issuers; Certain Equity Securities of Foreign Issuers

Category 3 is the most restrictive safe harbor. It is available for non-reporting U.S. issuers and equity offerings of non-reporting foreign issuers with SUSMI, and is generally available to any issuer.[235] Category 3 issuers are subject to the General Conditions of Regulation S[236] as well as the offering restrictions referred to above.[237] However, due to the non-reporting status and lesser availability of information about such issuers, the transactional restrictions applicable to Category 3 issuers are more stringent than those applicable to Category 2. The more stringent restrictions were imposed because of the increased potential harm to U.S. investors resulting from the flowback of the securities of Category 3 issuers.[238] Category 3 restricted periods for equity and debt are one year and forty days, respectively.[239] Non-convertible, non-participating preferred stock and ABSs are subject to the forty-day restricted period for debt.[240] During the forty-day restricted period, debt securities may not be sold to U.S. persons.[241] Debt securities are represented by a temporary global certificate and are exchangeable for definitive securities at the expiration of the period. At such time, purchasers are required to certify that they are not U.S. persons or that the purchase was exempt from registration.[242] During the restricted period, distributors are required to notify purchasers that they are subject to the distributor's offer and sale restrictions.[243]

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235. Rule 903(c)(3).

236. Rule 901; Rule 903(c)(3).

237. *See supra* notes 233-34 and accompanying text (describing offering restrictions on Category 2 securities).

238. Regulation S Adopting Release, *supra* note 171, at 80,679-80.

239. Rule 903(c)(3)(ii) (relating to debt); Rule 903(c)(3)(iii)(A) (relating to equity).

240. Rule 903(c)(4).

241. Rule 903(c)(3)(ii)(A).

242. Rule 903(c)(3)(ii)(B). Purchasers of equity securities are required to attest to their status as non-U.S. persons, agree not to transfer the securities during the one year restricted period, and agree to resell only in compliance with Regulation S. Rule 903(c)(3)(iii). U.S. equity issuers must restrictively legend the securities and otherwise limit their transfer. *Id.*

243. Rule 903(c)(3)(iv).

C. Resale Safe Harbor

The resale safe harbor provided by Rule 904 may be relied on by persons other than the issuer, distributors, affiliates or their agents.[244] Generally, persons relying on the Rule 904 safe harbor may resell restricted securities, whether acquired pursuant to Regulation S or any exemption from registration, subject only to the General Conditions.[245] Offers and sales, including transactions on a designated foreign securities market not prearranged with a U.S. person, must be conducted offshore and not be the subject of directed selling efforts in the United States.[246] Securities professionals, such as dealers and persons receiving compensation in connection with the transaction, may resell subject to the General Conditions,[247] but in the event the securities are not Category 1 securities and are sold during the restricted period, the seller may not knowingly sell to U.S. persons and must notify dealer-purchasers of resale restrictions.[248]

Failure to comply with either the offering restrictions or the prohibition against directed selling efforts by an issuer, distributor, affiliate, or their agent renders the Rule 903 issuer safe harbor unavailable for all persons.[249] Non-compliance with any other requirement renders the safe harbor unavailable only for the non-complying party.[250] The Rule 904 resale safe harbor generally remains available to the seller notwithstanding the actions of third parties not acting on the seller's behalf.[251]

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244. Rule 904. Officers and directors of the issuer and distributors who do not receive selling compensation, other than the usual broker's commission, or act as sales conduits in connection with the offering are permitted to resell in reliance on Regulation S. Rule 904(c)(2).

245. Regulation S Adopting Release, *supra* note 171, at 80,680 n.137. *See* Bogle & Gates, SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,489 (July 3, 1990) (directed selling efforts in U.S. by issuer or distributor will not bar reliance by officers and directors on resale safe harbor, subject to Rule 904 condition).

246. Rule 904; Regulation S Adopting Release, *supra* note 171, at 80, 680.

247. Rule 901.

248. Rule 904(c)(1)(ii).

249. Regulation S Adopting Release, *supra* note 171, at 80,681.

250. *Id.*

251. *Id.*

Regulation S is non-exclusive and does not affect the availability of other applicable registration exemptions.[252] Regulation S offerings will not be integrated with contemporaneous registered or domestic exempt offerings.[253] Offshore resales of restricted securities pursuant to Rule 144A are considered to be consistent with Rule 904.[254] With respect to Regulation S, the Commission has adhered to the position taken in Release 4708 that debt securities offered and sold offshore in compliance with Rules 903 or 904 need not be issued under a qualified trust indenture.[255] With respect to the Investment Company Act, Regulation S is presently available only to registered closed-end funds[256] and investment companies not required to be registered under the Act.[257]

V. RULE 144A, REGULATION S AND ASSET-BACKED SECURITIES

A. Expanding Markets and Impact on Structure

One of the collateral effects of Rule 144A may be to stimulate further experimentation in securitization, particularly in the less mature, non-real estate related segments of the ABS markets. As discussed above, Rule 144A permits the resale of restricted securities of a class not publicly traded in the United States to large

252. Preliminary Note 5 to Regulation S; Regulation S Adopting Release, *supra* note 171, at 80,681. Regulation S does not affect the availability of Securities Act §§ 4(1) and 4(3) of the Securities Act. Regulation S Adopting Release, *supra* note 171, at 80,680 n.137.

253. Regulation S Adopting Release, *supra* note 171, at 80,681.

254. Regulation S Adopting Release, *supra* note 171, at 80,681-82. *See* Preliminary Note 7 to Regulation D, 17 C.F.R. §§ 230.501-508 (1991) (providing that offshore Regulation S offers and sales do not affect availability of Regulation D for domestic offers and sales).

255. Regulation S Adopting Release, *supra* note 171, at 80,682. *See* 15 U.S.C. §§ 77aaa-bbbb (1988) (Trust Indenture Act of 1939).

256. Preliminary Note 8 to Regulation S. The SEC is seeking comment on whether and under what circumstances Regulation S should be available to open-end investment companies. Regulation S Adopting Release, *supra* note 171, at 80,683.

257. 15 U.S.C. § 80a-7 (1988).

institutional investors.[258] Rather than being viewed as an attempt to increase the liquidity of the U.S. secondary market for unregistered securities, Rule 144A is better seen as an effort to establish a new third market in addition to the public retail and private (negotiated transaction) markets.[259] It is in this quasi-public market as potentially delimited by Rule 144A, especially as its parameters are relaxed, that ABSs may undergo significant changes.

Of central importance to the growth of the Rule 144A debt market is the development of standardized private placement documentation and covenants similar to those included in U.S. public debt and Euromarket issues.[260] Standardization will likely mean diminished covenant protection and increased reliance on rating agencies to monitor covenant compliance.[261] Unless and until such developments narrow the spread of Rule 144A debt over registered offerings so that issuers' cost of funds is comparable to that of public financings, U.S. and foreign Exchange Act reporting firms will have little incentive to boost the liquidity of the Rule 144A market by offering otherwise qualified (non-fungible) debt privately in the United States. Further, the traditional strategy of insurance companies, which account for virtually all private

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258. According to the SEC's estimate, in excess of 4,000 institutions meet the qualified institutional buyer test (minimum of $100 million invested in securities; $10 million in the case of broker-dealers; depository institutions additionally required to have minimum net worth of $25 million). Citibank, *Citibank Launches 144A Securities Effort*, EUROMONEY, June 1990, at 53 (citing SEC's estimate). *See supra* note 116 (discussing SEC staff approval of Standard & Poor's QIB list).

259. Citibank, *supra* note 258, at 53 (quoting S. Hanks, formerly chief of the SEC's Office of International Corporation Finance and one of the architects of Rule 144A).

260. Greene & Beller, *Rule 144A: Keeping the U.S. Competitive in International Financial Markets*, 4 INSIGHTS: CORP. & SEC. L. ADVISOR 3, 6, 9 (June 1990) (outlining possible covenant structure of Rule 144A transactions). *See* Connolly, *Positive Reaction on Rule 144A*, LIFE & HEALTH (Fin. Scvs. Ed.) (May 7, 1990), at 3 (discussing Standard & Poor's initiating covenant ranking service to rate private debt offerings).

261. Karol, *The Effects of Rule 144A*, 23 REV. OF SEC. & COMM. REG. 125, 132 (1990) (asserting that diminished covenant protection likely). *Cf.* Longstreth, *supra* note 130, at 18 (observing that investors resist curtailing due diligence despite 144A market liquidity and issuers' credit worthiness). The antifraud implications of Rule 144A are discussed in sources cited *supra* note 132.

placement purchases, has been one of "buy and hold."[262] And, in fact, insurance firms have been attracted to restricted securities, in the view of some, because of their higher (il)liquidity premiums.[263] Moreover, the tepid initial response to the introduction of Rule 144A,[264] while due in substantial measure to adverse economic conditions, may also reflect resistance by some domestic U.S. corporate borrowers and investors to standard private offering covenants.[265] Those who hold this view are unwilling to forego the control and protection of customized documentation, particularly in the face of what they see as private secondary markets which had adequate liquidity prior to the advent of Rule 144A.[266] Should such views be widely held by significant market participants, the development of the Rule 144A market would be severely retarded.

Assuming a general market interest in Rule 144A, the rule may encourage new and different types of issuers, such as middle-market firms with $30-$200 million in sales, to use the private

262. Brady, *Evolution, Not Revolution*, EUROMONEY, June 1990, at 48. *See* Karol, *supra* note 261, at 132 (asserting that Rule 144A may cause institutional investors to be more active in private placement portfolios).

263. Brady, *supra* note 262, at 58. Although Rule 144A is not itself an exemption from registration requirements, with respect to the relative issuer cost -- interest spread (differential) -- of public and private debt offerings reference to Rule 415 (shelf-registration) may nevertheless be suggestive of Rule 144A potential cost savings. Although a number of empirical studies, *see, e.g.*, Marr & Thompson, *Shelf-Registration: Competition And Market Flexibility; Implications Of The Underwriter Certification And The Implicit Insurance Hypotheses*, 30 J. L. & ECON. 181 (1987), have concluded use of shelf-registration procedures reduces issuers' cost of debt, those conclusions have recently been challenged in a study which found that prior work did not take into account issuer self-selection bias. When such bias is considered, shelf-registration is shown to have had no incremental effect on lowering debt yields. Allen, Lamy & Thompson, *The Shelf Registration of Debt and Self Selection Bias*, 45 J. FIN. 275, 286 (1990).

264. *See* sources cited *supra* note 161 (discussing low-level of market reaction to introduction of Rule 144A).

265. Berkeley & Minarick, *supra* note 100, at 75; Feinberg, *Rule 144A: "Where's The Beef?" the Early Players Ask; Capital Ideas*, CORP. CASHFLOW MAG., Nov. 1990, at 47; Glover, *Good Intentions in a Bad Economy*, Legal Times, Dec. 31, 1990, at 20, col. 1.

266. Berkeley & Minarick, *supra* note 100, at 75; Feinberg, *supra* note 265, at 47; Glover, *supra* note 265, at 21, col. 1 (noting that issuers are reluctant to forego restrictive covenants and legends in 144A market).

market[267] for ABS offerings. Standardized documentation will have the most immediate effect on the mature sectors of the ABS markets: residential real estate-related, automobile loans, and credit card receivables. These types of ABSs are becoming commoditized in the markets, and as documentation and covenant conventions arise, Rule 415-type shelf procedures may be developed to facilitate offerings.[268] The fact that ABS middle-market issuers may not be well-known, highly-rated firms should not detract significantly from the marketability of their ABSs under Rule 144A because ABSs are often sufficiently credit-enhanced to attract investment grade ratings. Further, in some instances, such as in the newer sectors of the ABS markets, credit enhancement may promote document standardization for ABS offerings which would otherwise be rated triple-B or below, and for which standardization has not been possible. The documentation for multi-tranche ABSs, such as CMO-type vehicles which have been designed for specific investors, does not lend itself to standardization. Yet the existence of the 144A market in conjunction with proprietary trading systems such as PORTAL should accelerate the evolution of complex ABSs into commonplace securities, a trend which has consistently characterized several sectors of the ABS markets since their respective inceptions.

With regard to investors, Rule 144A may attract into the private secondary market new investors such as investment companies, which are active in managing their portfolios.[269] Liquidity premiums notwithstanding, the rule may also induce traditional

267. *See* Karol, *supra* note 261, at 132 (additional liquidity in private placement market created by Rule 144A may induce middle-market firms to use such market). *See also* Meyers & Hein, *Turn Assets Into Cash; Securitization*, CORP. CASHFLOW MAG., Aug. 1990, at 33 (discussing appeal of securitization to middle-market firms); Rose, *Securitization: Can It Work in Middle Market?*, AM. BANKER, Aug. 20, 1990, at 1 (discussing agency and portfolio diversification problems of banks in securitizing middle-market commercial loans); T. FRANKEL, *supra* note 19, § 2.7 at 59-60 (speculating about possible, although distant, development of secondary market in securitized loans of small commercial and industrial firms).

268. Green & Beller, *supra* note 260, at 9.

269. *See* Mahoney, *supra* note 3, at 69 (theorizing that Rule 144A may lead to creation of two-tier market to the detriment of individual investors; advocating that a rational response would be to diversify by increasing investment in mutual funds which would thus be one of the "principal unintentional beneficiaries" of the rule).

insurance company investors to increase turnover of restricted securities.[270]

Under Rule 144A, investment companies' directors have discretion[271] to determine which restricted securities are illiquid for the purposes of the SEC's ten percent limitation on funds' investment in illiquid securities.[272] As a result, investment companies will become a significantly larger market for ABSs in light of the securities' competitive returns. In turn, demand from new investor bases may result in creation of ABSs principal and interest payment schedules correlated to fund-specific cash flow and profit considerations,[273] as distinguished, for example, from insurance companies' cash flow requirements.[274] Moreover, with respect to insurance companies, if restrictions which limit the amount of privately placed securities in their portfolios were eased,

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270. Karol, *supra* note 261, at 132.

271. Rule 144A Adopting Release *supra* note 100, at 80,647-48. Structured financings usually involve an investment company under the Investment Company Act of 1940. Sabel & Bernstein, *Selected Legal Aspects of Structured Mortgage Financing*, PRAC. L. INST., NEW FIN. INSTRUMENTS AND TECHNIQUES, at 553, 578-83 (1990). In order to avoid registration under the Act, the effect of which would render ABS offerings impractical, issuers structure operations so that they meet one of the Act's exceptions from the definition of an investment company, or obtain an exemptive order from the SEC. *Id.* at 578-83. For a comprehensive treatment of the Investment Company Act in relation to ABS, see generally T. FRANKEL, *supra* note 19, at § 11. The SEC has recently indicated that it may seek legislative exemption from Investment Company Act registration for those ABS issuers, primarily non-MBS issuers, not qualifying for the Act's § 3(c)(5) exemption. *SEC May Ask Congress to Reduce Need for Funds to Seek Prior Exemptive Relief*, 23 SEC. REG. & L. REP. (BNA) 830-31 (May 31, 1991). With respect to the securities law aspects of ABSs generally, the drastic consequence of investment company classification has meant that 1940 Act issues have drawn the most attention -- including intense current scrutiny -- from the investment community, regulators, and academia.

272. Inv. Co. Act Release No. 40-5847 (Oct. 21, 1969), 35 Fed. Reg. 1,989 (Dec. 31, 1970). In response to a recent SEC release, Inv. Co. Act of 1940 Release No. 40-17534, 55 Fed. Reg. 25322 (June 21, 1990) [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,607, seeking comment on whether the Investment Company Act of 1940 should be substantially amended, the Investment Company Institute proposed, *inter alia*, that the Act's restrictions be eliminated or modified with regard to funds offered exclusively to institutional investors. *ICI Urges Less Stringent Regulation Of Funds Aimed At Institutional Investors*, Daily Rep. For Executives (BNA), Oct. 9, 1990, at 7. This would allow fund sponsors to offer products, including certain particularly high risk ABSs, to institutions which are not appropriate for individual investors. *Id.*

273. The small market for non-investment grade ABSs might also be enlarged by investment companies' purchases, based on similar considerations.

274. Life insurance company cash flow requirements, for example, are more easily projected than are the cash flow requirements of investment companies.

insurance firms would undoubtedly increase their ABS trading.[275] Relaxation of such restrictions would be a significant impetus toward making the 144A market a viable alternative to the public markets.[276]

As the 144A market matures, it may stimulate an increase in the number of start-up ABS issuers[277] which attempt to securitize and market new species of assets. The very few such issuers which exist to date have been shunned by the rating agencies. In future years development stage issuers' credit-enhanced ABS offerings may be rated, due in part to the liquidity provided by the Rule 144A market and amended Rule 144. As such, start-up issuers will attract the interest of larger investors directly, as well as that of investment banks seeking additional private placement revenue.[278] The probability of such a scenario evolving in the private ABS market, among others, will grow if Rule 144A is amended to lower

275. It should be noted, however, that insurance company purchases of foreign ABSs are subject to caps on foreign investment imposed generally by states. *See, e.g.*, N.Y. INSURANCE LAW § 1405(a)(7) (McKinney ed. 1985 & 1990 Supp.) (substantially restricting domestic insurers foreign investment activities). *See also* PRIVATE PLACEMENTS: NATIONAL AND INTERNATIONAL MARKETS 114 (H. Lund, R. Sibert & P. Chamberlain ed. 1984) (discussing limitations on foreign investment).

276. Greene & Beller, *supra* note 260, at 9.

277. *Cf.* Mann, *Rule 144A and Venture Capital Financing*, 4 INSIGHTS: CORP. & SEC. L. ADVISOR 24, 26-27 (Sept. 1990) (theorizing that Rule 144A may stimulate formation of new types of venture capital partnerships meeting QIB requirements which would have an added incentive to invest in emerging growth firms both before and after initial public offerings because of Rule 144 amendment permitting tacking of holding periods); Mills & Di Liso, *How Rule 144A May Shape Venture Capital's Future*, VENTURE CAPITAL J. (Nov. 1990) at 12, 16-18 (Rule 144A may benefit early stage venture capital investors at expense of later stage investors because increased liquidity created by the rule will increase pressure on company returns; Rule 144A may lower cost of funds; Rule's limited disclosure requirements reduce information costs and provide greater privacy for companies' sensitive data).

278. *See* Dannen, *supra* note 37 and Tufano, *supra* note 93 (describing alternative views of ABS profitability for investment banks).

or modify the QIB $100 million threshold,[279] and QIB fiduciaries are permitted to purchase securities for the accounts of non-QIBs.[280]

B. Offshore and Distribution Considerations

Middle-market and start-up firms aside, one of the most immediate and significant potential impacts of Rule 144A may be in conjunction with Regulation S in making the United States a more competitive alternative to the Euromarkets for foreign issuers. The adoption of Rule 144A and Regulation S comes at a time when foreign ABS markets are set for sustained growth,[281] paralleling on a smaller scale U.S. markets in their early stages. On the sizable assumption that the spreads between the Rule 144A Market and Euromarkets narrow sufficiently, a substantial number of foreign and U.S. issuers will privately place tranches of debt, including ABSs, generally in this country, while simultaneously conducting offshore public offerings of other tranches in reliance on Regulation S.[282] Subsequent resales of the offshore publicly-offered securities to QIBs in the United States may be made on the basis of Rule 144A.[283] The securities of all tranches are fungible with one another when resold offshore. Offshore resales on

279. Rule 144A as originally proposed in October 1988 would have permitted resales of securities, under certain circumstances, to the very broad class of entities with total assets in excess of $5 million. Proposed Rule 144A(a)(1)(iii) (Oct. 25, 1988); Rule 144A Proposing Release, *supra* note 100, at 89,543. *See supra* notes 130-32 and accompanying text (predicting that QIB definition likely to be amended).

280. *See generally* McLaughlin, *Foreign Issues and Rule 144A*, *infra* note 311, at 5, col. 1. Longstreth, *supra* note 130, at 19-21 (both sources arguing, *inter alia*, for expansion of QIB definition).

281. MOODY'S ANNUAL REPORT, *supra* note 13, at 6, 20-21; Shale, *Security In Big Numbers*, EUROMONEY, Mar. 1991, at 37. Query the effect of Regulation S and Rule 144A on the nascent market for securitized third world debt. *See supra* note 73 (securitization of third world debt).

282. Much of the foreign debt will be represented by American Depository Receipts (ADRs) which is frequently the preferred form of holding foreign securities. ADRs facilitate settlement of transfers of non-U.S. securities, and conversion of dividend and interest payments into U.S. dollars. *See* Citibank, *supra* note 258 (discussing how ADR depositories will assist in maintaining Rule 144A resale requirements and supplying information about issuer). *See generally* Joyce & Jungreis, *ADR Programs Under Rule 144A: The State of the Art*, 10 INT'L FIN. L. REV. 32, (June 1991) (discussing potential impact of Rule 144A on ADR market).

283. Rule 144A Adopting Release, *supra* note 100, at 80,681-82.

designated offshore securities markets are made in reliance on the Regulation S Rule 904 resale safe harbor.[284]

Regulation S Category 1 securities, including foreign debt with no SUSMI and ODOs, are not subject to a resale restricted period.[285] Category 2, which includes foreign debt with SUSMI and U.S. Exchange Act reporting issuers' debt other than ODOs, and Category 3, which includes non-reporting U.S. issuers' debt other than ODOs, are subject to a forty-day restricted period during which offers and sales cannot be made in the United States. Dealers may not offer or sell during the restricted period to U.S. persons in prearranged transactions.[286] section 4(3) of the Securities Act effectively prohibits dealers, whether or not participating in a distribution, from offering or selling in the United States unsold allotments of securities, as well as securities acquired in the market, until forty days after the offering commences.[287] Section 4(3) also limits dealers' immediate resales of all Regulation S offerings, including Category 1 issuers.[288] Nevertheless, the ability of investment banks involved in the placement of 144A securities to make a secondary market in such securities -- a critical factor in creating liquidity[289] -- should not be hindered by

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284. *See generally* Bloomenthal, *The SEC and Internationalization of Capital Markets: Herein of Regulation S and Rule 144A - Part II*, 19 DEN. J. INT'L L. & POL'Y 343 (1991) (analyzing in detail separate and joint operation of Rule 144A and Regulation S, as adopted).

285. Regulation S Adopting Release, *supra* note 171, at 80,672.

286. Rule 904(c)(1).

287. 15 U.S.C. § 77d(3) (1988).

288. *See* Silverman & Braverman, *Regulation S and Other New Measures Affecting the International Capital Markets*, 23 REV. OF SEC. & COMM. REG. 179, 184 (1990) (Category 1 issuers are not subject to the Regulation S restricted period; however, such issuers may remain subject to the § 4(3) forty-day "seasoning period").

289. Karol, *supra* note 261, at 132. Commercial banks originate considerable volumes of ABSs. The Glass-Steagall Act, 12 U.S.C. § 377 (1988), prohibits banks from directly underwriting and dealing in securities. However, it may be expected that bank holding companies' broker-dealer subsidiaries will deal in ABSs. Such activities may increase should the Federal Reserve Board increase the percentage income permitted by a bank to be derived from securities activities. *See generally* Fein, *Banking's Opportunities In Private Placements Under SEC Rule 144A*, BANKING EXPANSION RPTR., June 18, 1990, at 1 (noting that Federal Reserve Board's "strict position" on § 20 bank holding company private placement activities is not required by Glass-Steagall Act; stating that subsidiaries' purchases and sales of securities as principal under Rule 144A do not constitute distribution or underwriting pursuant to securities laws; arguing that Board's position unduly limits subsidiaries' activities in the 144A market); Karol, *New Private Placement Rule Has Diverse effects on Banks*, AMER. BANKER, May 4, 1990, at 4 (predicting bank holding company affiliates will be

Regulation S or section 4(3). Under Regulation S, the restricted period applicable to issuers in Categories 2 and 3 commences on the latter of the closing date or the date the securities are first offered to non-distributors.[290] For non-continuous offerings, the restricted period may begin before completion of the distribution in contrast to practice under Release 4708.[291] For continuous offerings, the period does not commence until the distribution has been completed.[292] However, for continuous non-convertible debt offerings sold in multiple tranches as ABSs commonly are, each tranche has a separate restricted period and can be released from resale restrictions upon completion of its distribution.[293] Further, Rule 144A permits resales into the United States by dealers before expiration of the Regulation S and section 4(3) restricted and seasoning periods.[294]

As of year-end 1990, a total of thirty-seven equity and debt issues totaling $3.7 billion had been placed with Rule 144A-eligible institutional investors.[295] Nineteen of the issuers were foreign entities.[296] The relatively large number of foreign issuers is attributable to the fact that they have taken advantage of the U.S. market for initial private placement of U.S. tranches, and sold the

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active 144A market participants, subject to revenue limitations). *Cf.* McQuiston, *Rule 144A, Regulation S and Amending The Glass-Steagall Act: A New Look at Foreign Banks and Foreign Issuers Participating In the United States Securities Market*, 17 SYRACUSE L. INT'L L. & COM. 171 (1991) (arguing, *inter alia*, for modification of Rule 144A's definition of "marketable security" to allow foreign banks to participate as QIB's in the 144A equity market). The resolution of the debate over the extent and manner in which banking and securities activities should be separated will influence the impact of Rule 144A. Note, *The Capital Markets in Transition*, *supra* note 69, at 243 n.46.

290. Rule 902(m).

291. *Id.*; Regulation S Adopting Release, *supra* note 171, at 80,677.

292. Rule 902(m).

293. *Id. See generally* Bloomenthal, *Regulation S and Offshore Distributions: Part II*, 12 SEC. & FED. CORP. L. REP. 137, 139-40 (1990) (discussing offering restrictions); Coogan & Kimbrough, *Regulation S Safe Harbors For Offshore Offers, Sales and Resales*, 4 INSIGHTS: CORP. & SEC. L. ADVISOR 3, 6 (Aug. 1990) (discussing offering restriction).

294. Such resales may not include unsold dealer allotments. Resales before expiration of the seasoning periods may also be limited by syndication agreements. *See* Greene & Beller, *supra* note 260, at 10; Silverman & Braverman, *supra* note 288, at 186, 188.

295. Eichenwald, *Market Place; Private Placements Off To A Slow Start*, N.Y. Times, Mar. 11, 1991, § D, at 10, col. 3 (*citing* IDD Information Services Figures).

296. *Id.*

balance of their offerings publicly in their home markets in reliance on Regulation S.[297] Lack of liquidity in the developing U.S. 144A-PORTAL market does not present foreign issuers with the same disincentives as U.S. issuers since their securities have liquidity in their public home markets.[298] U.S. issuers with no significant offshore markets have no such advantage and must await the maturity of the 144A market.[299]

C. TEFRA

The effect of Regulation S and Rule 144A on the attractiveness of the U.S. asset-backed primary market and U.S. offshore secondary market trading will be significantly diminished by the anti-bearer bond rules of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[300] In reaction to the relaxation of securities law restrictions on debt offerings under Regulation S, the Internal Revenue Service adopted TEFRA D.[301] The TEFRA D regulations are intended to ensure that offers and sales of unregistered debt securities cannot be made within the United States or to U.S. persons, wherever resident. Bearer debt issuers are required to obtain non-U.S. status certification prior to delivery of securities and payment of interest.[302] International offerings in which the tranches issued abroad are in bearer form will therefore not be fungible with U.S. tranches, which must be in registered form.[303]

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297. Cooper, *Misperceptions of a Move to Globalization*, PENSIONS & INVESTMENT AGE, Oct. 29, 1990, at 16; Eichenwald, *supra* note 295, § D at 10, col. 3.

298. Cooper, *supra* note 297, at 16.

299. *Id.*

300. I.R.C. § 163(f) (1986).

301. Treas. Reg. § 1.163-5(c)(2), 55 Fed. Reg. 19,622 (May 10, 1990). *See* Borisky & Liu, *New Tax Regulations Governing Debt Offerings in the International Capital Markets*, 4 INSIGHTS: CORP. & SEC. L. ADVISOR 3, 3 (July 1990); Vogel, Mooney & Stone, *New Securities and Tax Regulation*, 19 TAX. MGT. INT'L J. 342 (1990) (BNA).

302. Treas. Reg. § 1.163-5(c)(2)(i)(D)(3) (1991).

303. Silverman & Braverman, *supra* note 288, at 184-85, 188. TEFRA certification is not required for commercial paper maturing in 183 days or less. *Id.* at 184 n.26 *Cf.* Consequently, U.S. issuers can offer, for example, 183-day asset-backed Eurocommercial paper (ECP) in bearer form. Foreign issuers can offer ECP with maturities of under one year. *Id.*

D. Further Considerations

The U.S. ABS markets will remain dominant for the foreseeable future. Nevertheless, foreign ABSs may eventually become a presence in the Rule 144A market.[304] In 1985, foreign private placements in the U.S. amounted to $1.4 billion.[305] By 1989, foreign private placements had increased in volume to $22.2 billion, a figure which represents thirteen percent of the total $170 billion 1989 U.S. market.[306] The growth of foreign placements has been driven by the wave of acquisitions of U.S. firms by Japanese and European companies, and the resulting need to raise long-term debt and equity in the U.S.[307] Increasing foreign presence in U.S. public and private markets is also attributable to more restrictive bank capital standards, which have led to higher borrowing costs, and the weakness of the United States dollar, which has made borrowing in Eurodollar markets more expensive.[308]

As described above, during the restricted period U.S. broker-dealers may purchase foreign as well as U.S. public issues offshore for immediate resale into the 144A market.[309] With

304. *See* Parker, *Securities Geared For East Europe*, PENSIONS & INVESTMENT AGE, July 23, 1990, at 30 (discussing how U.S. investment banks are structuring ABSs collateralized by Eastern European Bloc assets and issued by government agencies). *See also*, *Structured Finance Takes Root in Europe*, EUROMONEY, Aug. Supp. 1989, at 11 (discussing signs that European ABS market is "on the move."); *Cf.* Doty, *Capitol Market Developments in Central and Eastern Europe: The SEC Perspective*, INTERNATIONAL SECURITIES MARKETS at 111 (PLI 1991).

305. Chu, *The U.S. Private Placement Market for Foreign Securities*, BANKER'S MAG., Jan./Feb. 1991, at 55.

306. *Id.*

307. *Id.* at 56. While the all-in costs of foreign borrowing may be lower during certain periods, U.S. debt markets have traditionally been attractive because of longer maturities (10-20 years) and greater flexibility of call-protections. *Id.* at 57. Further, the U.S. private placement market provides access to 7 to 20 year debt, depending on borrower credit standing, in contrast with the general 5-year maximum maturities available in the Euromarket. *Id.* Finally, the U.S. subordinated debt market and the lending market for non-investment grade borrowers are more developed than their foreign counterparts. *Id.*

308. Chesler-Marsh, *The Lure of the Yankee Dollar*, EUROMONEY, Jan. 1991, at 33.

309. Rule 902(o)(1)(viii). Regulation S excludes foreign branches and agencies of U.S. banks from the definition of U.S. person. Rule 902(o)(6). *Cf.* Miller & Farber, *Regulation of Foreign-Broker-Dealers in the United States*, 34 N.Y.L. SCH. L. REV. 395 (1989) (discussing SEC's modest relaxation of foreign broker-dealer registration requirements under new Rule 15a-6, and the Commission's concept release concerning foreign broker-dealers' exemption from registration as

respect to foreign issuers, one of the principal rationales for Rule 144A has been the aversion to U.S. capital markets arising from U.S. disclosure requirements, particularly industry segment and accounting disclosure, continuous Exchange Act reporting obligations, and the frequency of litigation in the United States.[310] Rule 144A allows foreign issuers to avoid extensive disclosure and section 11 and 12(1) Securities Act liability.[311] Paragraph (d)(4) of the rule provides that security holders and prospective purchasers have the right to receive certain information from non-reporting issuers upon request.[312] Foreign issuers may become reporting issuers for the purposes of Rule 144A by submitting to the SEC, pursuant to Rule 12g3-2(b), information they provide to home country security holders.[313]

In addition to establishing a registration-free safe harbor for issuers' offshore distributions, Regulation S will serve as an exit from U.S. private -- including 144A -- markets for offshore resales. This exit function will allow, for example, unrestricted flow of foreign issuers' securities into overseas markets where liquidity may be greater than in the United States, and should promote more rapid development of foreign ABS primary markets. Further, under Regulation S, distributors are permitted to sell unseasoned registered debt and equity in the United States directly to U.S. fiduciaries for discretionary accounts of foreign investors.[314]

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conditioned on similar foreign regulation and cooperation).

310. Rule 144A Proposing Release, *supra* note 100, at 89,533.

311. Rule 144A sales are exempt from registration. As such they are not subject to §§ 11 and 12(1) of the Securities Act, 15 U.S.C. §§ 77*k* and 77*l* (1) (1988), which are applicable to violations of the Act's § 5 registration requirements. *See* Karol, *supra* note 261, at 130-32 (discussing civil and anti-fraud liability under Rule 144A). *See also* Longstreth, *supra* note 130, at 16-18 (discussing anti-fraud liability in connection with information supplied pursuant to Rule 144A(d)(4)). *But see* McLaughlin, *Foreign Issues and Rule 144A*, N.Y.L.J., Oct. 25, 1990, 5, at 6, col. 1 (asserting that many foreign issuers may be averse to the Rule 144A market because of potential Rule 10b-5 and § 12(2) liability associated with responding to the Rule 144A(d)(4) information requirement; arguing that the requirement presents substantial disincentive for foreign issuers not registered under the Exchange Act reporting or exempt under Rule 12g3-2(b) to choose U.S. over competing markets).

312. *See supra* notes 131-37 and accompanying text (discussing information requirements of Rule 144A(d)(4)).

313. Rule 144A(d)(4)(i); Rule 144A Adopting Release, *supra* note 100, at 80,645-46.

314. Rule 902(o)(2); Regulation S Adopting Release, *supra* note 171, at 80,677; Silverman & Braverman, *supra* note 288, at 188.

Finally, although it remains to be clarified, distributors may also be permitted to sell unseasoned securities to the discretionary offshore accounts of U.S. investors, including U.S. pension funds.[315]

E. Asset-Backed Markets and the New Regime

In the near term Rule 144A and Regulation S are likely to have a very modest, if not marginal, effect on the liquidity of ABS primary and secondary markets. Significant liquidity increases will result more from the growth of asset securitization generally, as a function of the financial climate and economic conditions.[316] Indeed, as noted above, the weak market conditions in the United States, persisting since the introduction of the SEC's innovations in April 1990, have undercut the establishment of liquidity in the 144A market.[317] In 1990, overall private placement volume in the United States declined twenty-seven percent from 1989 levels.[318]

As experience with Rule 144A and Regulation S accumulates and their impact is observed, it is likely that both will be amended considerably. Rule 144A, in particular, will be subject to pressures to liberalize it, for example, by reintroducing some variation of the three-tier institutional buyer concept,[319] and by permitting QIBs fiduciaries to purchase for the discretionary accounts of non-QIBs.[320] In its present form, Rule 144A irrationally discriminates between non-QIB accounts managed by depository institutions on the one hand and investment companies on the other, which may aggregate shareholders' equity investments to

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315. Silverman & Braverman, *supra* note 288, at 186. The authors advise that "prudent" distributors should not offer to sell Categories 2 and 3 offerings to offshore U.S. pension fund accounts until the issue of permissibility is settled. *Id.*

316. *See* Hanks, *supra* note 100, at 350 (stating that Rule 144A may have greater potential effect on liquidity of privately place equity because of tendency for privately placed debt to be held to maturity and consequently perception of less need for liquidity in that debt market).

317. *See* Eichenwald, *supra* note 295, § D, at 10, col. 3; Cooper, *supra* note 297 (discussing low level of activity in Rule 144A market).

318. Gillen, *Private Placements Plunge 27% in 1990, Hurt By Flight To Quality, ESOPs' Decline*, BOND BUYER, Mar. 8, 1991, at 3.

319. *See supra* notes 100-12 and accompanying text (discussing the three-tier institutional buyer concept).

320. *See* Longstreth, *supra* note 130, at 19-21.

meet the QIB test and invest on behalf of non-QIB shareholders.[321] Regulation S will be targeted for restricting the definition of U.S. person, and expanding the concept of offshore offers and sales. Whatever the changes, they are likely to reflect the fact, as do the regulations themselves, that the globalization of the securities markets and the concern over U.S. competitiveness are obliging the SEC to make the U.S. disclosure and trading system regulations more accessible to foreign issuers, investment banks, and investors.[322]

Despite its relative youth, asset securitization has grown tremendously in scale over the past decade.[323] Although many types of ABSs are becoming commoditized, structured securities are becoming increasingly complex and involve risks that have yet to be identified and approximated in terms of appropriate levels of credit enhancement.[324] During 1989, for example, there were offerings involving swapped and unswapped interest-rate risk in collateralized bond obligations, hedging instruments, limited documentation loans supporting MBS pass-throughs, credit card receivables offered by lower-rated retailers, more diverse, lower-rated tranches in some ABSs, and market value-structured securities supported by assets trading in developing secondary markets.[325] Also noteworthy were developments in the market for partially supported commercial paper.[326] Transactions have been designed which employ a single pool of collateral to support joint commercial paper/medium-term note offerings.[327] "Conduit" offerings have allowed issuers to pool a range of asset types from different originators, the ABS paper to be issued under the name of a single issuer.[328]

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321. *Id.*

322. Karmel, *SEC Regulation of Multijurisdictional Offerings*, 16 BROOKLYN J. INT'L L. 2, 4, 8 (1990).

323. *See supra* notes 8-13 and accompanying text (discussing growth of asset securitization).

324. *See supra* notes 44-50 and accompanying text (discussing the complexity and risks of ABSs).

325. MOODY'S ANNUAL REPORT, *supra* note 13, at 5.

326. *Id.* at 9.

327. *Id.*

328. *Id.*

In 1988, Standard & Poor's began rating ABSs collateralized by junk bonds on the basis of cash flow instead of market value, permitting a reduction in levels of credit enhancement.[329] That year also marked the beginning of active closed-end leveraged (investment company) fund debt issues and preferred stock offerings supported by junk and international government bonds, and the initial securitization of home equity, boat, recreational vehicle and non-performing loans, and municipal equipment leases.[330]

Asset-backed securities are not widely understood outside money center finance circles, which to date have included institutional investors and the relatively small number of issuers and underwriters that have been involved with the securities.[331] As securitization becomes more prevalent, the knowledge and experience level among participants in ABS structuring and trading will decline in the near term. Competition among current and new participants, including underwriters, trustees, attorneys, accounting firms, and collateral credit enhancers, will have a negative effect on credit standards in developing sectors of the ABS markets.[332] The problem is not increased risk as such,[333] since one of the

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329. STANDARD & POOR'S CORP., *Asset-Backed Securitization*, STANDARD & POOR'S CREDIT REV., Mar. 1989, at 3, 9.

330. *Id.*

331. Indeed, even within such circles the level of investor comprehension varies. According to one account, investor confusion of credit risk as distinguished from prepayment risk in the ABS credit card receivables market exacerbated the downturn in that market in the first quarter of 1991. *See* Chesler-Marsh, *An Open And Shut Market*, EUROMONEY, Apr. 1991, at 59, 60-61 (describing allegations that rating agencies fail to adequately explain ABS risk structure to investment community compounding investors' over-reaction to national recession).

332. MOODY'S ANNUAL REPORT, *supra* note 13, at 5-6; Note, *The Private Investor's Action*, *supra* note 38, at 594-96 (noting that lowering mortgage insurance underwriting standards in late 1970's and early 1980's became a primary means of competition among underwriters). *See* Batte, *supra* note 38, at 49 (describing due diligence problems in mortgage banking industry).

333. *But see* Forsyth, *Tranche Warfare: In The CMO's It's The Institutions vs. Individual Investors*, BARRON'S, Aug. 19, 1991 at 12 (CMO's may be the most complex and highest risk instruments ever created; lack of CMO losses to date attributable to comparatively low level of interest rate volatility in recent years; while CMO default risk is low, some CMO structures are so complex that their substantial interest rate risks are incomprehensible to many institutional investors; CMO structure does not reduce aggregate risk but rather shifts it in varying degrees to specific tranches; high risk CMO tranches frequently marketed by uniformed brokers to similarly uniformed retail investors; this retail sales base supports institutional market in lower risk CMO tranches).

functions of markets is risk transference, of which ABSs are only one of many vehicles. Rather the concern is with the *transparency*[334] of the risk associated with new ABS products.

Asset-backed security risk structure may be classified into general and specific categories and further into constituent elements. The general structure of ABS risk is borne by: (1) The asset originator, and relates to possible loss on its asset portfolio; (2) the credit enhancer, and concerns exposure to losses exceeding the originator's loss limits; and (3) the investor, which bears, in addition to risk of originator and credit enhancer bankruptcy, the risk of adverse interest rate movements and unanticipated rates of borrower prepayments.[335]

Specific ABS risk structure involves the following: Potential fraud by participants in the securitization process, offering financing, and servicing; legal risks resulting from the paucity of precedence and guidance in the field of asset securitization; risks associated with performance failure by third parties such as servicers and credit enhancers; reduction in a security's credit rating; risks of insufficient diversification among types and geographic origin of ABS collateral; and potentially adverse ramifications on the national financial system resulting from significant asset quality or structure problems with institutionally-held ABSs.[336]

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334. SEC Chairman Breton has expressed concern about the lack of information transparency in the junk bond market. He noted that the NASD's Fixed Income Prototype System (FIPS) -- a screen-based quotation and trading system for high yield and fixed income securities, which has not been well-received by elements of the dealer community -- "appears to offer [substantial] improvement" in this regard. *Letter From SEC Chairman Richard C. Breton To Senator Donald W. Riegle, Jr., Chairman, Comm. on Banking, Housing and Urban Affairs, reprinted in*, Fed. Sec. L. Rep. (CCH) (Current) (Apr. 17, 1991) ¶ 84,721, 81,407.

335. Hayes, *The Risks of Investing in Asset-Backed Securities*, BANKERS MAG., Nov./Dec. 1990, at 34-35. *See generally* Caouette, *"Asset-Backed": Asset Securitization, All the Rage in Some Financial Circles, Carries Special Risk for the Uninitiated*, MAG. OF BANK MGMT., June 1990, at 50 (asserting that credit enhancer due diligence is the primary factor in successful asset securitization).

336. Hayes, *supra* note 335, at 35-40. *See* Schwartz, *Regulatory Issues in Connection with Securitization of Assets*, AM. BANKER, June 8, 1990, at 18A supp. (discussing application of Glass-Steagall Act to bank and thrift securitization programs, and new federal risk-based capital and reserve requirements); STANDARD & POOR'S CORP., *Asset-Backed Securitization*, STANDARD & POOR'S CREDIT REV., Mar. 1989, at 7-10 (discussing legal issues involved in transferring assets from

Rule 144A and Regulation S are intended to increase market efficiency and competitiveness at minimal added risk to U.S. investors and financial markets. To this end, Rule 144A and Regulation S posit decreased levels of disclosure and due diligence which, in the case of developing segments of the ABS markets, will lower transparency further and thereby heighten the risk of many instruments, impede efficient pricing, and invite abuses.

If the 144A market is to become highly liquid it will not be practical for investors to conduct due diligence activities on a scale comparable to that of the section 4(1 1/2) negotiated transaction market.[337] Despite their potential anti-fraud liability,[338]

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originator to issuing entity, and emerging legal concerns relative to pooling and servicing, securitization of vehicle and auto loans, and recoveries from seller of receivables which subsequently default); Shenker & Colletta, *supra* note 12, at 1414-16 (stating that new federal risk-based capital guidelines encourage depositary institutions to sell or securitize higher risk-weighted assets); T. FRANKEL, *supra* note 19, at §§ 6-14 (discussing full range of legal issues relating to securitization, including tax, bankruptcy, commercial, banking and securities law matters).

337. *See* Longstreth, *supra* note 130, at 18-19 (discussing evolution of due diligence function in 144A market). Recent findings concerning Rule 415 (shelf-registration) may have relevance to broker-dealer perceptions of due diligence-related exposure in the 144A market and consequent effect on the amount of potential issuer cost savings under the rule. *See* Blackwell, Marr & Spivey, *Shelf-Registration and the Reduced Due Diligence Argument*, 25 J. FIN. & QUANT. ANAL. 245 (1990) (concluding, upon the results of a study of equity offerings, that underwriters require added "insurance" premiums for Rule 415 offerings on the basis of perceived erosion of due diligence opportunities; observing that this has led some issuers to opt for full-fledged registration). *See also* J. AUERBACH & S. HAYES, INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION? 189 *passim* (1986) (arguing underwriters' statutory due diligence obligations have been compromised by Rule 415 and suggesting that sector of non-"household name" Rule 415 issuer universe poses substantial threat to investors because of current Rule 415 due diligence practice).

338. The potential liability of issuers, broker-dealers and third parties in connection with Rule 144A has been the subject of considerable concern and discussion. *See, e.g.*, Rule 144A Adopting Release, *supra* note 100, at 80,657-61 (opinion of Commissioner Fleischmann, dissenting) (criticizing Rule 144A(d)(4)'s information requirement as exposing issuers to liability under §§ 12(2) and 17(a) of the Securities Act, contrary to the policy implicit in rule); Greene & Beller, *supra* note 260, at 7-8 (arguing reliance on QIB undertakings sufficient to maintain issuer's § 4(2) exemption despite remote resales in violation of § 5 registration provisions); Karol, *supra* note 261, at 130-32 (discussing potential liability under § 10(b), Rule 10b-5, and § 12(2); asserting that § 12(2) liability may extend to seller's misrepresentations and omissions in connection with after-market transactions); Longstreth, *supra* note 130, at 16-18 (asserting that courts are unlikely to extend § 12(2) liability to issuers in connection with resales after distribution has been competed or resales not under issuer's control and that issuers may be liable to purchasers and sellers in secondary market transactions under Rule 10b-5 using fraud-on-the-market theory); McLaughlin, *Foreign Issuers and Rule 144A*, *supra* note 311, at 6 (lack of certainty about issuers' potential Rule 10b-5 and § 12(2) liability for investor resales and issuer information supplied pursuant to Rule 144A(d)(4) discourage use of rule); McLaughlin, *An Issuer's Obligation Is Unclear*, NAT'L L. J., Nov. 5, 1990, 16, at 18, col. 1 (asserting that an issuer

competitive pressures on ABS issuers and broker-dealers[339] may incline them to discourage investor verification. Issuers and broker-dealers will argue that there are practical limitations in connection with secondary trading and will emphasize the credit-enhanced ("insured") nature of asset-backed securities and note the low level of abuse in ABS markets to date. Also significant will be the comfort factor afforded by the competence of U.S. rating agencies which, with respect to foreign securities in particular, has been questioned.[340]

There are likely to be issuers which award business to broker-dealers on the basis of considerably less than optimal

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dealing in "good faith" with "responsible" intermediaries and investors is unlikely to be liable for improper resales; contending that restrictive resale legends are unnecessary and probably unacceptable to purchasers of investment grade debt).

339. It has been noted that some investment bankers perceive that financial product innovation -- despite its development costs which are not incurred by competitors with respect to their rival clone products -- ultimately results in lower costs for innovators. Tufano, *supra* note 93, at 234-35. Investment bankers employ information about the investors in initial innovative deals to create secondary trading markets in the new financial products in which they become the dominant market makers. *Id.* These firms then use their market positions to learn the identities of potential investors and their investment preferences, which results in reduced search costs relative to succeeding underwritings and market making activities. *Id. See* Levich, *Recent International Financial Innovations: Implications for Financial Management*, 1 J. INT'L FIN. MGMT. & ACCT. 1 (1989) (discussing, *inter alia*, significance of new financial instruments from issuer financial management perspective). *See also* E. BLOCH, INSIDE INVESTMENT BANKING 108-42 (1989) (describing impact of financial innovation on capitol markets). *Cf.* Dannen, *supra* note 37, at 61-64 (observing that commoditization of ABS products results in lower associated investment banking profit). *See generally* Hu, *New Financial Products, The Modern Process of Financial Innovations, And The Puzzle of Shareholder Welfare* 69 TEXAS L. REV. 1273 (1991) (analyzing implications of process and products of financial innovation for corporate law and governance).

340. *See, e.g.*, Lewis, *Too Big For Their Boots?* THE BANKER, Oct. 1990, at 6 (arguing U.S. rating agencies' competence to rate private placements, ABSs, mergers, offshore money-market funds, privatization, insurance, and pension plans unproven); Lowenstein, *Should the Rating Agencies Be Downgraded?*, EUROMONEY, Feb. 1990, at 34 (describing the negative view of investment banks and institutional investors concerning the rating process, and rating agency responses). *See also* Chesler-Marsh, *supra* note 331, at 62 (recounting criticism of rating agencies' reports on certain ABS issues which were prepared gratuitously, and without consultation with issuer management and opportunity for acquisition of information not contained in prospectuses). *Cf.* Zonana, *Are the Watchdogs Watching? Investors Increasingly Rely on Ratings Agencies to Say What's Safe and What's Not. But Apparent Failures in the Insurance Crisis Have Left the Firms Looking Unaware*, L.A. Times, July 18, 1991, § A, at 1, col. 1 (describing the failure of insurance rating agencies to anticipate financial collapse of major life insurance companies).

disclosure, as has occurred in sectors of the private markets.[341] It has been noted, moreover, that since the adoption of Rule 144A there have been cases of broker-dealers offering institutional investors debt securities without an opportunity for purchasers to investigate the issuer.[342] Further, the role of broker-dealers generally and the benefits of their due diligence activities may be curtailed in a highly liquid 144A market. It is possible that such a highly liquid market may stimulate the trend toward broker-dealer disintermediation, as issuers seek to save commission expenses by placing securities directly with investors.[343]

While QIBs presumably have the wherewithal to elicit substantial disclosure -- indeed Rule 144A rests on that presumption -- and should in the first instance bear any adverse consequences for failing to do so, the present $100 million QIB threshold is likely to be lowered substantially in the future. As has been pointed out, there is no logical basis for permitting non-QIB "accredited investors" under Regulation D to acquire securities directly from the issuer but barring those investors from purchasing the same securities in the 144A market.[344] Moreover the initial failure of the 144A market to develop liquidity, while partly attributable to unrealistic expectations, is likely to add to the pressures to expand the "universe" of potential QIBs by lowering the $100 million threshold requirement. The threshold may have to be lowered to stimulate formation of what has been termed a

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341. *See* Greene, *Reproposed Rule 144A*, TWENTY-FIRST ANN. INST. ON SEC. REG. 3, 15-16 (containing comments of J. Palmer, Managing Director-Capital Markets, Salomon Brothers, concerning "dark side" of Rule 144A competitive environment arising from lax disclosure in segments of private markets and increased broker-dealer exposure). *But see* McLaughlin, *Foreign Issues and Rule 144A*, *supra* note 311, at 6 (noting that existing private placement market for non-reporting issuers has "extensive information requirements"; contending that firms resisting disclosure are on "weak ground").

342. Longstreth, *supra* note 130, at 18-19.

343. Lewis, *Cutting Out the Middle Man*, EUROMONEY, Feb. 1990, at 62; McGough, *Money To Burn*, FIN. WORLD, June 26, 1990, at 18, 20; Milligan, *Two Cheers for 144A*, INSTITUTIONAL INVESTOR, July 1990, at 117, 119.

344. *See, e.g.*, Sontag, *Rule 144A Hindered by Limitations*, NAT'L L. J., May 14, 1990, at 22 (quoting comments of former SEC Commissioner B. Longstreth); Hanks, *supra* note 100, at 341 (stating that there is a "fundamental inconsistency" between definition of "accredited investor" under Regulation D and definition of "qualified institutional buyer" under Rule 144A).

necessary "critical mass" of investors to create liquidity.[345] Relaxation of the threshold is very likely to occur should 144A market liquidity fail to develop in an improved economic climate.

In conjunction with competitive forces, the growing liquidity of the 144A market[346] will be a further incentive for issuers and broker-dealers to discourage "lower tier" QIBs with less bargaining power from performing appropriate due diligence. Such a development would almost certainly have significant adverse consequences in sectors of the ABS markets. Due diligence in connection with asset-backed securities is singularly important. The quality of the "assets" collateralizing the securities, *including the regional and national economic environments in which they will perform*, must be examined closely -- "audited" as it were -- by technically competent persons. An in-depth assessment of collateral enhancement devices with an emphasis on the extent of the exposure of third-party guarantors is also vital. At present, investors rely on rating agencies' ability to perform these functions in connection with public issues and, to a lesser extent, in private markets.[347] The ABS structures of the future, which will include, for example, multiple types of assets originating in different countries, will test agencies' competence at new orders of magnitude. As securitization expands to encompass new types of assets and classes of investors, the existence of a liquid 144A

345. Cooper, *supra* note 297, at 16; Berkeley & Minarick, *supra* note 100, at 75-76.

346. The use of Regulation S by U.S. issuers, in particular, should boost the development of 144A market liquidity. U.S. securities offered offshore may be resold immediately in the United States under Rule 144A. *See* Cooper, *supra* note 297 (discussing how initial lack of 144A market liquidity resulting in bulk of offerings directed to Rule 144A-eligible purchasers is being conducted conjunction with Regulation S offshore public issues involving securities with existing foreign public resale markets).

347. *See* Hourican, *Procedures for Analyzing and Rating Asset-Backed Securities*, AM. BANKER, June 8, 1990, at 20A supp. (describing ABS rating process); STANDARD & POOR'S CORP., *Asset-Backed Securitization*, STANDARD & POOR'S CREDIT REV., Mar. 1989, at 4-5 (describing rating process). *See also* Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORN. L. REV. 411, 412 n.4, 424'(1990) (recounting oft-repeated observation that rating agencies' reports are lagging, "rear-view" analyses and noting that agencies such as Moody's and Standard & Poor's generally do not perform independent investigations of firms and issues, but rely on public information and information supplied by firms; observing that while ratings are "distilled, independent judgment[s] as to the credit-worthiness of a particular issue, [they] are not . . . audits").

market will encourage more non-investment grade and unrated ABS offerings.[348] Given the foregoing, a significant rise in ABS-related fraud centering on lower tier QIBs and traceable to issuer, third-party participant, and broker-dealer malfeasance or negligence may be expected.[349]

CONCLUSION

Among its varied missions, one the SEC's foremost priorities has been to maintain, if not extend, jurisdiction to enforce the anti-fraud provisions of U.S. securities laws.[350] As pressures from financial market internationalization grow, Congress will eventually be obliged to enact more relaxed disclosure standards.[351] It is highly likely that the Commission will continue with initiatives similar to Rule 144A and Regulation S that, once adopted, are progressively liberalized. Despite the success of cooperative efforts among regulators, exemplified by the SEC's memoranda of

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348. *But see* L. BRYAN, *supra* note 27, at 165-67 (arguing, *inter alia*, that FIRREA sell-off by thrifts of junk bonds and consequent shrinkage of junk bond market makes it likely that, "for the intermediate future," securitization of only "high quality assets" with straightforward risks will be possible; stating that current economies of scale make it "impossible" to securitize virtually all loans (those under $100 million) to small- and mid-sized firms).

349. *See* T. FRANKEL, *supra* note 19, § 2.1 at 29 (securitization "exposes investors to the risks of novel untested instruments and potential fraud from new and often unregulated actors in the process (e.g., guarantors, rating agencies, and appraisers.)") *See also id.* § 3.4 at 94-100 (discussing implication of risks posed by securitization in detail). With respect to the future involvement of commercial banks in securitization, subjecting banks' securities-related activities to market discipline by segregating banking functions among different entities and insuring only traditional "core" deposit/loan banking operations would reduce, although not eliminate, moral hazard-engendered fraud. *See* Bryan, *A Blueprint for Financial Reconstruction*, 69 HARV. BUS. REV. 73, 79 (May/June 1991) (stating that restricting "core banks" to traditional deposit taking/lending activities "will control the distortions that have led to self destructive practices...").

350. *See* Karmel, *supra* note 322, at 16-17 (stating that the SEC is "preoccupied" with its antifraud jurisdiction).

351. *See* McLaughlin, *Listing Foreign Stocks on U.S. Exchanges: Time to Confront Reconciliation?*, 24 REV. OF SEC. & COMM. REG. 91, 101 (1991) (arguing that rather than acting primarily to ease restrictions on sale of new foreign equity in U.S., SEC should concentrate on "disclosure-related" elements of foreign securities trading in U.S. markets, and emphasize improving the efficiency and transparency of U.S. secondary markets by, *inter alia*, reevaluating requiring reconciliation of financial data to U.S. generally accepted accounting standards (GAAP)). *Cf.* McGoldrick, *Does 144A Threaten the Standardization of Accounting Statements?*, INSTITUTIONAL INVESTOR, Aug. 1990, at 118 (describing speculation about whether Rule 144A's lack of U.S. GAAP requirement may impede efforts to develop internationally recognized accounting standards).

understanding and accords with a growing number of countries, and the activities of IOSCO[352] and others directed toward variously "harmonizing" disclosure, accounting and capital adequacy standards, international enforcement of securities laws will increasingly conflict with diverse national disclosure systems.[353]

Countries do have a self-interest in maintaining some degree of financial market integrity, as shown for example, by the success of cooperative efforts to combat insider trading.[354] Nevertheless, the deregulation being driven by competition among national capital and trading markets entails costs as well as benefits.[355] The international marketing of complex investment vehicles such as asset-backed securities, as well as high yield debt and low-priced stocks,[356] in highly liquid private secondary markets will bring, in addition to the benefits of greater diversification, an increase in financial fraud.[357] Given the projected growth of the

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352. International Organization of Securities Commissions. *See* OTA Paper, *supra* note 3, at 75-78 (describing recent activities of IOSCO).

353. Disparate historical and cultural forces underlie and shape nation-states' approaches to financial market and competition regulation. Such forces ensure that the integrity of an international regulatory regime, assuming one is desirable, would be subject to significant stresses -- indeed, very considerable stress during national recessions. *See generally* Henderson, *Security Markets in the United States and Japan: Distinctive Aspects Molded by Cultural, Social, Economic and Political Differences, Globalization of Securities Markets '90*, 14 HASTINGS INT'L & COMP. L. REV. 263 (1991).

354. Grundfest, *supra* note 3, at 367-70.

355. *See generally* Hahn & Hird, *The Costs and Benefits of Regulation: Review and Synthesis*, 8 YALE J. REG. 233 (1990) (commenting generally on relative lack of economic research on aggregate effect of regulation on U.S. economy, and noting in particular dearth of studies on effectiveness of federal regulatory oversight).

356. *Cf.* McLaughlin, *An Issuers Obligation Is Unclear*, *supra* note 338, at 19.

357. The SEC is currently considering tightening its regulation of ABS pools under the Investment Company Act of 1940. Inv. Co. Act. Release No. 40-17534, *supra* note 272. *See* Salwen & Mitchell, *supra* note 146, § C at 1. Restrictions being considered include limitations of asset pools to investment grade debt, restrictions on substitution of assets within existing pools, and mandating that pools be monitored by independent trustees. *Id.* The adoption of such proposals (compliance with which would be necessary to avoid classification as an investment company) would work very substantial changes in ABS markets; preempting potential abuses in the view of some, and "crippling" the ABS industry according to others. *Id. See also* Shenker & Colletta, *supra* note 12 at 1413 nn. 229-32 (describing positions of various interests on the application of the International Company Act to asset-backed securities). Professor Tamai Frankel has argued strongly that asset pools (a term encompassing typical asset-backed security structures) are "investment companies" as defined in section 3(a) of the Investment Company Act, 15 U.S.C. §§ 80a-3(a) (1988). *See* T. FRANKEL, *supra* note 19, § 11.4-11.14 at 457-88. However much regulatory "tightening up" the Commission does in the near term, financial market globalization is certain to continue and

securitization phenomenon, the rise in fraud fostered by Rule 144A will oblige Congress, for this reason among others, to reexamine the premises of U.S. securities laws.[358]

In the future "effective" regulation of national financial markets will occur as never before, in the context of "international [market] quality competition."[359] Former SEC Commissioner

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accelerate. Ultimately, international market forces will be decisive in shaping regulatory structures. L. BRYAN, *supra* note 27, at 180-91.

358. *See* Mahoney, *supra* note 3, at 69-70 (arguing that "the entire structure of federal securities makes sense only if viewed in connection with the paradigm of the small investor who is imperfectly diversified and therefore in need of information about firm-specific risks: If that paradigm vanishes, the structure would vanish with it).

359. Grundfest, *supra* note 3, at 372. Professor Grundfest notes that market "price-quality" competition can occur within a single national jurisdiction, and cites Rule 144A, *inter alia*, as an example of a market with "different rules for investors" and "transaction characteristics." *Id.* Such competition entails countervailing costs. *Id.* *See* Eisenbeis, *Asset Securitization And Internationalization: Themes For The Future Of The Financial Services Industry*, 9 ANN. REV. BANKING L. 347, 350-51 (1990) (observing that financial market globalization is making continued maintenance of respective national regulatory structures increasingly difficult; contending that the United States cannot create a regulatory regime saddling financial institutions operating within country with costs in excess of those placed on institutions abroad); McLaughlin, *Listing Foreign Stocks on U.S. Exchanges: Time to Comfort Reconciliation*, *supra* note 351, at 100-01 (noting that many foreign issuers do not now need access to U.S. capital markets, and arguing that existing U.S. regulatory policy is failing to assist U.S. exchanges and NASDAQ in attracting "reasonable proportion" of "world class" foreign issuers). *See also* Cohen & Conroy, *An Empirical Study of the Effects of Rule 19c-3*, 33 J. L. & ECON. 277, at 277, 299, 302-05 (1990). The authors note Rule 19c-3, which permits stock exchange members to make off-board markets in securities -- while increasing competition in the market for securities trading services, as evidenced by a narrowing of bid-ask spreads -- may have negative effects on price discovery process and price quality. *Id.* They conclude that it is unclear if increased trading service competition results in a net increase to traders of transactional efficiency, *i.e.*, lower cost. *Id.* at 281. *Cf.* P. DRUCKER, THE NEW REALITIES: IN GOVERNMENT AND POLITICS/IN ECONOMICS AND BUSINESS/IN SOCIETY AND WORLD VIEW 117 (1989) (arguing that new "transnational" economy lacks institutions to protect it; asserting that foremost requirement is transnational law); *Administrative Conference of the United States Colloquy: Globalization of Securities and Financial Market Regulation in the 1990's*, 10 ANN. REV. BANKING L. 345, 369-70 (1991) (quoting remarks of Honorable S. Sporkin, U.S. District Judge for the District of Columbia and former Director, Division of Enforcement, SEC, that competition in regulation "is usually a race to the bottom. You cannot regulate that way."); MORGAN GUARANTY TRUST CO., *Financial Markets in Europe: Toward 1992*, WORLD FIN., Sept. 9, 1988, at 6 (indicating that principals of home country control and mutual recognition entailed in 1992 integration of European Community likely to increase competition among states' regulatory regimes initially, leading to rising pressures to "converge" systems); OTA Paper, *supra* note 3, at 71-72 (noting "strong tendency" for securities to trade in most liquid market, generally country of origin, without regard to degree of regulation; asserting that assumptions that least regulated market is most efficient and attractive to investors are "dubious"); Warren, *supra* note 3, at 231-32 (proposing exploration of the creation of supranational European Community regulatory agency to combat arbitrage among member states; such an authority might serve as a model for a international regulatory body).

Joseph Grundfest has termed the 1990's as the era in which financial market "internationalization will revolutionize . . . securities regulation."[360] It is suggested here that a decade hence -- perhaps earlier -- the growth of securitization in the Rule 144A and Regulation S trading environment may be seen in retrospect as one of the advance elements of that revolution.

360. Grundfest, *supra* note 3, at 367.