

Clients & Friends Memo

Applicability to Insurance-Linked Securities of SEC Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities

August 4, 2011

On July 26, 2011 the Securities and Exchange Commission (the "SEC") issued a release¹ (the "Proposing Release") revising and re-proposing certain rules (the "Proposed Rules") initially proposed in April 2010² related to asset-backed securities in light of the provisions added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and comments received on the 2010 ABS Proposals. Among other things, the 2010 ABS Proposals propose amendments to the safe harbor for exempt offerings and resales for "structured finance products"³ in reliance on Securities Act Rule 144A, which would include many Insurance-Linked Securities ("ILS") such as CAT bonds. Under the Proposing Release, the SEC has requested additional comment on these proposals relating to exempt offerings.

Background:

The 2010 ABS Proposals would require an issuer of a "structured finance product" to grant any purchaser, holder, and any prospective purchaser designated by a holder the right to obtain information that would be required if the offering were registered on Form S-1 or proposed Form SF-1 under the Securities Act and any ongoing information that would be required by Section 15(d) of the Exchange Act, if reporting were required under that section. The SEC staff has taken the position that ILS is a "structured finance product".

The 2010 ABS Proposal would also require such issuers to provide, upon request, asset-level disclosures in a standardized format. While asset-level disclosures are prescribed in Regulation AB for certain asset classes (i.e., residential mortgage backed securities; commercial mortgage backed securities; automobiles loans or leases; equipment loans or leases; student loans; floorplan financings; corporate debt; and resecuritizations) it is unclear how this requirement would apply to,

¹ Release No. 33-9244; 34-64968; File No. S7-08-10. Available for review at <http://www.sec.gov/rules/proposed/2011/33-9244.pdf>.

² SEC Release No. 33-9117 (April 7, 2010) [75 FR 23328] (the "2010 ABS Proposing Release" or the "2010 ABS Proposals").

³ As proposed to be defined in the 2010 ABS Proposing Release at 23393.

or be satisfied in, ILS transactions, which are typically collateralized by treasury money market funds or a “repo” arrangement.

The Effect of the Proposed Rules on ILS Transactions:

The Proposing Release would require the issuer of a “structured finance product” to meet the disclosure requirements of the 2010 ABS Proposals. For more information about the 2010 ABS Proposal disclosure requirements, please see our memorandum of June 23, 2010 “Regulation AB Proposals and Cat Bond Market” (attached as Annex A).

The Proposing Release makes specific requests for comment on the applicability of requirements for asset-level disclosures for issuers of “structured finance products” that are not collateralized by an asset class subject to prescribed asset-level reporting requirements in Regulation AB. ILS meets such criteria. These requests for comment are summarized below.

SEC Requests for Comment:

- Should asset-level disclosures only be required where the “structured finance product” being sold in reliance on Rule 144A or Rule 506 of Regulation D is backed by or collateralized by assets of an asset class for which there are prescribed asset-level reporting requirements in Regulation AB (which would exempt structured finance products such as ILS, typically).
- For securities that fall outside the Regulation AB definition of “asset-backed securities,” how can the SEC address commentators’ concern that those securities would be subject to a hybrid of the corporate and Regulation AB disclosure requirements?
- If the SEC does not require asset-level disclosures for certain “structured finance products” or “novel asset types or structures” that fall outside the Regulation AB definition of “asset-backed securities,” are there other types of disclosure that we should require the issuer to provide to investors or prospective purchasers? How should “novel asset types or structures” be defined? Is there any guidance that the SEC should provide for structured finance products that fall outside of Regulation AB’s definition of ABS?

Comments on the Proposed Rules will be due on or before sixty days from the date of publication in the *Federal Register*.

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Please feel free to contact any of the following if you have any questions regarding this memo:

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Annex A

Memorandum

To: Catastrophe Bond Market Clients

From: Cadwalader, Wickersham & Taft LLP

Date: June 23, 2010

Re: Regulation AB Proposals and Cat Bond Market

The Securities and Exchange Commission (the “SEC”) recently 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 (“ABS”), and would significantly broaden the range of transactions covered by such regulations.^{1 2} Of particular interest to participants in the CAT bond market, the Proposed Rules condition the availability of Rule 144A and Regulation D as exemptions from registration for “structured finance products” (which is a newly-introduced definition that is broader than the SEC’s definition of “asset-backed security” and may possibly be broad enough to cover CAT bonds) 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 SEC is soliciting comments on the Proposed Rules, with the comment period ending on August 1, 2010.

This memo provides an overview of the impact the Proposed Rules would have on the CAT bond market if enacted by the SEC in their proposed form.

What is a Structured Finance Product?

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 “structured finance products” transactions

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 For a discussion of the Proposed Rules, see our Clients and Friends Memo at http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf.

that are offered pursuant to Rule 144A and Regulation D. If CAT bonds are determined to be covered by the term “structured finance product”, then CAT bond transactions offered under Rule 144A or Regulation D would need to require that investors be provided, upon request, all of the disclosure that would be available for transactions offered pursuant to a registration statement.³
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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.

It is unclear from the Proposed Rules whether CAT bonds would be considered a “structured finance product”. There is no mention of CAT bonds or insurance related products in the SEC’s

³ 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:

- (i) 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); and
- (ii) the issuer must represent that it will provide such information upon request of the purchaser (and with respect to Rule 144A, the holder).

⁴ 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(1-1/2)” exemption, would not need to comply with the new requirements. These transactions do not qualify for the book entry system maintained by DTC.

release. However, the SEC cast a wide net with their proposed language in the last bullet point above (i.e., “any security. . . commonly known as . . . a structured finance product”). In its release adopting changes to Rule 17g-5 of the Securities Exchange Act of 1934, the SEC made reference to the term “structured finance products”.⁵ The SEC specifically stated that it intends for the amended Rule 17g-5 “to cover the full range of structured finance products.” Under revised Rule 17g-5, the rating agencies are responsible for determining whether a particular transaction is covered. While not conclusive for purposes of the Proposed Rules, to date, S&P, Fitch and DBRS have indicated that CAT bonds, insurance securitizations and multi-tranched insurance securitizations, respectively, are covered by Rule 17g-5.

Disclosure Requirements

If CAT bonds are determined to be structured finance products, it is not clear what initial disclosure and ongoing periodic reporting requirements would apply. For offerings of “structured finance products” where the securities fall outside the Reg AB definition of “asset-backed security” (CAT bonds do not satisfy this definition), the disclosure required under Form S-1 registration statements would apply, and, in addition, 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.

Form S-1 is a generalized registration form used for all issuers for which another form is not prescribed. It is used for corporate IPOs and for registration of securities by issuers that are not seasoned in the market. It is not designed for issuances of sophisticated financial instruments and it is not clear how the various disclosures required by Form S-1 would apply in the context of a CAT bond offering.

Reg AB was initially adopted in January 2005 and established a tailored set of rules governing the issuance of ABS. The regulation was intended to address the fact that the SEC’s existing (pre-Reg AB) disclosure and reporting requirements were designed primarily for corporate issuers, and did not elicit the information that is relevant for most asset-backed securities transactions. The original Reg AB codified much of the disclosure practice that had been followed by market participants to that point and added substantial new disclosure requirements relating to the background, experience, performance and roles of various transaction parties, including annual compliance certification by such parties. Among other things, the Proposed Rules would require detailed loan-level disclosure for most ABS. Because CAT bonds do not meet the definition of

⁵ The changes to Rule 17g-5 require persons seeking a rating of structured products and asset backed securities to establish and maintain a password-protected website containing all information provided to each rating agency hired by such person in connection with issuing or maintaining such rating. For a discussion of the changes to Rule 17g-5, see our Clients & Friends Memo at http://www.cadwalader.com/assets/client_friend/030310RecentChanges_SECRating.pdf.

“asset-backed security” and are not otherwise specifically addressed by the SEC in the Proposed Rules, it is not clear to what extent the requirements of Reg AB would apply.

To determine what Reg AB disclosure could be required, one should examine the assets the CAT bond issuer will own and the third parties charged with administering the activities of the issuer. The assets of a CAT bond issuer typically consist of a reinsurance policy or counterparty contract and permitted investments (e.g., money market funds), which collectively, represent the sole source of payments to the bondholders. Reg AB could require enhanced disclosure about those assets and could require financial statement disclosures with respect to the obligors under those assets. Reg AB could also require enhanced disclosure with respect to the trustee and other third parties responsible for administering any aspect of the issuer’s activities (e.g., reset agent, calculation agent). Reg AB would not only require initial disclosure regarding these parties in the offering document, but ongoing reporting and annual compliance certifications would also be required.

To ensure that issuers 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 fails to provide such information.⁶

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.

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.

Filing Notice of Placement

Rule 144A would also 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

⁶ Specifically, Proposed Rule 192 provides that:

- (i) 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
- (ii) 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.

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.

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.

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For purposes of confining the concerns expressed herein to those most directly involved, we have limited the distribution of this memo.