

SEC Proposes Extensive Reform to the Rules and Regulations for Public and Private Offerings of Asset-Backed Securities

Authors' Note

Seven hundred pages, more or less. After almost three years since the market meltdown began and just about every other regulatory and legislative constituency has weighed in (not to mention untold numbers of sound bites from the chattering class), the SEC has joined the effort to reform and restart the securitization market.

What follows is an overview of this important document. It's a meritorious effort. The industry has ninety days to provide comment and the SEC is giving every indication that it really wants thoughtful input. There are dozens of excellent questions to the industry interspersed throughout the proposal. There are thoughtful questions that demand thoughtful answers. The big issues of the quality and timeliness of disclosure and the risks retained by issuers and those assumed by investors are well and thoroughly joined.

There is "skin in the game" in yet another incarnation, an effort to address concerns about the need for a fair and reliable mechanism to enforce representations and warranties and more and more detailed disclosure throughout. Does it deliver the basis for a better informed and, hence, more confident investor? Will this materially change underwriting standards and the flow of credit?

Here are the practical, here and now, money points from this missive:

- It's not going to be effective for at least a year and could change significantly in the interim. We've got time.
- What was a soft forty-eight hours is now purportedly a hard five days. Whatever. The market will adjust. Will it really make investors feel better? That's far from clear.
- The proposed rules on the content of disclosure are broadly fine. For RMBS, this follows the guidance of Project RESTART. As to CMBS, the detailed loan level data is already essentially market standard.
- We need to sort out the interplay between the proposed rules and new accounting guidance under FAS 167. We cannot get adequate levels of capital formation without a sales model of securitization.
- We now have four versions of "skin in the game": House, Senate, FDIC and now SEC. More important, however, is what do investors want and what will they demand? We're going to find that out long before any of these regulatory and legislative initiatives are effective.

And are there better ways to accomplish the SEC's admirable goals? As we now begin to gear up for an industry deep dive into this proposal to prepare to provide comment, we must not get distracted from the bigger issues of what securitization 2.0 should look like.

That cannot wait until these new rules become effective. We need a structure that gives investors confidence and fixes things that we now know don't work. This, we think, means better and more understandable disclosure, and structures and deal features that address the disabilities of the model now tainted if not discredited.

Responding to these new SEC proposed rules is important, but not the whole story.

During the April 7, 2010 open meeting¹ of the Securities Exchange Commission (the “SEC” or the “Commission”), the Commission unanimously approved the release, for a 90-day public comment period, of a proposal to revise Regulation AB and other rules regarding the offering process, disclosure and reporting for asset-backed securities (“ABS”). These proposed rules would (i) establish new offering procedures and new shelf registration eligibility requirements, (ii) significantly expand disclosure requirements for ABS offerings, and (iii) have the effect of requiring the same disclosure in certain private offerings of ABS as will be required in SEC-registered public offerings. The SEC’s proposals, if adopted, would only apply to new issuances of ABS after the implementation date of the new rules and would not impose new requirements on outstanding ABS. This *Dechert OnPoint* summarizes the proposed rules addressed during the SEC’s open meeting and described in much greater detail in the Commission’s proposing release.²

Overview of Proposed Rules

New Registration Forms and Procedures

As part of the amendments, the SEC would make changes to the forms and procedures used in registered ABS offerings. The proposed rules would replace Forms S-1 and S-3 with new forms to be used for ABS offerings, namely Forms SF-1 and SF-3, respectively. Additionally, the use of a base prospectus and prospectus supplement would be abolished. A new Rule 430D would prescribe the information that is to be included in the form of prospectus (which form would at the time of a takedown be made into a deal specific prospectus) that must be part of the registration statement as a condition to approval for effectiveness. In connection with each takedown from an effective shelf, a preliminary prospectus that contains all transaction-specific information except for pricing information would be required to be filed with the SEC pursuant to a new Rule 424(h) at least five business days in advance of the first sale (or, if earlier, within two

¹ Securities Exchange Commission, April 7, 2010 Open Meeting Webcast Regarding Asset-Backed Securities, available at <http://www.sec.gov/news/openmeetings/2010/040710openmeeting.shtml>.

² Securities Exchange Commission, Release Nos. 33-9117 and 34-61858 – Asset-Backed Securities - Proposed Rule, available at <http://www.sec.gov/rules/proposed/2010/33-9117.pdf>.

business days of first use) and delivered to potential investors. If a material change occurs from what is included in the Rule 424(h) filing, then a new Rule 424(h) filing must be made and a new five business day waiting period would apply. Rule 424(b) would continue to require the filing of a final prospectus containing the pricing information and this filing would trigger a new effective date for the registration statement.³

At the time of the Rule 424(h) filing, the ABS issuer would also be required to file by Form 8-K the following: (i) asset-level disclosure regarding the pool assets; (ii) a computer program that investors can use to model the cash flow waterfall; and (iii) static pool information.⁴ The filing of these materials by Form 8-K would make them part of the registration statement for Section 11 liability purposes.

An ABS shelf issuer could continue to use free writing prospectuses, including for term sheets and computational materials. However, the SEC would require the use of a statutory prospectus for purposes of new Rule 424(h). The proposed rules would not change Rule 159.

The proposal would also allow all issuers to participate in the SEC’s “pay as you go” program and would only require payment of SEC filing fees for each takedown at the time of the related Rule 424(h) filing.

New Shelf Eligibility Requirements

Under the current rules, ABS may be registered on a Form S-3 registration statement and can later be offered “off the shelf” if, in addition to meeting other specified criteria, the securities are rated investment grade by a nationally recognized statistical rating organization. Due to its belief that investors may have unduly relied upon ratings in making investment decisions, the Commission now questions the value of the credit ratings requirement for shelf registration and proposes to replace it with four new ABS shelf eligibility

³ The SEC has stated that these revisions have been proposed to address investor concerns (i) regarding insufficient time to review material provided to make an informed investment decision; and (ii) that the practice of submitting free writing prospectuses in lieu of preliminary prospectuses was insufficient for evaluating the full scope of an ABS investment. Remarks of Katherine Hsu, Division of Corporate Finance, *supra* fn. 1.

⁴ The SEC would repeal its temporary website accommodation for static pool disclosure and instead require issuers to make Form 8-K filings on EDGAR in portable data format (.pdf). *Supra* fn. 2 at 233.

requirements. Specifically, the SEC proposes that, to be eligible for shelf registration:

- the chief executive officer of a sponsor or depositor must provide a certification at the time of each takedown that “the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities described in the prospectus”;⁵
- the sponsor must retain a minimum amount of each tranche of the securitization in the form of a vertical slice of at least 5%, net of hedge positions,⁶ as measured at the time of issuance and on an ongoing basis (or in the case of a revolving master trust, the sponsor must retain an “originator’s interest” of at least 5% of the nominal amount of the securitized exposures, net of hedge positions as measured at the time of origination);⁷
- the transaction documents must include a provision that requires the periodic delivery of an independent third-party opinion confirming that the party making representations and warranties regarding the assets has acted consistently with the terms of the transaction documents in declin-

⁵ *Id.* at 15.

⁶ Hedge positions that are not directly related to the securities or exposures taken by the sponsor or its affiliate are not required to be netted under the SEC’s proposal. *Id.* at 50. The SEC notes that issuers seeking to make offerings without risk retention could continue to do so on Form SF-1 provided there is clear disclosure that there is no sponsor risk retention component included in the offering. *Id.* at 51.

⁷ The SEC notes that it does not believe that the risk retention requirement would necessitate true sale implications regarding the transfer of assets from the originator to the depositor because the shelf eligibility condition would apply to the sponsor, which may not necessarily be an originator. *Id.* at 52-54.

Furthermore, the Office of the Chief Accountant reasons that while the new FASB requirements are reliant upon (i) whether control or power to direct the activities of the issuer has been retained; and (ii) whether there is “skin in the game” (or a retained risk in an issuance); and the risk retention requirement of the proposed amendments would obviously result in “skin in the game,” the risk retention requirement would not be dispositive of whether consolidation would occur for sale accounting purposes and instead this analysis should be done on a case by case basis. Remarks of Office of the Chief Accountant, *supra* fn. 1.

ing to repurchase or replace any assets with respect to which a breach of representation or warranty was alleged;⁸ and

- an undertaking by the issuer to file all periodic Exchange Act reports for so long as the related securities are outstanding (replacing the existing practice of ceasing to file such reports at the end of the calendar year in which such securities were issued).⁹

Additionally, an issuer would no longer be eligible for shelf registration if the depositor or an affiliate of the depositor, with respect to a class of ABS involving the same asset class, failed to file an Item 6.05 Form 8-K Exchange Act report (describing a change in asset pool characteristics) as or when required during the 12-month period prior to the filing of the registration statement. The issuer would also be ineligible for Form SF-3 registration if it has not complied with the new eligibility requirements proposed in lieu of credit ratings criteria during the same time period.¹⁰

Furthermore, under the rationale that it would provide more timely and detailed disclosure regarding the pool assets to investors, the SEC is proposing changes to the Regulation AB definition of ABS, which ultimately would affect who is eligible for shelf registration on Form SF-3. Specifically, a limitation would be placed on the availability of exceptions to the discrete pool requirement for ABS by (i) restricting eligibility to master trust issuers backed by revolving assets, (ii) reducing the permissible duration of revolving periods (i.e., the period during which cash flows from the pool assets may be used to acquire additional pool assets) of non-revolving assets from three years to one year, and (iii) reducing the amount of pre-funding permitted from 50% to 10% of the aggregate principal balance of the total asset pool whose cash flows support the ABS.

Enhancement of Disclosure Requirements

Currently, Regulation AB requires that material, aggregate information about the composition and

⁸ The party making such representations and warranties would be required to furnish such opinions on at least a quarterly basis. *Supra* fn. 2 at 65.

⁹ Under the proposed rule, the prior 15(d) exemption from filing ongoing 34 Act reports due to less than 300 investors would be eliminated. *Id.* at 75-77.

¹⁰ Evaluation of eligibility to use Form SF-3 for takedowns would be conducted on a quarterly basis. *Id.* at 83.

characteristics of the asset pool be filed with the Commission and provided to investors. Due to its belief that investors based decisions primarily on the securities' credit ratings and that investors must be provided with more information to increase the likelihood that such investors conduct an independent evaluation of ABS, the SEC is proposing additional and in some cases, revised disclosure requirements for ABS offerings and ongoing reporting. The proposed rules would require disclosure with respect to each loan or asset pool of specified asset-level or group account¹¹ data relating to the terms of the asset, obligor characteristics and underwriting of the asset. Through the implementation of new Item 1111(h) and Schedule L, the SEC seeks to enumerate all of the data points that must be provided for each asset in the asset pool at the time of the offering.¹²

Schedule L would incorporate general data points consistent with the principles-based definition of an asset-backed security as well as specific data point requirements related to the following asset classes: residential mortgages, commercial mortgages, auto loans, auto leases, equipment loans, equipment leases, student loans, floorplan financing, corporate debt and re-securitizations. The proposed standardized data points would serve to indicate the payment stream related to a particular asset, such as the terms, expected payment amounts, indices¹³ and whether and how payment terms change over time. Schedule L data would be required to be filed on EDGAR in eXtensible Markup Language ("XML") format (i) as an exhibit to a

¹¹ The SEC has indicated that it would exclude ABS backed by credit cards, charge cards and stranded costs from the requirement to provide asset-level data at the time of securitization and on an ongoing basis. *Id.* at 126-128, 166.

¹² To the extent that the standards regarding data points have been developed by third-party organizations (as is the case with respect to Residential Mortgage-Backed Securities and Commercial Mortgage-Backed Securities), the SEC has used such data points as the foundation for development of the data points it proposes to require for each asset class. For other assets, the data points were derived from information provided in the aggregate pool level disclosure. Remarks of Katherine Hsu, Division of Corporate Finance, *supra* fn. 1; See also American Securitization Forum, Project RESTART – Model RMBS Representations and Warranties, available at <http://www.sec.gov/rules/proposed/2010/33-9117.pdf>.

¹³ In light of privacy concerns, instead of requiring issuers to disclose a specific location, credit score, or exact income and debt amounts, the SEC is proposing ranges or categories of coded responses. *Supra* fn. 2 at 116-118.

Form 8-K filing at the time of the offering¹⁴ and when changes are made to the pool that require reporting under Item 6.05; and (ii) as an exhibit to Form 10-D in the case of a periodic distribution filing.

Additionally, the downloadable source code for a "waterfall computer program" that tracks the contractual cash flow provisions of the securities would be required to be filed on EDGAR as an exhibit to Form 8-K at the same time the 424(h) preliminary prospectus filing is made.¹⁵ The waterfall computer program would be required to be submitted as tagged XML data. Once downloaded, the program must provide users with the ability to programmatically input their own assumptions regarding the future performance and cash flows from the pool assets including but not limited to assumptions about future interest rates, default rates, prepayment speeds, loss-given default rates, and any other necessary assumptions required to be described under Item 1113 of Regulation AB. The program must also allow use of the proposed asset-level data file.¹⁶

The Commission also seeks to refine disclosure requirements for ABS by requiring (i) disclosure regarding aggregated and loan level data relating to the type and amount of assets that do not meet the underwriting criteria specified in the prospectus; (ii) information relating to the amount of the originator's publicly securitized assets that, in the last three years, has been the subject of a demand to repurchase or replace; (iii) additional information regarding originators and sponsors; (iv) descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of

¹⁴ The Form 8-K filings would be made at the same time the 424 (h) preliminary prospectus is filed as well as at the same time as the filing of the 424 (b) final prospectus. *Id.* at 113.

¹⁵ ABS backed by stranded costs would be excluded from the requirement to provide the waterfall program. *Id.* at 346-347.

¹⁶ The SEC has allowed a hardship exemption, which allows a registrant that experienced unanticipated technical difficulties preventing the timely preparation and submission of the waterfall computer program or an asset data file to still be considered timely if (i) the program or asset data is posted on a website on the same day it was due to be filed on EDGAR, (ii) the website address is specified in the required exhibit, (iii) a legend is provided in the appropriate exhibit claiming the hardship exemption, and (iv) the program or asset data file is filed on EDGAR within six (6) business days of the original filing deadline. *Id.* at 196-197, 215-216.

the pool performance as well as any terms or abbreviations used; (v) disclosure regarding compliance of static pool information for amortizing assets pools with Item 1100(b) requirements for presentation of historical delinquency and loss information; and (vi) Form 8-K filings for changes of 1% or more in any material pool characteristic from what is described in the prospectus (the prior requirement was 5%).

Greater Access to Information in Private Offerings

The Commission has taken the position that the ongoing financial crisis has called into question the ability of ABS rules and regulations to ensure that investors in private offerings have access to, and sufficient time and incentive to adequately consider, appropriate information regarding privately offered ABS. Consequently, the SEC has indicated that it plans to implement new rules that condition the use of the safe harbors of Rule 144A and Regulation D¹⁷ upon the transaction documents requiring that ABS issuers provide an investor, upon such investor's request, with the same information that would be required in a public offering at the time of the offering and on an ongoing basis. The SEC has further indicated that certain specified "structured finance products" would also be covered by this proposed rule, namely, synthetic ABS, collateralized debt obligations (CDOs) and fixed income or other security collateralized by any pool of self-liquidating financial assets. The SEC has indicated that it intends these new requirements for private issuances to permit (i) private investors to bring breach of contract actions and/or (ii) the SEC to bring enforcement actions on the basis of these new rules, in each case, if information is not provided to the investors in accordance with the proposed revisions.

Additionally, as referred to above, the proposed rules would add a public notice filing requirement on new Form 144A-SF for the initial placement of securities to be sold under Rule 144A. The notice would contain information related to major participants in the securitization, the date of the offering, the types of securities offered, the basic structure of the securitization and the principal amount of the securities offered. The SEC is proposing that if an issuer has failed to file Form 144A-SF, then Rule 144A would not be available for subsequent resales of newly issued structured finance products of the issuer or its affiliates. In addition, the notice would contain an issuer undertaking

to furnish the offering materials to the SEC upon written request. Form D also would be revised to provide for the notice required, or the same information as required, in Form 144A-SF when filed in connection with an ABS offering.

Concerns of Commissioners Regarding Proposed Rules

While the SEC unanimously approved release of the proposed rules for public comment, several commissioners expressed concern over certain of their aspects and indicated an eagerness to receive feedback on particular aspects of the proposal, specifically whether (i) the proposed "skin in the game" requirements would ultimately address the SEC's concerns over asset quality; (ii) the privacy concerns of individuals and businesses are adequately addressed by the proposed rules; (iii) the potential competitive advantages to Government Sponsored Enterprises ("GSEs") resulting from the proposed amendments should be addressed; and (iv) the proposed Rule 192 would ultimately have a negative impact on the private ABS market.

Commissioners Kathleen L. Casey and Troy A. Paredes both expressed particular concern over whether the risk retention requirement is appropriate for aligning the interests of ABS issuers and investors given the continued debate and analysis regarding "skin in the game." Commissioner Casey questioned whether the SEC should seek to improve the quality of assets as opposed to maintaining its tradition of ensuring that disclosure is adequate to allow an investor to make decisions about whether the quality of assets available meets with such investor's investment objectives. Commissioner Paredes's concerns focused on whether there would be true sale, regulatory capital and accounting implications created by the risk retention requirement. Furthermore, both Commissioners indicated that even if the risk retention requirement were to be deemed appropriate, they were not confident that the proposed amount and form of risk retention (i.e., retention of a 5% vertical slice and/or ongoing independent analysis of compliance with repurchase obligations following breaches of representations and warranties) would be the most effective and least invasive approach to aligning the interests of ABS issuers and sponsors with those of investors.

Additionally, Commissioners Casey and Paredes both articulated general privacy concerns regarding asset-level data disclosure requirements. Commissioner Casey

¹⁷ The SEC has indicated that exemptions provided in Sections "4(1-1/2)" and 4(2) of the Securities Act, would not be subject to proposed Rule 192. *Id.* at 271-272.

expressed particular concern over whether the asset-level data provided (notwithstanding safeguards currently contemplated by the proposed amendments) could be reverse engineered to obtain sensitive information about individual consumers or businesses.

With respect to the impact of the proposed rules on GSEs, Commissioners Casey and Paredes both expressed concern that Fannie Mae, Freddie Mac and Ginnie Mae (each of which is exempt from securities registration) and the originators who are able to securitize with these GSEs would gain a further competitive advantage through the implementation of these rules. Commissioner Casey had additional concerns over whether the proposed rules would have the ultimate effect of further subsidizing the GSEs and increasing their relative dominance, both of which she believes could result in longer-term systemic risk and burdens to taxpayers.

Lastly, both Commissioners indicated some discord with the proposed revisions to rules governing private offerings. Commissioner Casey had hesitation over the implementation of proposed Rule 192 and whether it would undermine current fiduciary duty obligations required of institutional investors that are permitted to participate in private offerings issued under SEC safe harbors. Commissioner Paredes expressed apprehension over treating ABS private offerings differently from other private securities offerings and whether what he perceived to be the “substantive judgment” being made against ABS could result in a “slippery slope effect”

leading to similar regulations for other types of securities offerings.

Particularly because two Commissioners expressed reservations regarding various features of the proposed rules, we anticipate that there will be a great deal of debate regarding the proposing release, and that there will be significant feedback provided during the 90-day comment period. The Commissioners stated that, notwithstanding their detail and length, the proposed rules are the SEC’s preliminary views and that input from market participants during the comment period is encouraged. We will update you as appropriate throughout what we expect may become a long and winding road to the promulgation of final rules.



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