

# Clients & Friends Memo

## SEC Proposed Rules for Regulation of Asset-Backed Securities

May 11, 2004

In a massive new release<sup>1</sup> (the "Release"), the Securities and Exchange Commission (the "SEC") recently proposed sweeping changes to the rules governing the issuance of asset-backed securities ("ABS").<sup>2</sup> This memorandum summarizes certain of the new rules proposed by the Release (the "Proposed Rules").

The existing securities laws do not completely address current market practice in the ABS industry. The express provisions of the rules adopted by the SEC under the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are more suitable to an ordinary operating company that issues conventional debt or equity securities than to a securitization trust that issues pass-through or pay-through securities. As the SEC observed in the Release, "[m]any of the SEC's existing disclosure and reporting requirements, which are designed primarily for corporate issuers, do not elicit the information that is relevant for most asset-backed securities transactions."

In the past, the SEC bridged the gap between rule and practice with informal guidance, no-action letters and, in very limited instances, rules directed specifically to the ABS industry. However, as the SEC acknowledged in the Release, "the accumulated informal guidance, while helpful to some ABS transactions, has diminished the transparency of applicable requirements because an ABS registrant or investor seeking to understand the applicable requirements must review and assimilate a large body of no-action letters and other staff positions. This time-consuming practice decreases efficiency and transparency and leads to uncertainty and common problems."

The SEC proposes to remedy this in releasing the Proposed Rules. The Release primarily addresses four areas of securities regulation:

- **Securities Act Registration.** The SEC proposes to expand the definition of "asset-backed security" and codify certain, with some changes, staff positions relating to

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<sup>1</sup> Release Nos. 33-8419; 34-49644; File No. S7-21-04. Available for review at <http://www.sec.gov/rules/proposed/33-8419.htm>.

<sup>2</sup> This would include residential and commercial mortgage-backed securities.

registration of securities on Form S-3, including the loss of eligibility as a consequence of failure to timely file Exchange Act reports.

- **Disclosure.** The SEC proposes to add substantial disclosure requirements relating to the background, experience, performance and roles of various transaction parties, as well as historical performance data relating to the applicable party's portfolio and individual securitized pools, and, where relevant, for the assets proposed to be securitized.
- **Communication During the Offering Process.** The SEC proposes to codify, with some changes that may limit existing term sheet practice, the SEC's no-action positions with respect to (a) distribution of term sheets and computational materials to investors prior to the distribution of the final prospectus and (b) publication of research reports relating to ABS.
- **Ongoing Reporting Under the Exchange Act.** The SEC proposes to codify, with some changes, the modified reporting system under the Exchange Act that is currently in place for issuers of ABS, but also proposes to add a "responsible party" servicing compliance assessment which may impose servicer oversight responsibility on the ABS transaction sponsor.

We summarize certain highlights of the Proposed Rules below.

### **SECURITIES ACT REGISTRATION**

For purposes of registering ABS under the Securities Act, the Proposed Rules address two related topics: (a) the definition of "asset-backed security" and (b) eligibility to use Form S-3 for shelf registration.

#### **Definition of "Asset-Backed Security"**

Under current authority, investment-grade securities that meet the SEC's definition of "asset-backed security" may be registered on a shelf-registration basis on Form S-3. As defined in Form S-3, "asset-backed security" means "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders." The SEC proposes to make the changes to the definition of "asset-backed security" described below.

***Lease-Backed Securities.*** The SEC proposes to extend shelf registration to securities backed by leases with the addition of a proviso to the definition of "asset-backed security" to the effect that "in

the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.”

However, the SEC also proposes to limit the portion of the cash flow to repay the securities anticipated to come from the residual value of the physical property. For the general definition of “asset-backed security,” the residual value would not be permitted to constitute 50% (or, solely with respect to automobile leases, 60%) or more, as measured by dollar volume, of the original asset pool. However, in order to use Form S-3 for shelf registration, the residual value would not be permitted to constitute 20% (or, solely with respect to automobile leases, 60%) or more, as measured by dollar volume, of the original asset pool.

***Nature of the Issuing Entity.*** The SEC proposes to codify two staff interpretations concerning the issuing entity as conditions to the definition of “asset-backed security.” The first condition is that neither the depositor nor the issuing entity is an “investment company” under the Investment Company Act of 1940, as amended, nor will either become one as a result of the ABS transaction. The second condition is that the issuing entity must be passive and its activities must be restricted to acting in a single ABS transaction. This position excludes from the definition of “asset-backed security” any security issued by a “series trust,” where a single trust issuer holds multiple pools of assets and issues multiple series of securities.

***Synthetic Securitizations.*** The Release expresses the SEC’s view that the definition of “asset-backed security” specifically excludes “synthetic” securitizations. Synthetic securitizations often involve derivatives such as a credit default swap or total return swap to create exposure to an asset not in the pool. The SEC takes the position that the definition of “asset-backed security” is limited to those securities whose payments are primarily based on the performance of a discrete pool of assets, not by reference to assets outside the pool. This interpretation, if adopted, would materially inhibit the growth of a public market for “synthetic” securitizations and will force these transactions into the Rule 144A, Regulation S and private markets.

***Delinquent and Non-Performing Pool Assets.*** The SEC proposes to codify its interpretive position that non-performing assets may not be part of the original asset pool at the time of issuance of the ABS. The Release defines “non-performing” as a pool asset meeting the transaction-level definition of a charged-off asset or an asset meeting the charge-off policies of the sponsor.

The SEC also proposes to codify the current no-action position with respect to delinquent assets. For the general definition of “asset-backed security,” delinquent assets would not be permitted to constitute 50% or more, as measured by dollar volume, of the original asset pool. However, in order to use Form S-3 for shelf registration, delinquent assets would not be permitted to constitute 20% or more, as measured by dollar volume, of the original asset pool. According to the Release,

an asset would be deemed delinquent if any portion of a payment on such asset is 30 days or more past due. The Release also proposes additional provisions that prohibit improper re-aging or restructuring of delinquent accounts.

***Exceptions to the “Discrete Pool” Requirement.*** By its express terms, the current definition of “asset-backed security” is limited to securities that are backed by a “discrete pool” of financial assets. In the past, the SEC has stated that, notwithstanding the discrete pool requirement, the definition of “asset-backed security” would include any security that involves a master trust structure, a prefunding period or a revolving period. The SEC proposes to codify these recognized exceptions, as set forth below:

- Under the Proposed Rules, any security issued in a master trust structure would meet the definition of “asset-backed security.”
- For prefunding periods, the Release proposes a two-tier method similar to the residual values and the delinquent assets described above. For Form S-3 eligibility, up to 25% of offering proceeds may be used for subsequent purchases and the length of the prefunding period may not exceed one year. For the general definition of “asset-backed security,” a 50% threshold over a one-year period applies.
- For revolving periods, the applicable rule would depend on the type of asset that backs the related ABS. For revolving assets like credit cards and home equity lines of credit, there is no limit on the quantity of assets or the duration of the revolving period. For fixed receivables, like residential mortgage loans and auto loans, the two-tier thresholds set forth above with respect to prefunding periods would apply (*i.e.*, additional assets acquired in the revolving period may constitute up to 50% of the proceeds of the offering in a one year period, with Form S-3 eligibility limited to 25% of proceeds).

### **Securities Act Registration Statement**

The Proposed Rules would require that, as a condition for continued use of Form S-3 for new transactions (even using a currently effective Form S-3 registration statement), the reporting obligations regarding other ABS transactions established by the sponsor and the depositor have been complied with for the prior 12 months. As a result of this requirement, if a depositor fails to comply with its obligations under the Exchange Act, that depositor, and *any other currently existing or newly formed depositor that is a subsidiary of the same “sponsor”*, would be precluded from registering securities on a new Form S-3 or selling any more securities off a currently effective Form S-3 for twelve months. “Sponsor” would be defined as “the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.”

The inability to use Form S-3 is very significant to active issuers (and their sponsors) because under the Proposed Rules, registration of new ABS transactions that do not qualify for Form S-3 would only be permitted under Form S-1. Form S-1 does not permit shelf registration of ABS or incorporation by reference of other documents, thus precluding the use of term sheets and computational materials or the more efficient method of satisfying a market-making prospectus delivery requirement, if applicable. The impact, perhaps unintended, on the ability of a large, diverse sponsor to continue its securitization efforts through affiliate depositors could be severe.

### **Foreign ABS**

The Release allows ABS issued by a foreign issuer, backed by foreign assets or effected by credit enhancement provided by a foreign entity to be registered on Form S-3, as long as the registration statement also describes applicable legal, tax, and other factors that could materially affect payments on, the performance of, or other matters relating to, the assets contained in the pool or the ABS.

### **Registration of Underlying Pool Assets**

In some ABS transactions, such as resecuritizations, the underlying assets are themselves securities issued by another issuer. The Release proposes that, absent an exemption for the underlying securities under Section 3 of the Securities Act, registration of the underlying securities would be required unless all of the following three conditions are satisfied:

- Neither the issuer of the underlying securities nor any of its affiliates has a direct or indirect agreement, arrangement, relationship or understanding, written or otherwise, relating to the underlying securities and the ABS transaction;
- Neither the issuer of the underlying securities nor any of its affiliates is an affiliate of the sponsor, depositor, issuing entity or underwriter of the ABS transaction; and
- The depositor would be free to publicly resell the underlying securities without registration under the Securities Act.

If any of the three conditions is not met, the offering of the relevant underlying securities itself would be required to be separately registered as a primary offering of such securities, subject to additional conditions set forth in the Release.

## **DISCLOSURE**

The SEC is proposing new Regulation AB, which sets forth a “principles-based” set of disclosure items for ABS. While the Release generally recognizes and adopts much of the disclosure regime

reflected by current practice, the SEC proposes to add *substantial* disclosure requirements relating to the background, experience, performance and roles of various transaction parties such as the sponsor, the depositor, the servicer and the trustee, as well as historical performance data relating to the applicable party's portfolio and individual securitized pools, and, where relevant, for the assets proposed to be securitized. In many cases, these disclosures are required "to the extent material" to the investors' understanding of the ABS, although the SEC is clearly of the view that current transactions have too much unnecessary disclosure and not enough content related to the experience and performance of the transaction participants and their prior securitizations.

The discussion below focuses primarily on those aspects of the Proposed Rules that materially differ from existing disclosure standards.

### **The Sponsor**

The SEC proposes to require disclosure relating to the sponsor of an ABS transaction. In addition to basic identifying information about the sponsor, the SEC proposes to require a description of the sponsor's securitization program. The description would consist of a general discussion of the sponsor's experience in securitizing assets "*of any type*" as well as a more detailed discussion of the sponsor's experience in, and overall procedures for originating *or* acquiring and securitizing assets of, the type to be included in the current transaction. To the extent material, information regarding the size, composition and growth of the sponsor's portfolio of assets of the type to be securitized and information or factors related to the sponsor that may be materially relevant to an analysis of the origination and performance of the pooled assets would be required to be disclosed. This may include information relating to prior securitizations that have defaulted or experienced an early amortization or other performance trigger event, or any action taken outside the ordinary performance of the transaction to prevent such an occurrence. Sponsor data would also include, to the extent material, the sponsor's underwriting criteria for the assets being securitized and the extent to which they have changed, the extent to which the sponsor outsources to third parties any of its origination or purchasing functions, and the extent to which the sponsor relies on securitization as a funding source. The Proposed Rules would also require a description of the sponsor's roles and responsibilities in the securitization, including whether the sponsor or an affiliate is responsible for the selection of the pooled assets.

As mentioned above, the SEC proposes to require, if material to the transaction, historical performance data, or "static pool data." Specifically, the Proposed Rules would require three years, of delinquency and loss information for the sponsor's overall portfolio of the particular asset type involved (or information for such shorter period that the sponsor has been making originations or purchases), presented in time increments (*e.g.*, monthly or quarterly) material to the asset type. The Proposed Rules would also require, if material, static pool data on a pool level basis with respect to the sponsor's prior securitized pools involving the same asset type established during the period.

To the extent material, this information should be presented separately according to factors relevant to the pool involved, such as by asset term, asset type, yield, geography or ranges of credit scores.

### **The Depositor**

If the depositor is not the same entity as the sponsor, separate identifying information about the depositor would be required, including information on the ownership structure of the depositor and the general character of its activities other than securitizing assets. In addition, if materially different from the sponsor (such as in a “rent-a-shelf” context), information similar to that discussed for sponsors above regarding the depositor’s securitization program and its experience would be required. Disclosure would also be required regarding the continuing duties of the depositor in the securitization.

### **Issuing Entity and Transfer of Asset Pool**

Various information relating to the issuing entity and the transfer of the assets would be required. This would include the issuing entity’s capitalization, the amount paid or to be paid by the issuing entity for the pooled assets (including the principles followed in determining such amount), as well as information on any expenses incurred in connection with the selection and acquisition of the pool to be payable from offering proceeds. To the extent material, disclosure would also be required regarding whether security interests granted are perfected, whether the issuer can become subject to a bankruptcy or receivership proceeding, and whether the assets of the issuing entity could become part of the bankruptcy estate of the sponsor, originator, depositor or other seller of pool assets.

### **Servicers**

The Proposed Rules define “servicer” as any person responsible for the management or collection of the pooled assets or making allocations or distributions to holders of the ABS. This definition would not include trustees *if* the trustee receives the allocation or distribution information from the servicer. The proposed disclosure requirements would require information regarding all servicers, including primary servicers that service 10% or more of the pool assets. Required information would include a general discussion of the servicer’s experience in servicing assets *of any type*, as well as a more detailed discussion of the servicer’s experience in, and procedures for, servicing assets of the type included in the current transaction. In addition to size, composition and growth of the servicer’s portfolio-serviced assets of the type to be securitized, the Proposed Rules would require information regarding the servicer’s collection practices, billing processes, computer systems and back-up systems. Other material information could include whether the servicer has been involved in any prior transactions that have defaulted or experienced an early amortization or other performance triggering event because of servicing, the extent to which the servicer outsources its responsibilities, and whether there has been any material noncompliance with

servicing criteria in other transactions. Other required disclosure include any material changes to the servicer's policies or procedures in servicing assets of the same type during the past three years, as well as information regarding the servicer's financial condition where it could have a material impact on one or more aspects of servicing.

### **Originators**

Recognizing that some ABS transactions involve pool assets that were not originated by the sponsor, the Proposed Rules would require information regarding originators that have originated 10% or more of the pool assets. The required information would include a brief description of the originator, and, to the extent material, a description of its origination program and experience, including the size and composition of the originator's portfolio as well as other information material to an analysis of the performance of the pool assets, such as the originator's underwriting criteria.

### **Pool Assets and Sources of Pool Cash Flow**

The Proposed Rules would require that the solicitation, credit granting or underwriting criteria used to originate or purchase pool assets be described, as well as the selection criteria for the asset pool. Static pool data of the type discussed above would be required for the pool in the current transaction to the extent material (*e.g.*, if the pool is a seasoned pool).

If the asset pool includes leases or other assets and a portion of the cashflow is anticipated to come from the residual value of an underlying physical asset, the Proposed Rules would require additional disclosure on how residual values are estimated and derived, statistical information regarding estimated residual values and historical statistics on term-end rates and residual value realization rates. Information would also be required regarding the manner and process in which residual values are to be realized, including disclosure of the entity that will convert the residual values into cash and the experience of such entity.

### **Significant Obligor**

Under the Proposed Rules, a significant obligor would trigger additional disclosure. A "significant obligor" is defined as:

- An obligor or a group of affiliated obligors on any pool asset or group of pool assets if such pool asset or group of pool assets represents 10% or more of the asset pool; or
- A single property or group of related properties securing a pool asset or group of pool assets if such pool asset or group of pool assets represents 10% or more of the asset pool; or

- A lessee or group of affiliated lessees if the related lease or group of leases represents 10% or more of the asset pool.

Required descriptive information regarding a significant obligor would include its identity, its form of organization, the general character of its business, the nature of the concentration that causes it to be a significant obligor, and the material terms of the pool assets or agreements with the significant obligor. If the pool assets relating to a significant obligor represent 10% or more but less than 20% of the asset pool, selected financial data required by Item 301 of Regulation S-K would need to be provided. Item 301 requires, among other things, for each of the last five fiscal years (or the life of the significant obligor and its predecessors), the following financial data (subject to appropriate variation to conform to the nature of the obligor's business): net sales or operating revenues; income (loss) from continuing operations; total assets; and long-term obligations. If the pool assets related to a significant obligor represent 20% or more of the asset pool, audited financial statements meeting the requirements of Regulation S-X would be required. If the significant obligor is an asset-backed issuer and the pool assets related to the significant obligor are ABS, the SEC would require ABS disclosure conforming to much of the new Regulation AB rather than the foregoing financial information.

### **Credit Enhancement**

Under the Proposed Rules, the extent of information required of a significant credit or liquidity enhancement provider would essentially be the same as that of a significant obligor. However, the analysis of whether the amount of the enhancement exceeds the 10% and 20% thresholds would not be based on the current value of the enhancement, but rather on the payments that the enhancement provider is liable or *contingently liable* to provide. So, for example, if a swap is currently out of the money and no payments are required, but the swap provider would be contingently liable for more than 10% or 20% of the cashflow supporting a class (assuming interest rates change), disclosure would be required on the same basis as any other form of 10% or 20% enhancement, even though the probability of payment might be remote.

### **Transaction Structure**

Although the SEC does not propose to change significantly the disclosure for the structure of the ABS, as a result of increased emphasis in the market on levels of fees and expenses involved in an ABS transaction, the SEC proposes to require a separate table itemizing all estimated fees and expenses to be paid or payable out of the cashflows for the transaction, including the amount of the fee or expense, its general purpose and the party receiving such fee or expense. The Proposed Rules would also require disclosure of parties with authority to make decisions regarding the investment and use of cash generated by the pool assets, as well as information on the ownership of any residual or retained interests.

### **Affiliations in Certain Relationships and Related Transactions**

Where material to an investor's understanding of the ABS, the Proposed Rules would require disclosure of any relationships, agreements, arrangements and the like entered into outside of the ordinary course of business or on terms other than would be obtained in an arm's length transaction with an unrelated third party (apart from the ABS transaction) between the sponsor, the depositor or the issuing entity, and any other material party to the transaction (e.g., servicer, trustee, 10% originator, significant obligor, 10% enhancement provider, or underwriter). The Instructions to the Proposed Rules specifically address the disclosure of material credit arrangements relating to the pool assets, such as providing a warehouse line of credit to fund originations or acquisitions pending securitizations. In addition, affiliations between the sponsor, the depositor and the issuing entity with the servicer, the trustee, a significant originator, obligor or enhancement provider, an underwriter or any other material parties to the transaction would also require disclosure.

### **COMMUNICATIONS DURING THE OFFERING PROCESS**

Under the heading "Communications During the Offering Process," the Release addresses two discrete topics: (a) the use of term sheets and computational materials in the offering of ABS and (b) the publication by broker/dealers of research reports concerning ABS around the time of a registered offering of similar ABS.

The SEC declined to use the Proposed Rules to implement any proposals to liberalize current restrictions on the use of communications in the offering process, observing that such proposals raise broader issues having implications for non-ABS offerings as well as ABS offerings. The Release indicates that the Division of Corporate Finance is developing recommendations for reforms to the current restrictions on communications in connection with all securities offerings, but no indication was given as to when such recommendations might be made. This section of the Proposed Rules represents primarily a codification of existing SEC rules and informal positions, with certain clarifications and other changes, the most significant of which are summarized below.

#### **ABS Informational and Computational Material**

***New Definition.*** The Release proposes the adoption of a streamlined approach to regulation of the use of term sheets and computational materials in ABS offerings. The centerpiece of the new approach is the adoption of a single definition of "ABS informational and computational material" to prescribe all permissible varieties of such materials. The new definition refers to written communications consisting *solely* of one or more enumerated categories of information. It permits the inclusion of some categories of information that were not clearly permitted under previous authority but, in its current form, also appears to omit (perhaps inadvertently) some types of information that are now commonly included in term sheets for certain types of ABS offerings.

- The new definition allows the inclusion in term sheets of “static pool data,” as described above under “Disclosure,” concerning assets that are similar to the assets to be included in an upcoming ABS offering, but which are not the actual securitized assets themselves. It is suggested that this type of information can be used to illustrate the historical performance of assets originated or purchased by the sponsor of an ABS offering during defined periods in the past, and that such information may be used by potential investors in evaluating the future performance of the assets to be included in an ABS offering. This portion of the new definition appears to be in response to growing requests by investors in residential MBS transactions for delivery of information, prior to the availability of a final prospectus, relating to the originators’ prior experience with certain types of residential mortgage loans. The new definition does not allow the inclusion of static pool data concerning assets originated or acquired by competing sponsors for comparative purposes.
- The new definition specifically allows term sheets to identify the issuer of an ABS offering, but does not, in its present form, specifically allow the identification of other key parties in an ABS transaction, such as servicers, trustees, rating agencies, credit enhancers and other important players. In addition, the new definition does not expressly permit the inclusion of other structural information commonly included in structural term sheets, such as servicing terms, ratings, legal investment, tax and ERISA information.
- Existing authority expressly sanctions the inclusion in collateral term sheets of information concerning the assets underlying an ABS offering on a pool-wide, statistical basis. The Release clarifies that it is also permissible to provide information on a specific asset-by-asset basis, with due consideration for the privacy concerns of individual borrowers. This clarification is consistent with long-standing practice in the CMBS industry of providing information on specific loans and the related collateral properties, although the practice was not universally acknowledged as permissible by participants in other markets, such as the RMBS market.

***New Filing Deadline.*** The Proposed Rules eliminate the existing inconsistency in the filing deadlines for different types of term sheets and computational materials. Under the Proposed Rules, all types of ABS informational and computational materials will be required to be filed with the SEC by the later of (i) the due date for the filing of the related final prospectus and (ii) two business days after the first use of such materials.

***Information Provided to Analytics Firms.*** The Release discusses proposed requirements for filing of information that is provided to third-party analytics firms with respect to ABS offerings. These firms use data provided by the transaction parties to enable potential investors to perform their own analytics and computations in making their investment decisions. In general, the Release clarifies

that only the information provided to the analytics firm must be filed as ABS informational and computational materials (and not the myriad outputs that a particular investor may achieve by manipulating the information through the facilities of the analytics firm). However, the discussion suggests that an affiliate relationship between an issuer or underwriter with such an analytics firm or an unusual compensation structure between the firms may change the conclusion as to which materials must be filed.

***Aggregation of Information Permitted.*** The Release also clarifies that, where data may have been provided to different investors and to analytics firms at different times and in different forms, it is permissible to aggregate the data and file it in a consolidated form, so long as such aggregation does not result in omitting any information that was required to be filed.

***Limitation on Restrictive Legends.*** The Proposed Rules continue the current requirement that term sheets and computational materials carry a specified legend. However, the Release indicates that it is not permissible to include disclaimers regarding the accuracy or completeness of the information or to include additional legends indicating that such materials do not constitute a prospectus or indicating that the materials are privileged or confidential. The inclusion of such statements on a term sheet or in computational materials is inconsistent with the incorporation of such materials in the issuer's registration statement upon filing with the SEC.

***Elimination of Hardship Exemption.*** In light of improvements in the SEC's EDGAR system that make possible the electronic filing of materials in various software formats, the Proposed Rules modify the current EDGAR rules to eliminate the ability of issuers to file computational materials in paper form rather than electronically.

***Anti-Abuse Rule.*** The Proposed Rules contain a provision specifying that they do not provide an exemption for any communications that may technically comply with the Proposed Rules, if the primary purpose or effect of such communications is to condition the market for another offering, or if the communications are part of a scheme to evade the requirements of Section 5 of the Securities Act.

### **Research Reports**

The Proposed Rules codify the provisions of an SEC no-action letter issued in 1997 concerning the publication of research reports covering ABS. Specifically, the SEC proposed new Rule 139a, which provides a safe harbor under which the publication by a broker/dealer of research reports concerning a particular type of ABS at a time when such broker/dealer is participating in an offering of similar ABS would not be deemed to be an illegal offer of, or a non-conforming prospectus for, such ABS. The new rule does not contain any significant variation from the existing authority on the subject.

## **ONGOING REPORTING UNDER THE EXCHANGE ACT**

The SEC proposes to codify the basic modified reporting system under the Exchange Act that is currently in place for ABS issuers. Foreign ABS issuers would report on the same forms as domestic issuers. ABS issuers would be required to file periodic distribution and pool performance reports on a new Form 10-D, annual reports on Form 10-K and current reports on Form 8-K. Contrary to the current practice of some issuers, the SEC will require that separate reports be filed for each issuing entity (*i.e.*, no combined reporting covering multiple issuing entities of the same depositor).

### **Form 10-D (Periodic Reports)**

The SEC proposes to require a new Form 10-D be used to file the periodic distribution and pool performance reports of an issuing entity that are currently filed under Form 8-K. The timing of the filing would be the same as under the current regime (within 15 days after each required distribution date), regardless of whether a distribution was made or a distribution date statement was actually prepared. The Form 10-D must be signed by the depositor or the servicer. The trustee may not sign.<sup>3</sup>

Form 10-D would require disclosure in a number of broad categories, including cash flows received, updated pool composition information, material modifications, extensions or waivers to pool asset terms and breaches of material pool asset representations or transaction covenants. All the required information may be included in the distribution date statement delivered to investors (and filed with the SEC). The SEC did not propose a standard format for the presentation of the required information, stating that the disclosure should be tailored to the nature of the specific asset pool and transaction.

Form 10-D would also cover legal proceedings, sales of securities and use of proceeds, defaults upon senior securities, submission of matters to a vote of securityholders, and updated financial information on significant obligors of pool assets and significant enhancement providers, as further described under "Disclosure" above.

### **Form 10-K (Annual Reports)**

The SEC proposes to add additional disclosure items to the Form 10-K filed by ABS issuers and to codify, with certain modifications, the staff's previous statement regarding Section 302 Sarbanes-

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<sup>3</sup> It is not clear whether this would preclude the trustee from signing on behalf of the depositor under a power of attorney, as is the practice in many Exchange Act reports today. In addition, as indicated elsewhere in this memorandum, the term "servicer," as defined in the Proposed Rules, includes "any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed securities." Therefore, in many deals, the trustee may be a "servicer" and may be permitted to sign.

Oxley certifications. The Form 10-K report must be signed by the depositor or the servicer.<sup>4</sup> The SEC indicated that, contrary to the staff's position in prior no-action letters, a Form 10-K is required to be filed for those issuing entities that issued ABS near the end of its fiscal year where no distributions were made to investors prior to the end of such fiscal year.

***Servicer Compliance Statement.*** As is the case under the current system, the SEC proposes to require a compliance statement by the servicer to be filed as an exhibit to the Form 10-K. This will address the servicer's compliance with its servicing obligations under the specific transaction agreement. If multiple servicers are involved for a pool of assets, the master servicer, each affiliated servicer, each unaffiliated servicer that services 10% or more of the pool of assets, each special servicer and each other person performing a material aspect of servicing the pool would be required to provide the statement.

***Servicing Criteria Compliance and Accountant's Attestation.*** The SEC believes that the criteria set forth in the Uniform Single Attestation Program for Mortgage Bankers (USAP) is not designed for the variety of asset classes included in ABS offerings today. In addition, the SEC does not believe that USAP addresses all aspects of the servicing function that may be important in servicing ABS. This is because multiple unaffiliated third parties may be responsible for servicing an ABS and under the current system only the servicer's compliance with the transaction agreement is addressed. There is a gap because the compliance by other parties involved in the ABS, such as a trustee or paying agent, is not addressed. As a result, the SEC proposes to require one "responsible party" to provide a report on assessment of compliance with the SEC's proposed servicing criteria, together with an attestation report of a registered public accounting firm, to be filed as an exhibit to the Form 10-K report. The "responsible party" must be the same party that signs the Form 10-K report (either the depositor or the servicer). The SEC proposes this to be a disclosure-based system. Accordingly, if material servicer non-compliance is reported, the SEC will not take any action.

The SEC recognizes that the current practice among servicers in performing compliance reviews appears to be a "platform" level review across all transactions involving a particular asset class and not a transaction specific review. The SEC proposes to accept the "platform" level of assessment for the assessment report.

The assessment must address the entire servicing function (which functions, for any ABS, could be performed by multiple parties (e.g., primary servicers, master servicers, trustees, etc.)). Since a responsible party may not be involved with all the aspects of servicing, the SEC proposes to allow such party to "reasonably rely" on information that it receives from unaffiliated parties in making its

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<sup>4</sup> See footnote 3.

assessment report. The information relied upon by the responsible party could be based on a “platform” level assessment by that unaffiliated third party.

The SEC proposes a set of servicing criteria to be used by the responsible party and accounting firm in assessing servicing compliance. There are four categories of servicing criteria: general servicing considerations, cash collection and administration, investor remittances and reporting and pool asset administration. The proposal allows the responsible party to exclude any servicing criteria that is not applicable to servicing a particular asset class. Under an alternate proposal, the SEC would allow the responsible party to exclude certain criteria, even if the criteria are applicable to the specific asset class. The responsible party would be required to identify what criteria it excluded and provide a reason for its exclusion.

If the report identifies any material instance of noncompliance with the SEC’s proposed criteria, the report must identify the “material impacts or effects that have affected or that may reasonably be likely to affect” pool performance, servicing of the pool or payments on the ABS. Disclosure of noncompliance would be required if noncompliance occurred during the relevant period of the report, regardless of any correction that occurred before the end of the period.

The SEC proposes that a registered public accounting firm would be required to attest to the assessment of compliance made by the responsible party, which attestation would be filed as an exhibit to the Form 10-K report. The attestation would need to state the opinion of the accountant as to whether the responsible party’s assessment of compliance with the servicing criteria was fairly stated in all material respects, or must include an opinion that such an opinion cannot be provided. In addition, the attestation must not include any restricted use language.

### **Sarbanes-Oxley Certification**

The SEC has codified, with some modification, its previous releases regarding compliance by ABS issuers with the certification requirement of the Sarbanes-Oxley Act. The certification, which would continue to be filed, as under current practice, as an exhibit to the Form 10-K report, would continue to cover the absence of material misstatements and omissions in all Exchange Act reports taken as a whole for the covered period. It would be expanded to require an affirmative statement that all information required under the Proposed Rules (rather than under the transaction documents) is contained in the Exchange Act reports and would reference the compliance review of the servicer and the servicer compliance statement required under the Proposed Rules as a basis for certification that the servicer has complied with its obligations under the servicing agreement and that any material noncompliance with the prescribed “platform” servicing criteria has been disclosed.

It should be noted that (i) given the expansive definition of “servicer” contained in the Proposed Rules, which encompasses not only primary servicers, but “any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed securities,” and (ii) the requirement for multiple servicer compliance statements under the Proposed Rules, the scope of the Sarbanes-Oxley certification would include the activities of a securities administrator (including a trustee that performs bond computations using raw servicing data supplied by the servicer), a master servicer, each affiliated servicer, each unaffiliated servicer who services 10% of the pool and each special servicer.

The Sarbanes-Oxley certification would be required to be signed by the senior officer in charge of securitization of the depositor or by the senior officer in charge of the servicing function of the servicer (or of the master servicer if multiple servicers are involved). The trustee would not be permitted to sign the Sarbanes-Oxley certification.<sup>5</sup>

#### **Form 8-K (Current Report)**

In March 2004, the SEC adopted amendments to expand the number of events reportable on Form 8-K, as well as to shorten the filing deadline for most items to four business days after the occurrence of the event requiring disclosure. The SEC now proposes to clarify the application of the Form 8-K reporting items for ABS, as well as introduce new reporting items specific to ABS issuers.

With respect to the Form 8-K reporting items as previously amended, the SEC proposes to clarify that a reportable event for an ABS issuer would also include the occurrence of an early amortization, performance trigger or other event, including an event of default, that would materially alter the payment priority, distribution of cash flows or amortization schedule for the ABS. The new items that are proposed to be reported on Form 8-K for ABS issuers include ABS informational and computational materials that are required to be filed, change of servicer or trustee, change of credit enhancer or other external support, and failure to make required distribution to securityholders.

Also, a new ABS item would be added for sales of additional securities. This would require disclosure of information regarding any sale of securities that are either backed by the same asset pool or are otherwise issued by the same issuing entity, whether or not registered under the Securities Act. Accordingly, information would need to be included regarding the privately offered, below investment grade classes of securities issued in an ABS offering. This information would include the consideration received for such securities, the underwriters’ compensation, the names of the investors or class of investors to whom such securities were sold and the exemption from registration being claimed.

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<sup>5</sup> See footnote 3.

In addition, the SEC proposes to add a new item to Form 8-K for ABS issuers to address cases where the final pool at the time of issuance of the ABS is different from the pool of assets described in the final prospectus. Essentially codifying the current position of the SEC staff, disclosure of the composition of the final pool would be required if, in connection with a transaction off a shelf registration statement on Form S-3, the pool of assets at the time of issuance of the ABS differs by 5% or more from the pool of assets described in the prospectus.

### **TRANSITION PERIOD**

The SEC proposes that any new registration statements filed more than three months after the effective date of the Proposed Rules would be required to comply with all of the Proposed Rules, as adopted. Similarly, takedowns off of existing shelf registration statements occurring more than 3 months after the effective date will be subject to the new rules. With respect to any ABS that are currently outstanding, the SEC proposed that compliance with the Proposed Rules governing ongoing reporting under the Exchange Act would be required for fiscal years ending six months after the effective date of the Proposed Rules.

### **CONCLUSION**

This memorandum summarizes certain notable changes proposed by the SEC. Partners in our Capital Markets Department are actively involved with industry and legal organizations in formulating responses to the Proposed Rules. During the next few weeks, various groups will organize and strategize concerning appropriate responses, clarifications, expansions or other reactions to specific sections of the Release.<sup>6</sup> We welcome your input regarding the impact these Proposed Rules would have on your current businesses, and will keep you updated on developments in the comment process. If you have any questions regarding the Proposed Rules or any other matter addressed in the Release, please call any of the partners in the Capital Markets Department.

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<sup>6</sup> The SEC has requested comment from the public regarding the Proposed Rules as well as any additional areas that should be addressed regarding the registration, disclosure or reporting requirements for asset-backed securities under the Securities Act or the Exchange Act. According to the Release, the comment period expires on July 12, 2004.

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