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the US market

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# Legal considerations in structuring asset-backed securities in the US market

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A successful asset-backed securities ('ABS') transaction will depend, in part, on the treatment of the transaction under relevant laws. While every ABS transaction will give rise to its own set of legal issues, sponsors should recognise that such transactions need to comply with applicable federal securities registration requirements (if not exempt from such requirements) and that they need to find an exemption from the registration requirements of the federal investment company laws.

Sponsors also need to ensure that the issuer and its assets will be neither subject to any bankruptcy proceedings nor adversely affected by the bankruptcy of any other entity. Transactions should be structured to avoid inefficient taxation of both the issuer and the investor. Other federal or state laws may also be relevant to ABS transactions in the US market.

## Securities law issues

Securitisation transactions subject to US law must comply with the Securities Act of 1933. This Act makes it illegal to offer or sell securities without proper registration or an exemption from registration.

The issuer may satisfy this requirement by filing a registration statement with the Securities and Exchange Commission ('SEC'). A registration statement must be filed with the SEC before any securities are offered to the public, and it must be declared effective before the sale of any publicly offered securities.

The SEC allows for the shelf registration of investment grade-rated ABS so that the issuer can offer ABS from time to time after the registration statement becomes effective, without getting SEC approval of the offering document for a specific ABS transaction.

New regulations promulgated by the SEC, which come into effect on 1 January 2006, expand the list of ABS types eligible for shelf registration. The list will then include certain lease-backed securities, and will codify the SEC's prior

position that certain ABS structures involving master trusts, revolving periods or pre-funding periods are eligible for shelf registration. The new regulations also facilitate the use by foreign issuers of shelf registration.

There are circumstances in which an issuer may wish not to offer ABS publicly. For example, an investor may want to review documents relating to the transaction in advance of getting a prospectus, which would not be permitted in a public ABS offering. This is often the case with less traditional asset classes. In these circumstances, issuers may rely upon an exemption for private offerings. A transaction does not involve a public offering if:

- the offer is made on a limited basis to selected persons and not pursuant to a general solicitation to the public or general advertising;
- the securities are sold only to persons who either are sophisticated in business matters or able to obtain assistance necessary to make informed investment decisions; and
- prior to making the decision to purchase the securities, the investors are either furnished with or given access to information of the type that would be obtained through the registration process.

The private offering exemption is limited to sales of securities by an issuer; any subsequent resale of securities must independently obtain an exemption from registration.

Rule 144A is a frequently-used exemption for resale of privately-offered securities. The rule provides the following advantages:

- it allows for an underwritten offering of unregistered securities to eligible institutional investors;
- it facilitates the establishment of a liquid secondary market for unregistered 'restricted' securities that otherwise would be unavailable for resale by the original holders unless they were to hold the securities for a specified holding period of at least one year; and
- it eliminates the need for issuers to take reasonable care in ensuring that the purchasers are not taking securities with a view to distributing them.

To qualify for a Rule 144A exemption, resale of restricted securities must be made to 'qualified institutional buyers' ('QIBs'). QIBs generally include institutional investors that own and invest on a

discretionary basis at least US\$100 million in securities of issuers which are not affiliated with the QIB.

Securities sold outside of the United States do not have to be registered with the SEC, so long as they meet the requirements of Regulation S under the Securities Act. Among other conditions, Regulation S requires that the offer and sale of securities is made in an offshore transaction. This means that:

- the offer is not made to a person in the United States, and either at the time the buy order is originated, the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States; or
- the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States.

Regulation S also requires that no 'directed selling efforts' (meaning any activity that conditions the market in the United States for such securities) may be made in the United States by the issuer, a distributor, any of their respective affiliates, or any person acting on their behalf. Directed selling efforts include the placing of an advertisement in a publication with a general circulation in the United States that refers to the offering of securities being made in reliance upon Regulation S, except for tombstone advertisements that meets certain requirements. Legitimate selling activities carried on in the United States in connection with registered or exempt offerings generally will not constitute directed selling efforts with respect to Regulation S offers and sales.

#### US Investment Company Act

The costs incurred through the registration and compliance with the other requirements of the Investment Company Act of 1940 are prohibitive for most ABS transactions. Thus, it is essential for the sponsor to structure the securitisation to fit within one of the following exemptions to registration under the Investment Company Act:

#### Rule 3a-7

Rule 3a-7 permits securities to be sold either to investors in a public offering so long as the securities are rated in one of the four highest rating categories or to institutional investors that meet certain minimum income or assets tests. This exemption is useful for securities that will be

marketed, at least in part, to the general public. The issuer must comply with the following additional limitations:

- the assets must consist of only those types that convert into cash within a finite time period;
- the pool of assets must be fixed at the outset of the securitisation and cannot be actively managed during the term of the securitisation to take advantage of market value changes; and
- the securities cannot be redeemable.

### Section 3(c)(1)

Section 3(c)(1) of the Investment Company Act provides an exemption where the beneficial owners of all outstanding securities of the issuer number no more than 100 at any given time. Under certain circumstances, persons or entities will be deemed as holding the issuer's securities even though these persons or entities do not themselves directly hold any of these securities.

### Section 3(c)(7)

Section 3(c)(7) of the Investment Company Act provides an exemption where the issuer will not make a public offering of the securities and the securities are solely owned by certain qualified purchasers that meet certain minimum income or asset tests.

Issuers of mortgage-backed securities generally may also rely on the exemption under section 3(c)(5)(C) of the Investment Company Act, which applies where the assets primarily consist of mortgage loans or other real estate interests.

### Bankruptcy considerations

An ABS rating should be based solely on the credit quality of the assets, free from the effects of the sponsor's actions outside the scope of the securitisation or from the credit quality of any other entity. The sponsor must ensure that the issuer itself will not become a debtor in bankruptcy. It should also ensure that the issuer and its assets will be 'bankruptcy remote', meaning that they will not be adversely affected by the bankruptcy of any other entity.

To structure an issuer which is bankruptcy remote:

- The sponsor must prohibit the issuer from engaging in activities other than those related to owning and managing the assets that are the subject of the securitisation. The issuer generally cannot incur debt or obligations other than the ABS.

- To ensure that the issuer and its assets will not be affected by the transferor's bankruptcy, the transfer of the assets to the issuer must be structured as a true sale, not a loan by the issuer to the transferor. If the transfer is considered a loan, then a court may deem the assets to be owned by the transferor, leaving the issuer with nothing more than a security interest in the assets. In the context of bankruptcy this could adversely affect the ability of investors to get paid on a timely basis or to realise on the securitised assets.
- The sponsor must document the transaction as a sale and indicate its intention to treat the transaction as a sale for accounting purposes. This may be achieved by creating a legal structure with the transaction's characteristics being consistent with the rights that one would expect to pass to a transferee in a sale. This ensures that the economic substance of the transaction is a sale, and that the risks and rewards of owning the assets have passed to the issuer.
- The issuer must be structured to minimise the risk of the issuers being included in the bankruptcy of any of its affiliates or of the transferor of the assets pursuant to the doctrine of substantive consolidation. Such doctrine provides that to prevent a perceived injustice, the separate legal status of two or more entities may be disregarded so that their assets and liabilities may be consolidated and dealt with as if the assets were held by, and the liabilities were incurred by, a single entity.
- The possibility that an issuer will be consolidated with a bankrupt transferor or affiliate may be avoided by prohibiting the issuer from engaging in any activity that would suggest that the issuer is merely the alter ego or an instrument of the bankrupt transferor or affiliate. Courts view the following as indications consolidation may be proper: the entities have officers or directors in common; the entities share an office location at the same address; the entities share operational expenses; the bankrupt entity has majority control or ownership of the issuer; and the bankrupt entity has assumed the issuer's obligations.

### Tax considerations

The primary tax concern with regard to securitisations is the avoidance of dual taxation of income from the assets – once to the investor and once to the issuer. To avoid

income taxation at the issuer level, the sponsor must establish a tax-free entity. The choice of entity will turn, in part, on whether the sponsor desires to finance the pool of assets through the issuance of debt or instruments representing beneficial ownership of the underlying assets.

#### **Debt**

Sponsors can create debt structures by using one of the following five forms of entities:

#### ***SPCs***

A special-purpose corporation ('SPC') may be created as a subsidiary of the sponsor, in which case tax at the SPC level is avoided through consolidation (for tax purposes) with the sponsor. Other structures, particularly asset-backed commercial paper, use standalone corporations nominally owned by an unaffiliated accommodation party to help achieve off-balance sheet financing. These standalone corporations are usually thinly capitalised and are generally designed to have zero taxable income through their fee structures.

#### ***Owner Trusts***

The issuer may utilise an owner trust, which is often a Delaware statutory trust. It is often unclear whether an owner trust should be treated as a grantor trust or a partnership for tax purposes. Typically, the more activity the trust permits in the way of substituting collateral or reinvesting reserve funds, the more likely a court is to find that a partnership exists if there is more than one owner. An unincorporated entity can opt to be treated as a partnership, and an unincorporated entity that is not a grantor trust and has only one owner is disregarded (ie combined with the owner) for federal income tax purposes.

#### ***LLCs***

Limited liability companies ('LLCs') may be formed under statutory authority in nearly all the states. Under the 'check the box' regulations they will either be automatically treated as partnerships (with two or more owners) or disregarded.

#### ***Partnerships or publicly-traded partnerships***

Structuring the issuer as a partnership will avoid taxation at the issuer level. However, partnerships and owner trusts or LLCs treated as partnerships for tax purposes must avoid

being classified as a publicly-traded partnership ('PTP'), which is taxable as a corporation. Interests in a PTP are either traded on an established securities market or are readily tradable on a secondary market. However, an issuer will not be a PTP if its interests are not offered to the public and fewer than 100 beneficial owners exist at any given time or if 90 per cent or more of its gross income is qualifying passive income, including interest that is not derived from the conduct of a 'financial business' (which might exclude securitisations involving fixed pools of assets).

#### ***Non-US entities***

Organising an entity in a non-US jurisdiction that does not impose income tax, such as the Cayman Islands, allows an issuer to avoid federal income tax. Non-US entities may not engage in business in the US. This is generally accomplished by imposing restrictions on the issuer's activities and investments that allow the issuer to qualify for the exception under federal tax law for being a mere trader in stock or securities.

#### ***Grantor trust or fixed investment trust***

An alternative to the debt structures discussed above is to form the issuer as a grantor trust or fixed investment trust. To obtain such classification, the trust cannot have multiple classes of ownership, other than interests that qualify as fixed coupon strips or senior and subordinated interests that pay principal on a *pro rata* basis unless a default occurs. Each owner in the trust would have an undivided beneficial interest in all of the trust's assets. (Undivided beneficial interests are central to the idea of avoiding tax at the issuer level). The trust cannot have the power to vary the investment of the trust's owners to profit from changes in the market.

#### ***REMICs***

Sponsors of multi-class mortgage-backed securities typically structure the issuer as a real estate mortgage investment conduit ('REMIC'). A REMIC is the only tax vehicle that can be used for a multi-class, sequential-pay, mortgage loan securitisation. Treatment as a REMIC generally permits the issuer to avoid federal income taxation. Any type of entity (eg partnership, trust or corporation) may elect to be treated as a REMIC so long as it satisfies the specific requirements necessary for REMIC status.

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