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Clients&FriendsMemo

SEC Proposes Significant Enhancements to Regulation of Asset-Backed Securities

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On April 7, 2010, the Securities and Exchange Commission (the "**SEC**") released proposed rules (the "**Proposed Rules**") that would significantly revise Regulation AB ("**Reg AB**") and other laws governing offerings, sales and reporting for asset-backed securities, including mortgage-backed securities ("**ABS**"), and would significantly broaden the range of transactions covered by such regulations.[1] Reg AB was initially adopted in January 2005 and established a tailored set of rules governing the issuance of ABS. Reg AB was adopted some 8 months after it was initially proposed by the SEC, following an industry comment process, with an effective date of March 8, 2005.[2] Although the SEC adopted Reg AB to "address comprehensively the registration, disclosure and reporting requirements" for ABS,[3] the perceived role of ABS in the recent financial crisis has caused the SEC to re-think the regulation of the ABS markets just over 5 years after the initial effective date of Reg AB.

Among other things, the Proposed Rules require detailed loan-level disclosure for most ABS (which the SEC declined to do in the original Reg AB[4]), revamp the process for registration of ABS and condition the availability of certain exemptions from registration for "structured finance products" (which is a newly-introduced definition that is broader than "asset-backed security") on the availability of disclosure equivalent to that required in an SEC registered offering of those instruments, thus regulating the private securities market in an unprecedented way.

The Proposed Rules are intended to improve investor protection and promote more efficient ABS markets by:

- providing investors with timely and sufficient information for publicly and privately issued ABS;

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1 See Asset-Backed Securities, SEC Release Nos. 33-9117; 34-61858, File No. S7-08-10, Proposed Rule (April 7, 2010), available at http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

2 See Asset-Backed Securities, 70 Fed. Reg. 1506-1631, at 1506 (January 7, 2005), available at http://www.sec.gov/rules/final/33-8518fr.pdf.

3 See Id. at 1507.

4 See Id. at 1509.

- reducing the likelihood of undue reliance on credit ratings; and
- restoring investor confidence in representations and warranties for securitized assets.[5]

The Proposed Rules would modify the treatment of ABS under the Securities Act of 1933, as amended (the "**Securities Act**"), and the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") by:

- revising Securities Act registration procedures and prospectus filing and delivery requirements for ABS;
- requiring enhanced disclosure and reporting for ABS; and
- revising safe harbor provisions for privately-placed ABS.

The SEC is soliciting comments on the Proposed Rules, with the comment period running for 90 days after the Proposed Rules are published in the Federal Register. Cadwalader will be working with industry groups and individual clients in analyzing and commenting on the Proposed Rules. The Proposed Rules will not apply to ABS issued before the SEC enacts the Proposed Rules[6] and therefore any transactions completed prior to the effective date specified by the SEC will be "grandfathered".[7]

This memo summarizes the Proposed Rules and analyzes some of the effects the rules would have on the ABS market if enacted by the SEC in their proposed form.

I. Revisions to Securities Act Registration Procedures for ABS

New Shelf Eligibility Criteria

One of the major objectives of the Proposed Rules is to reduce the likelihood of undue reliance by investors on credit ratings. In furtherance of this objective, the SEC is proposing to remove the current requirement that securities eligible for offering under a shelf registration statement must be rated investment grade at the time of offering.[8] In place of the investment grade rating, the Proposed Rules introduce the following four new criteria for shelf eligibility, each as further described below:

- 5% vertical risk retention;
- periodic opinions regarding repurchase obligations;

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5 See Proposed Rules at 13.

6 See Proposed Rules at 22.

7 However, with respect to resecuritizations, the SEC has indicated that loan-level disclosure requirements would apply to the assets underlying the resecuritized securities, regardless of whether those securities were issued prior to the effective date.

8 See Form S-3, General Instructions (I)(B)(5).

- a depositor CEO certification of asset adequacy; and
- a perpetual Exchange Act reporting obligation.

These criteria are only applicable to securities registered on a shelf registration statement and do not apply to securities registered on a stand-alone basis or to privately offered securities (in each case, with the exception of the proposed Rule 144A ongoing information requirements described below), although registration of securities on a stand-alone basis would subject them to a longer review period since the new registration statement would need to be filed and would be subject to review and comment by the SEC.

1. **5% Vertical Risk Retention**: The SEC has taken the position that securitization with sponsors that have continuing risk exposure are likely to be of higher quality than those without such continuing exposure. Accordingly, the SEC is proposing a requirement that the sponsor of an asset-backed securities offering, or one of its affiliates, retain a minimum of 5% of the nominal amount of each tranche sold or transferred to investors. In the case of a revolving-asset master trust, the requirement could be satisfied by retaining an owner's interest whose cash flows are at least equal to 5% of those paid to investors, at all times and in all scenarios, and represents a claim to the same pool of assets as the securities held by investors and an equivalent priority to those securities.[9] Other important features of this proposal include:

   - In each case, the sponsor's exposure must be net of any hedge that directly relates to the securities or exposures taken; however hedge positions that relate to overall market movements, such as interest rates, currency exchange rates or the overall value of a particular broad category of ABS, would be permitted.

     ***Note**: The reference to hedges that relate to "the overall value of a particular broad category of ABS" appears to be a specific reference to hedges using indices such as the ABX or CMBX. This type of sector-specific hedging would not insulate a sponsor from the specific credit risk of aggressive underwriting of assets in a particular transaction, and therefore would not undermine the SEC's objective of encouraging disciplined underwriting of assets to be securitized. As long as a sponsor underwrites assets in accordance with standards that reflect the broader market, it should be able to hedge general market risk.*

   - The economic interest required to be retained is measured at issuance (or origination, in the case of the originator's interest) and is required to be maintained as long as non-affiliates of the depositor hold any of the issuer's securities sold in the offering.

     ***Note**: The SEC stated that it considered the impact of the risk retention requirement on financial reporting consolidation under the newly issued Financial Accounting Standards No. 166 and 167, but noted that although risk retention would give the retaining party a*

[9] See Proposed Rule 17 C.F.R. § 239.45(b)(1)(i)(B) at 506 and Proposed Rules at 49.

variable interest in a variable interest entity, that feature alone, without the right to direct the activities of the variable interest entity would not by itself give the retaining party a sufficient "controlling financial interest" that would result in consolidation. Nevertheless, the impact of risk retention on financial reporting consolidation will need to be considered on a deal-by-deal basis.

2. **Quarterly Third-Party Opinion Regarding Repurchase Obligations**: The SEC is concerned about ensuring that the representations and warranties given by originators and sponsors about the assets in a securitization pool provide meaningful protection to investors, thereby encouraging sponsors to include higher quality assets in their pools. The Proposed Rules therefore require that, as a condition to shelf eligibility, the party making representations and warranties will be obligated to furnish a third-party opinion regarding any asset as to which the trustee has alleged a breach of a representation and warranty, but which was not repurchased or replaced because the representing party asserted that the asset did indeed comply with the representation or warranty. The third-party opinion would be required to confirm that the asset did not violate a representation or warranty in the pooling and servicing agreement or other transaction document, and would be required to be furnished to the trustee on a quarterly basis.

   ***Note**: The SEC did not specify what sort of third-party would be required to give such an opinion, although it does request comment on whether such opinions should be rendered by lawyers or third-party diligence firms. The SEC also failed to specify any standard under which the question of whether or not a breach has occurred should be analyzed. Contractual disputes rarely arise in instances where the language of a contract is clear and incontrovertible. Perhaps an appropriate standard might be that the party declining to repurchase an asset in response to an alleged breach has a reasonable good-faith position that a breach has not occurred or some other standard short of an unqualified opinion that there has been no breach.*

   ***Note**: The Proposed Rules are not proposing that a sponsor or originator make any specific representations or warranties nor do the Proposed Rules propose any specific remedies for a breach of a representation or warranty. The Proposed Rules are focused on enhancing the enforcement of the contractual remedies that are already included in the transaction documents.*

3. **Depositor CEO Certification**: Another new condition for shelf eligibility is a requirement that the registrant file a certification signed by the CEO of the depositor certifying that, at the time of each offering or takedown off of a shelf, to such person's knowledge, "the securitized assets backing the issue have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows at times and in amounts necessary to service

any payments of the securities as described in the prospectus," and that such person has "reviewed the prospectus and the necessary documents to make such certification."[10]

> ***Note**: The Proposed Rules require that the certification be filed in the form specified, without any alterations. Any concerns with providing the certification, such as risks or probability of non-payment would need to be addressed through the disclosure in the prospectus and the disclosure may be taken into account when executing the certification.*[11]

> ***Note**: The proposed certification, as written, could be read to address the adequacy of required cash flows on the underlying securitized assets to make promised payments on the ABS to be issued, rather than the likelihood that the underlying obligors will perform in accordance with their payment obligations. However, the words "taking into account internal credit enhancements" (as well as the request for comment as to whether, in the alternative, the sponsor should be required to disclose its estimates of default probability for all tranches in the transaction) indicate that the SEC does intend for the statement to address the credit quality of the underlying securitized assets.*

4. **Ongoing Undertaking to File Exchange Act Reports**: The last new condition for shelf eligibility is a requirement that a registrant undertake to file Exchange Act reports under Section 15(d) of the Exchange Act as long as any non-affiliate of the depositor holds any of the issuer's securities sold in registered transactions. This requirement would effectively eliminate the option of a registrant to suspend its Exchange Act reporting requirements at the end of the year of issuance of the securities if such securities are held of record by less than 300 persons (which is very often the case for ABS deals). The prospectus would also be required to disclose that the registrant has undertaken to, and will, file such reports with the SEC, and such statement would be subject to the same liability as other disclosures in the prospectus.[12]

> ***Note**: Although the Proposed Rules would add significant new eligibility criteria to the use of a shelf registration statement for ABS, the elimination of the investment grade ratings criterion would, for the first time, allow certain below investment grade tranches of ABS deals that were previously offered in simultaneous private offerings to be conveniently registered on a shelf basis.*

To enhance compliance with the new eligibility criteria, the Proposed Rules provide that if a registrant is not currently holding the required retained risk or has not been in compliance with the other filing/reporting requirements for the last 12 months with respect to previous offerings, it will

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[10] See Proposed Rule 17 C.F.R. § 239.45(b)(1)(iii) at 507 and Proposed Rule 17 C.F.R. § 229.601(b)(36) at 373.

[11] See Proposed Rules at 71.

[12] See Proposed Rule 17 C.F.R. § 239.45(b)(1)(iv) at 507.

not be eligible to register securities on a shelf registration statement. See "*Additional Requirements for Using Form SF-3*" below.

> ***Note**: The extension of Exchange Act filing requirements for the life of an ABS deal also extends the requirement for annual Sarbanes-Oxley certifications, annual servicer compliance statements, assessments of compliance with servicing criteria, accountant attestations and other required reports for the life of the transaction. This requirement, combined with the possibility of loss of shelf eligibility for failure to timely file required reports, will increase the burden on sponsors of securitizations to monitor the ongoing reporting apparatus for transactions, and may be perceived as raising the barriers to entry into the ABS markets for smaller lenders.*

New Registration Forms for ABS

The Proposed Rules would establish new registration statement Form SF-1 (non-shelf registration) and Form SF-3 (shelf registration) to be used for registration of "asset-backed securities" (as such term is defined in Item 1101 of Reg AB).[13] Current registration statement Form S-1 and Form S-3 would be revised to exclude ABS.[14]

Form SF-1 and Form SF-3 would generally follow the previous registration scheme for ABS under Form S-1 and Form S-3, respectively, with the following important differences:

- **Shelf Eligibility Criteria**: The requirement that securities be rated investment grade by a nationally recognized statistical rating organization (a "**NRSRO**") would be replaced with 4 new eligibility criteria as described above under "*New Shelf Eligibility Criteria;*"
- **Single Document Prospectuses**: An instruction to Form SF-3 would require ABS issuers to file a single form of prospectus for each asset class at the time of effectiveness of a Form SF-3 registration statement.[15] ABS issuers would then be required to use a single prospectus for each offering. Issuers would be able to include bracketed information in the form of prospectus filed with the Form SF-3 registration statement, and then include only the disclosure applicable to a specific offering in the prospectus provided to investors. This proposal would eliminate the current practice in the public ABS markets of using a "base prospectus" supplemented by a "prospectus supplement".[16]
- **One Depositor/One Asset Class per Registration Statement**: To facilitate investor understanding and access to prospectuses, the Proposed Rules restrict each Registration

[13] See Proposed Rules at 38; proposed Form SF-1 at 492 and proposed Form SF-3 at 503.

[14] See Proposed Rules at 16; 17 C.F.R. § 239.11 at 489 and 17 C.F.R. § 239.13(b)(5) at 491.

[15] See proposed Form SF-3, General Instruction (IV) at 520.

[16] See Proposed Rules at 99.

Statement to a single depositor and single asset class. This proposal would eliminate the current practice of registering multiple base prospectuses and prospectus supplements on a single registration statement to accommodate different asset classes.

***Note**: The SEC has indicated that resecuritizations are a separate asset class from the underlying security and, therefore, that the resecuritization ABS and the underlying ABS would need to be registered on separate registration statements even if the depositor is the same.*

Additional Requirements for Using Form SF-3.

The Proposed Rules also contain the following additional requirements for using Form SF-3:

- If the sponsor or an affiliate of the sponsor was required to retain risk with respect to previous ABS offerings involving the same asset class, then, at the time of filing the registration statement, such sponsor or affiliate must still be holding that risk.[17]
- If the depositor or an issuing entity previously established, directly or indirectly, by the depositor or any affiliate of the depositor was, at any time during the 12 calendar months immediately preceding the filing of a registration statement, required to comply with the requirements of Form SF-3 with respect to a previous offering of securities involving the same asset class, the depositor and each such issuing entity must:
    - have timely filed all transaction agreements containing the required provision relating to third-party opinion review of repurchase demands;
    - have timely filed all required certifications of the depositor's CEO;
    - have filed all reports that they had undertaken to file during the previous 12 months (or such shorter period during which the depositor or issuing entity had undertaken to file reports) as would be required under Section 15(d) of the Exchange Act if they were subject to the reporting requirements of that section;[18] and
    - represent in the registration statement that they have complied with the preceding 3 filing requirements and the risk retention requirement.[19]
- The threshold amount of change to the characteristics of an asset pool between the date of the final prospectus and the issuance date that triggers a filing under Item 6.05 of Form 8-K would be lowered from 5% to 1%. In addition, the failure by the depositor, an issuing entity created by

[17] See proposed Form SF-3, General Instructions (I)(A)(1) at 511.

[18] See proposed Form SF-3, General Instructions (I)(A)(2) at 511-512.

[19] See proposed Form SF-3, General Instructions (I)(A)(3) at 512.

the depositor or an affiliate of the depositor to make a timely filing under Item 6.05 of Form 8-K with respect to ABS involving the same asset class would result in the loss of form eligibility.[20]

- An ABS issuer wishing to conduct a takedown off of an effective shelf registration statement would be required to evaluate on a quarterly basis whether it complied with the proposed new eligibility requirements as of the last day of the most recent fiscal quarter.[21] This would require the issuer to confirm once a quarter that it remains eligible under the effective registration statement.

  ***Note**: The Proposed Rules do not condition shelf eligibility upon a sponsor or its affiliates retaining unhedged risk from prior ABS securitizations of assets of the same class at all times, but rather that the sponsor or affiliate held the required risk (i) on the last day of the most recent fiscal quarter and (ii) at the time of filing the new registration statement.*

Filing Deadlines

For each takedown off of a shelf registration statement on form SF-3, ABS issuers would be required to file with the SEC a preliminary prospectus containing substantially all of the information required in the prospectus at least 5 business days prior to the first sale in the offering.[22] For these purposes, a sale would include entering into a "contract of sale" (i.e., the time of pricing). The preliminary prospectus may omit only information relating to the offering price, discounts or commissions to underwriters or dealers, the amount of proceeds or other matters dependent upon the offering price.[23] If a material change other than price occurs in the information provided in the preliminary prospectus, the ABS issuer would be required to file a revised preliminary prospectus with the SEC reflecting the changes at least 5 business days prior to the first sale in the offering.[24] If the preliminary prospectus is used earlier than 5 business days before the first sale of securities, it would have to be filed by the second business day after first use.[25] The filing of a preliminary prospectus under Rule 424(h) would be deemed part of the registration statement on the earlier of the date it is filed with the SEC or the date of first use.[26]

***Note**: This new requirement to file preliminary prospectuses 5 days prior to pricing will significantly affect the timetable utilized in public offerings of ABS in some markets. In markets where it has not been typical to utilize preliminary prospectuses (e.g., the prime*

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[20] See Proposed Rules at 40 and 17 C.F.R. § 239.45(a)(2) at 504.

[21] See Proposed Rule 17 C.F.R. § 230.401(g)(4)(i) at 471.

[22] See Proposed Rule 17 C.F.R. § 230.430D(a)(1) at 474.

[23] See Id.

[24] See Proposed Rule 17 C.F.R. § 230.430D(a)(2) at 475.

[25] See Proposed Rule 17 C.F.R. § 230.424(h) at 473-474.

[26] See Proposed Rules at 31.

RMBS market), it will now be necessary to prepare preliminary prospectuses, which will impact the time required to execute such transactions. Even in markets where the use of preliminary prospectuses is typical (e.g., the CMBS market), the requirement that a revised preliminary prospectus reflecting any material change in information reflected in the previously filed preliminary prospectus, other than pricing information, be filed 5 days prior to pricing could slow down the offering process substantially.

Miscellaneous ABS Registration Provisions

- **Delivery of Preliminary Prospectuses**: Exchange Act Rule 15c2-8(b) would be revised to require delivery of a preliminary prospectus by a broker or dealer to an investor at least 48 hours before sending a confirmation of sale for all offerings of ABS, including shelf offerings and those involving master trusts, which were previously exempted from this requirement.[27]
- **Pay-As-You-Go Registration Fees**: Pursuant to Proposed Rule 456(c), ABS issuers would be permitted to pay registration fees for securities issued under a registration statement on Form SF-3 on a "pay-as-you-go-basis"[28] at the time of each filing of a preliminary prospectus pursuant to Proposed Rule 424(h).[29] The cover page of the preliminary prospectus filed pursuant to Proposed Rule 424(h) would have to include a "Calculation of Registration Fee" table listing (i) the class and aggregate offering price of offered securities and (ii) the amount of registration fees paid or to be paid in connection with the offering.[30]

  ***Note**: The ability of ABS issuers to access "pay-as-you-go" pricing for shelf offerings is one issuer benefit provided by the Proposed Rules. This payment method, which permits issuers to pay registration fees at the time of each offering rather than up-front at the time of filing (or immediately prior to effectiveness) of a registration statement, was previously available only to so called "well known seasoned issuers," a category of issuers that specifically excluded ABS issuers.*

II. Enhanced Disclosure and Reporting Requirements for ABS

Disclosure of Asset-Level Information

The Proposed Rules include many changes to the disclosure requirements of Reg AB. Aside from enhancing and refining the information required by existing Reg AB disclosure items, the Proposed Rules introduce the following two new significant changes:

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[27] See Proposed Rules 17 C.F.R. § 240.15c2-8(b) at 536 and Proposed Rules at 91.

[28] See Proposed Rule 17 C.F.R. § 230.456(c)(1)(i) at 481.

[29] See Id.

[30] See Proposed Rule 17 C.F.R. § 230.456(c)(1)(ii) at 481.

- Requiring issuers to disclose, at issuance and on an ongoing basis, standardized specific asset-level information regarding each asset in the pool backing an ABS (in the case of ABS backed by credit cards, based on standardized distributional groups, also referred to "grouped account data"); and
- Requiring issuers to provide a computer program containing the flow of funds or "waterfall" in a form that would enable investors to input their own assumptions and test their own scenarios.

Standardized Asset-Level Disclosure at Time of Offering. To ensure that investors receive sufficient information to evaluate an investment in ABS, the Proposed Rules require ABS issuers to disclose granular asset-level data (or with respect to credit card receivables, grouped account data) relating to the terms, obligor characteristics, and underwriting of each asset backing an ABS (or group of assets, as applicable).[31]

In proposing rules for standardized asset-level disclosure in ABS transactions, the SEC is embracing an approach that it declined to take in the original adoption of Reg AB, where it concluded that it would not be "practical or effective to draft detailed disclosure guides for each asset type that may be securitized."[32] In the Proposed Rules, the SEC has provided very detailed disclosure requirements for all the most common asset classes (other than credit card ABS and stranded cost ABS).

The required asset-level information would consist of 28 general fields (including, among other things, whether the asset was originated as an exception to defined or standardized underwriting guidelines) that would apply to all asset types (other than credit cards, charge cards and stranded costs), and additional specified fields for each of the following 10 asset types:

- residential mortgage loans (137 additional data points);
- commercial mortgage loans (61 additional data points);
- automobile loans (31 additional data points);
- automobile leases (33 additional data points);
- equipment loans (5 additional data points);
- equipment leases (8 additional data points);
- student loans (28 additional data points);
- floorplan financings (6 additional data points);

[31] See Proposed Rule 17 C.F.R. § 229.1111(h) at 383. The SEC is proposing to exempt ABS backed by stranded costs from the obligation to provided asset-level data. Stranded costs are certain capital costs incurred by public utilities which are permitted, by action of a state legislature or other regulatory authority, to be recouped over time from rate payers.

[32] See page 1509 of the adopting release for Regulation AB (Release Nos. 33-8518 and 34-50905).

- corporate debt (9 additional data points); and
- resecuritizations (dependent upon the type of the underlying assets).[33]

The asset-specific fields for residential mortgage loans are generally based on information provided by loan sellers to Fannie Mae and Freddie Mac and likely to be collected by issuers participating in the American Securitization Forum's Project RESTART. The asset-specific fields for commercial mortgage loans are generally based on the CRE Finance Council's (formerly known as the CMSA) Investor Reporting Package.[34] The asset-specific data fields for the other asset classes are based on pool-level disclosure commonly provided in prospectuses for such assets.[35]

Some of the required data points require personal data such as geographic location, income levels and credit scores, and therefore raise significant privacy concerns. To deal with privacy concerns the Proposed Rules provide that certain data may be provided as ranges instead of specific locations or dates, for example, geographic location can be provided by referring to a more general Metropolitan or Micropolitan Statistical Area, or Metropolitan Subdivision as designated by the U.S. Office of Management and Budget.

For resecuritizations, an ABS issuer would have to provide asset-level information for each underlying ABS in the pool as well as asset-level information for each asset backing the underlying ABS.[36]

> ***Note**: Despite the SEC's statement that the new rules would apply only to transactions after the new rules are effective, a new resecuritization would still be subject to the new disclosure requirements even though the underlying ABS may have been issued prior to the effectiveness of the new rules and might not provide for the reporting of information necessary to comply with the new requirements. Accordingly, such resecuritizations may be precluded (even in a 144A or Regulation D offering) unless the underlying ABS provides or can provide for such information. A phased approach to implementing the new requirements for resecuritizations, suggested by the SEC's request for comment, may provide some relief in this regard.*

As noted above, for ABS backed by credit card receivables, ABS issuers would be required to provide grouped account data.[37]

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[33] See Proposed Rule 17 C.F.R. § 229.1111A Schedule L at 385-423.

[34] See Proposed Rules at 135 and 143.

[35] See Proposed Rules at 149.

[36] See Proposed Rule 17 C.F.R. § 229.1111A Schedule L, Item 11 at 423.

The Proposed Rules require asset-level or grouped account data be disclosed:

- (i) at the time a preliminary prospectus is filed, in the case of an issuance under shelf registration statement (Form SF-3) or (ii) at the time of effectiveness of a stand-alone registration statement (Form SF-1), in each case as of a date as recent as practicable as determined by the registrant (the "**Measurement Date**");[38]
- at the time a final prospectus is filed, such information to be current as of the "cut-off" date for the ABS pool; and
- at the time a report is filed under Item 6.05 of Form 8-K, in the case of assets added to a pool after the filing of a final prospectus.[39]

Ongoing Asset-Level Performance Information. The Proposed Rules would also require ABS issuers to provide similar asset-level performance information on an on-going basis. Such information would be provided as an exhibit to the Form 10-D distribution reports that are filed within 15 days after each distribution date[40]. This information would be required to be provided in XML format. [41]

For resecuritizations, the Proposed Rules require ABS issuers to provide asset-level performance information for each resecuritized asset as well as asset-level performance information for each asset backing those assets.[42] The SEC has indicated that even if the issuer of the underlying asset suspends its reporting obligation and stops reporting, the issuer of the resecuritization ABS would still have to provide the required asset-level performance information for each asset underlying those resecuritized assets.[43]

Waterfall Computer Program

In addition to increased asset-specific data, the Proposed Rules would require ABS issuers to provide a computer program that gives effect to flow of funds provisions in the transaction agreements (the "**Waterfall Computer Program**").[44] The Waterfall Computer Program would be provided in an open source format that would enable users to:

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[37] See Proposed Rule 17 C.F.R. § 229.1111B Schedule CC, Item 11 at 423.

[38] See Proposed Rule 17 C.F.R. § 229.1111(h)(1) at 384.

[39] See Proposed Rule 17 C.F.R. § 229.1111(h)(2),(3) at 384.

[40] See Proposed Rule 17 C.F.R. § 229.1121(d) at 430.

[41] See definition of "Asset Data File" in Proposed Rule 17 C.F.R. § 232.11 at 485.

[42] See Proposed Rule 17 C.F.R. § 229.1111A Schedule L, Item 11 at 423.

[43] See Proposed Rules at 182.

[44] See Proposed Rule 17 C.F.R. § 229.1113(h)(1)(i) at 426.

- input their assumptions regarding future performance and cash flows from the pool assets, including future interest rates, prepayment speeds and default rates; and
- input the current state and performance of the pool assets by uploading the initial XML-based Asset Data File and any subsequent monthly updates.[45]

The Waterfall Computer Program is required to produce "a programmatic output, in machine-readable form, of all resulting cash flows associated with the asset-backed security, including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities, and each other person or account entitled to payments or distributions in connection with the securities."[46] The Waterfall Computer Program must be written in the Python programming language and able to be downloaded and run on a local computer properly configured with a Python interpreter.[47]

In addition, in order to enable users to test the accuracy of the program, the Proposed Rules require ABS issuers to provide a sample expected output from the Waterfall Computer Program for each class of securities in an ABS transaction based on the asset-specific data file and sample input assumptions used to generate the sample output.[48]

The Waterfall Computer Program would be filed as an exhibit to Form 8-K in accordance with Item 6.07 of Form 8-K on the same date that each preliminary prospectus and final prospectus is filed.[49]

> ***Note**: The Proposed Rules require a sample of inputs and outputs to be provided to investors in order to confirm that the Waterfall Computer Program is functioning correctly. While the SEC has helpfully clarified that the sample inputs and outputs would not be construed as a representation or warranty as to actual deal performance,[50] because the Waterfall Computer Program is required to be filed and incorporated by reference into the registration statement, programming errors or omissions in the program itself, at least those which produce materially misstated or misleading results, would carry the same liability as any other material misstatement or omission in the registration statement.*

Temporary Hardship Exemption for Filing Asset Data Reports and the Waterfall Computer Program. Registrants would be granted a self-executing temporary hardship exemption from filing an asset data file or Waterfall Computer Program as an exhibit to form 8-K. If a registrant

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[45] See Proposed Rule 17 C.F.R. § 229.1113(h)(1)(ii) at 427.

[46] See Proposed Rule 17 C.F.R. § 229.1113(h)(1)(iii) at 427.

[47] See Proposed Rule 17 C.F.R. § 232.314 at 489.

[48] See Proposed Rule 17 C.F.R. § 229.1113(h)(2) at 428.

[49] See Proposed Rule Form 8-K, Item 6.07 at 540.

[50] See Proposed Rules at 212, Footnote 349.

experiences technical difficulties preventing the timely filing of an asset data file or Waterfall Computer Program, the filing would still be considered timely if:

- it is posted on a website that is unrestricted as to access and free of charge;
- the website address is specified in the required exhibit;
- a legend is provided in the appropriate exhibit claiming the hardship exemption; and
- the asset data file or Waterfall Computer Program is filed on EDGAR within 6 business days.[51]

Registrants would, however, be excluded from the continuing hardship exemption under Rule 202 of Regulation S-T for filing asset data reports or the Waterfall Computer Program.[52]

Other Revisions to Reg AB Disclosure and Reporting Requirements

The Proposed Rules contain many other revisions to the disclosure and reporting requirements of Reg AB, including the following:

- *Underwriting Criteria and Exceptions.* The Proposed Rules require further detail regarding assets that deviate from an issuer's disclosed origination standards.[53] Assets that deviate from disclosed origination standards must be accompanied by specific data about the amount and characteristics of those assets, and, if any compensating or other factors were considered in determining to include the assets in the pool, the issuer would be required to specify the factors that were used and provide data on the amount of assets in the pool that are represented as meeting those factors and on those assets that do not meet those factors.[54]
- *Description of the Waterfall.* The Proposed Rules would require a description of the flow of funds in the transaction (and any related defined terms) in one location in the prospectus.[55]
- *Identification of Originators*. Although Reg AB Item 1110(a) requires identification of originators, apart from the sponsor and its affiliates, that originated or are expected to originate, 10% or more of the pool assets, the existing rules do not require any disclosure in the event that there are multiple originators that originated less than 10% that make up a major part of the securitization assets. The Proposed Rules would require disclosure regarding originators that originated less than 10% of the pooled assets if such originators, in the aggregate, originated more than 10% of the total pool of assets.[56]

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[51] See Proposed Rule 17 C.F.R. § 232.201(d) at 487.

[52] See Proposed Rules at 196.

[53] See Proposed Rule 17 C.F.R. § 229.1111(a)(3) at 382.

[54] See Id.

[55] See Proposed Rule 17 C.F.R. § 229.1100(g).

[56] See Proposed Rule 17 C.F.R. § 229.1110(a) at 381.

- *Sponsor and Underwriter Asset Repurchase Information*. The Proposed Rules would require the sponsor or any originator of 20% of the pool assets that would be required to repurchase or replace a pool asset for breach of a representation and warranty to disclose, on a pool-by-pool basis, the amount, if material, of publicly securitized assets originated or sold by such sponsor or originator that were the subject of demands to repurchase or replace for breach of representations and warranties made in the prior 3 years, including the percentage of that amount that were not repurchased or replaced by the sponsor or originator, and, for any such assets that were not repurchased or replaced, whether an opinion of an unaffiliated third-party had been furnished to the trustee that confirmed that the assets did not violate such representations and warranties. In addition, disclosure would be required on such sponsor's or originator's financial condition to the extent that there is a material risk that such entity's financial condition could have a material impact on (i) the originator's origination of the assets in the pool, (ii) the sponsor's or the originator's ability to comply with the provisions relating to the repurchase obligations for the assets or (iii) with respect to the sponsor, the asset pool.[57]

Static Pool Information. Reg AB currently requires disclosure of historical performance information, referred to as "static pool information," regarding a sponsor's prior securitized pools of the same asset class. The Proposed Rules would further revise the requirements regarding static pool data in order to enhance clarity, transparency and compatibility, by requiring:

- a narrative disclosure that contains (i) introductory explanatory information introducing the characteristics of the static pool, (ii) the methodology used in determining or calculating the characteristics, (iii) any terms or abbreviations, (iv) an explanation as to how the static pool differs from the pool underlying the securities being offered and (v) if an issuer does not include static pool data or provides disclosure that is intended to be an alternative to static pool data, the issuer would be required to describe why it has not included static pool data or why the alternative disclosure is being provided;[58]
- static pool information to be presented graphically if doing so would aid in understanding.[59] For amortizing asset pools, ABS issuers would be required to provide graphical illustration of delinquencies, prepayments and losses for each prior securitized pool or by vintage origination year for that asset type;[60]
- static pool information to be presented in accordance with Item 1100(b) of Reg AB (i.e., in 30-day buckets through liquidation and foreclosure);[61] and

[57] See Proposed Rule 17 C.F.R. § 229.1104(f) at 377 and Proposed Rule 17 C.F.R. § 229.1110(c) at 381.

[58] See Proposed Rule 17 C.F.R. § 229.1105 at 378.

[59] See Proposed Rule 17 C.F.R. § 229.1105 at 378.

[60] See Proposed Rule 17 C.F.R. § 229.1105(a)(3)(iv) at 379.

[61] See Instruction to Proposed Rule 17 C.F.R. § 229.1105(a)(3)(ii) at 379.

- all static pool information to be filed on EDGAR in PDF format (the temporary web site accommodation set to expire on December 31, 2010 that allows ABS issuers to post static pool information on internet websites would be repealed).[62]

Material Agreement Filing Requirements. Registrants would have to file agreements or other documents required be filed as part of a registration statement by the date the final prospectus is required to be filed under Rule 424,[63] although, such finalized agreements could be filed in preliminary form. The SEC noted that under current market practice, final pooling and servicing agreements are often filed after the offering has been completed.

Form 8-K Item 6.05 Reporting. In connection with an offering on Form SF-3, if any material pool characteristic of an asset pool at the time of issuance differs from the description of the asset pool in the final prospectus (other than as a result of the pool assets converting into cash in accordance with their terms), the issuer would be required to file a Form 8-K describing the nature of those changes. This trigger for filing would be reduced from a change to 5% of the asset pool to a change to 1% of the asset pool.[64]

Changes to Definition of Asset-Backed Security. The definition of "asset-backed security" in Item 1101 of Reg AB would be revised to narrow certain exceptions from the discrete pool requirement of the definition by:

- requiring master trusts to be backed by receivables or other financial assets that arise under revolving accounts;
- reducing the permissible duration of the revolving period for revolving securities backed by non-revolving assets from 3 years to 1 year; and
- reducing the permissible amount of prefunding from 50% of the offering price to 10% of the offering price.[65]

Servicer's Assessment of Compliance. Item 1122 of Reg AB would be revised to add an additional servicing criterion requiring that the aggregation of information by a servicer is mathematically accurate and the information conveyed by a servicer accurately reflects the information.[66]

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[62] See Proposed Rule 17 C.F.R. § 232.321 at 488.

[63] See Proposed Rule 17 C.F.R. § 229.1100(f) at 375.

[64] See proposed Form 8-K, Item 6.05 at 538.

[65] See Proposed Rule 17 C.F.R. § 229.1101 at 376 and Proposed Rules at 252-254.

[66] See Proposed Rule 17 C.F.R. § 229.1122(d)(1)(v).

In addition, Item 1122 of Reg AB would be revised to require an ABS issuer's annual report on Form 10-K to:

- identify any material instance of noncompliance with servicing criteria;
- disclose whether the identified instance of noncompliance involved the servicing of the assets backing the ABS covered in such report; and
- discuss any steps taken to remedy a material instance of noncompliance previously identified by an asserting party for its activities with respect to ABS transactions taken as a whole involving such party and that are backed by the same asset type backing the ABS.[67]

In addition, an instruction will be added to Item 1122 of Reg AB that the servicer's assessment of compliance should cover all ABS transactions involving such party that are backed by the same asset type backing the class of ABS which are the subject of the SEC filing. The proposed instruction would state that the asserting party may take into account divisions among transactions that are consistent with actual practices. However, if the asserting party includes in its platform less than all of the transactions backed by the same asset type that it services, a description of the scope of the platform should be included in the assessment.[68]

> ***Note**: Because assessments of compliance are made on a platform level under Item 1122 of Reg AB, it is unclear how a depositor that is unaffiliated with the reporting participant in the servicing function would know that an identified instance of noncompliance relates to the assets backing the ABS covered in the Form 10-K report, unless such participant was also required to deliver a compliance statement under Item 1123 of Reg AB.*

III. Revisions to Safe-Harbor Provisions for Privately-Placed ABS

Disclosure Requirements – Rule 144A and Regulation D Safe Harbors

In perhaps the most significant extension of the SEC's regulation of ABS, the Proposed Rules would regulate the level of disclosure to be provided in ABS transactions that are offered pursuant to Rule 144A and Regulation D. In proposing these rules, the SEC seems to have concluded that even relatively sophisticated classes of investors, such as qualified institutional buyers and accredited investors, require the protection of SEC-mandated levels of disclosure by requiring that transactions offered under these exemptions from the registration requirements of the Securities Act nonetheless provide, upon request, all of the disclosure that would be available for transactions offered pursuant to a registration statement.

> ***Note**: In describing these new requirements, the text of the Proposed Rules focuses heavily on practices in the CDO market and the role of CDOs in the financial crisis. Even*

[67] See Proposed Rule 17 C.F.R. § 229.1122(c).

[68] See Instruction 1 to Proposed Rule 17 C.F.R. § 229.1122 at 465.

though there is no explicit suggestion that a lack of information existed in the private markets for other types of ABS, the new rules would apply broadly to all forms of ABS, including any security "commonly known as an asset-backed security or structured finance product."[69]

Rule 144A and Rule 502 of Regulation D would be revised to require that (i) for a reseller of a "structured finance product" to sell a security in reliance on Rule 144A or (ii) for an issuer of a "structured finance product" to sell a security in reliance on Rule 506 of Regulation D:

- an underlying transaction agreement must grant any purchaser (and with respect to Rule 144A, any security holder or prospective purchaser) the right to obtain from the issuer promptly, upon request, information that would be required if the offering were registered on Form S-1 or Form SF-1 under the Securities Act (and, with respect to Rule 144A, any ongoing information regarding the securities that would be required by Section 15(d) of the Exchange Act if the issuer were required to report under that section);[70] and
- the issuer must represent that it will provide such information upon request of the purchaser (and with respect to Rule 144A, the holder).[71]

***Note**: Read literally, the new requirements for the Rule 144A safe harbor would require not only ongoing reporting of asset performance information with respect to structured finance products, but the full range of information required to be contained in periodic reports for asset-backed securities transactions under the Exchange Act. Absent further clarification from the SEC, information required to be provided could thus include annual servicer compliance statements, assessments of compliance with the servicing criteria of Item 1122(d) of Reg AB, accountant attestations and all other information required to be reported on or to accompany Forms 8-K, 10-D and 10-K with respect to public ABS.*

The new exemption requirements for private transactions apply only where there is reliance on the safe harbors in Rule 144A and Regulation D. Transactions that rely solely on the statutory exemption contained in Section 4(2) of the Securities Act, or on the so-called "4(1-½)" exemption, would not need to comply with the new requirements.

***Note**: Asset-backed commercial paper is often issued in reliance on the Section 4(2) private placement exemption and the so-called "4(1-½)" exemption for private resales, so these transactions may not be affected by these additional disclosure requirements.*[72] *It is*

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[69] See Proposed Rule 17 C.F.R. § 230.501(i) at 483.

[70] See Proposed Rule 17 C.F.R. § 230.144A(d)(4)(iii) at 468 and Proposed Rule 17 C.F.R. § 230.502(b)(3) at 484.

[71] See Id.

[72] See Proposed Rules footnote 455, at 272.

unclear whether these new informational requirements will have the result of pushing certain other ABS transactions out of the Rule 144A and Regulation D market into the so-called "pure" private placement market, with its more significant restrictions on the manner of offering. This may be the only option for securitizing assets where the information required to be disclosed by the Proposed Rules is simply not available.

With respect to the sale of a "structured finance product" under Rule 506, the Proposed Rules require the issuer to provide the information specified above to each purchaser a reasonable time prior to sale.[73]

Significantly, the definition of "structured finance product" under the Proposed Rules would be broader than the definition of "asset-backed security" under Reg AB, and would include:

- a synthetic asset-backed security; or
- a fixed-income or other security collateralized by any pool of self-liquidating financial assets, such as loans, leases, mortgages, and secured or unsecured receivables, which entitles the security holders to receive payments that depend on the cash flow from the assets, including:
    - an asset-backed security as used in Item 1101(c) of Reg AB;
    - a collateralized mortgage obligation;
    - a collateralized debt obligation;
    - a collateralized bond obligation;
    - a collateralized debt obligation of asset-backed securities;
    - a collateralized debt obligation of collateralized debt obligations; or
    - a security that at the time of the offering is commonly known as an asset-backed security or a structured finance product.[74]

The SEC has indicated that this definition would cover certain managed ABS, such as CDOs, that would not be considered "asset-backed securities" under Reg AB.[75] Managed CDOs generally do not meet the definition of an "asset-backed security" because managers can add and remove assets, making the managed CDO not "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets".[76] In addition, the SEC has indicated that the definition of

[73] See Proposed Rule 17 C.F.R. § 230.502(b)(1) at 484.

[74] See Proposed Rule 17 C.F.R. § 230.144A(a)(8) at 467 and Proposed Rule 17 C.F.R. § 230.501(i) at 483.

[75] See Proposed Rules at 276.

[76] See 17 C.F.R. § 229.1101(c)(1) for the definition of "asset-backed security".

"structured finance products" would include asset-backed commercial paper and the residual tranche of any other included ABS transaction.[77]

The SEC has indicated that for an offering of "structured finance products" where the securities meet the Reg AB definition of an "asset-backed security", the disclosure requirements of Form SF-1 would apply. For offerings of "structured finance products" where the securities fall outside the Reg AB definition, the requirements of Form S-1 would apply, and the issuer would be required to provide information required under Reg AB regarding the assets and parties as well as additional information required under Regulation S-K.[78]

> ***Note**: It is not clear to what extent the requirements of Reg AB, including the requirement to provide loan level disclosures, would apply to "structured finance products" that are not "asset-backed securities," although the SEC would presumably require many comparable disclosures in connection with its review of Form S-1 registration statements for such products.*

To ensure that ABS issuers in private placements provide investors with required disclosure information, the SEC has proposed a rule that would enable the SEC to bring an enforcement action against any issuer that failed to provide such information. Specifically, Proposed Rule 192 provides that:

- if an issuer of structured finance products has represented and covenanted to provide information pursuant to Rule 503(b)(3) of Regulation D, Rule 144A(d)(4)(iii) or Rule 144(c)(2), then the issuer must provide such information, upon request of the purchaser or security holder; and
- a failure to provide such information would constitute an engagement in a transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser of the securities.[79]

The SEC has noted that the failure of an issuer of structured finance products to provide a purchaser or security holder such information upon their request would not mean that the conditions for the safe harbor would not have been met. However, such purchasers or security holders could sue the issuer under the applicable transaction documents and the SEC could bring an enforcement action against the issuer under Proposed Rule 192.[80]

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[77] See Proposed Rules footnote 467, at 277.

[78] See Proposed Rules at 278.

[79] See Proposed Rule 17 C.F.R. § 230.192 at 470.

[80] See Proposed Rules at 281.

The SEC has noted that the proposed revisions to Rule 144A and Regulation D would not affect the sale of structured finance products outside of the United States pursuant to the safe harbor provided by Regulation S. The SEC has queried whether it should adopt similar changes for Regulation S as it has proposed for Rule 144A and Regulation D.[81]

Reporting Requirements – Rule 144A and Regulation D Safe Harbors

Rule 144A would be revised to require that, if an issuer offers or sells "structured finance products", the issuer must file with the SEC a notice of initial placement of securities eligible for resale in reliance on Rule 144A that contains the information required by new Form 144A-SF. The notice must be signed by the issuer and filed no later than 15 calendar days after the date of the first sale of securities in the offering, unless the end of that period falls on a Saturday, Sunday or holiday, in which case the due date would be the first business day following such period. If the issuer fails to file Form 144A-SF, the Rule 144A safe harbor will not be available for subsequent resales of newly issued "structured finance products" of the issuer or any affiliate of the issuer until such Form 144A-SF notice has been filed with the SEC.[82]

Form 144A-SF would require issuers to:

- identify the issuer, sponsor and CUSIP number of offered structured finance products;
- describe the type, structure, number of tranches and amount of securities to be sold (including the amount of any tranches retained by the sponsor or originator);
- briefly describe the asset pool, including the types of assets and the issuer of any underlying securities;
- disclose the date of the initial placement and initial resale in reliance on Rule 144A; and
- undertake to provide to the SEC, upon written request, the offering documents used in connection with the initial placement of securities.[83]

Rule 30-1 of the SEC's Rules of General Organization would be revised to delegate authority to the Director of the Division of Corporation Finance to request information materials from issuers that are required to be furnished to the SEC, upon written request, pursuant to Form D and Form 144A-SF.[84] Hardship exemptions would not be available for filing Form 144A-SF.[85]

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[81] See Proposed Rules at 287.

[82] See Proposed Rule 17 C.F.R. § 230.144A(f) at 468.

[83] See proposed Form 17 C.F.R. § 230.144A at 530.

[84] See Proposed Rule 17 C.F.R. § 200.30-1(a)(11) at 366.

[85] See Proposed Rule 17 C.F.R. § 232.201(a).

Form D would be revised to collect the same information collected by Form 144A-SF and would include a checkbox to indicate if the issuer is offering or selling "structured finance products".[86]

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The SEC has requested comments on the Proposed Rules. Comments must be provided to the SEC within 90 days after publication of the Proposed Rules in the Federal Register.[87] If adopted, the Proposed Rules would apply to ABS that are issued after the implementation date of the new requirements.[88]

Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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[86] See Proposed Rules at 290.

[87] See Proposed Rules at 2.

[88] See Proposed Rules at 297.