



...In Other Securitization News

Securitization reform has been a hot topic since the beginning of the financial crisis. As the industry struggles to regain investor confidence, it has been further challenged by a flurry of new rules and regulations. The introduction of FAS 166 and 167 by the Financial Accounting Standards Board (FASB) in August 2009, the SEC's proposed changes to Regulation AB released in April 2010, changes to regulatory capital and leverage requirements for financial institutions, and the final safe harbor rule adopted by the Board of the Federal Deposit Insurance Corporation (FDIC) (the "FDIC Safe Harbor Rule") last month have been the focus of many articles, much debate and numerous conference panels. However, these are not the only regulatory challenges facing the securitization industry. The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in July 2010 requires various government agencies to promulgate hundreds of rules, many relating to various aspects of securitizations, within the year. These new rules must be reconciled with recently passed legislation, pending SEC rules and existing filing accommodations. In addition, there are Basel III and the revised Capital Requirements Directive in the European Union.

Static Pool Disclosures

When Regulation AB was first adopted in December 2004, Item 1105 required issuers to provide static pool information in the prospectus, to the extent material, for each ABS offering. The disclosure requirements under Item 1105 required five years of data and could be extensive, including a significant amount of statistical information that would be difficult to file electronically on EDGAR and difficult for investors to use in that format. In response to concerns raised by both issuers and investors at the time of adoption, the SEC adopted Rule 312 of Regulation S-T ("Rule 312") which permitted issuers to post information required under Item 1105 on an internet website. Rule 312 was adopted as a temporary filing accommodation for filings made on or before December 31, 2009.

The rule was further extended until December 31, 2010 to allow time for industry participants and investors to provide feedback after the SEC proposed changes to Regulation AB in April 2010 that included additional disclosure requirements and a proposal to remove the temporary accommodation under Rule 312 and instead require issuers to submit all required information to be disclosed in the prospectus, in a form 8-K incorporated by reference into a prospectus, or in Adobe PDF format that would be made available on EDGAR. The passage of the Dodd-Frank Act has given the SEC an additional reason to extend the temporary filing accommodation as it now needs to consider additional disclosure requirements under the Dodd-Frank Act and how such disclosures should be reported. As a result, last month the SEC proposed extending Rule 312 for filings made on or before June 30, 2012.

The Dodd-Frank Act

The passage of the Dodd-Frank Act provided a framework for additional securitization reform; this month the SEC began proposing rules to meet the requirements of the Dodd-Frank Act.

Repurchase Disclosures

On October 4, 2010, the SEC issued a proposed rule pursuant to section 943 of the Dodd-Frank Act, to be known as Rule 15Ga-1, that would require securitizers to disclose fulfilled and unfulfilled requests to repurchase securitized assets across all transactions, and would require credit rating agencies to include information regarding the representations, warranties and enforcement mechanisms available to investors in the asset-backed securities offering in any report accompanying a credit rating issued in connection with the offering. The disclosures in the proposal would be required for registered offerings and non-registered offerings relying on Rule 144A or any other safe harbor under the Securities Act of 1933, as amended (the "Securities Act"). The definition of asset-back securities under proposed Rule 15Ga-1 is broader than the definition under Regulation AB and includes collateralized debt obligations, securities issued or guaranteed by a government sponsored entity, and municipal entity securities collateralized by a self-liquidating pool of loans. However, if transaction documents underlying the issuance of a security meeting the asset-backed security definition do not contain any covenant to repurchase or replace an asset, the reporting requirements would not be triggered. The definition of "securitizer" would include both sponsors and depositors.

The disclosures required under the proposed Rule 15Ga-1 would have to be reported on a new Form ABS-15G and would include disclosure of assets subject to a repurchase demand, and whether such assets were repurchased or replaced by the end of the cure period set forth in the transaction documents. The information would have to be presented by a number of repurchase demands, as well as by outstanding principal amount and percentage by principal balance of such demands. The reporting obligation would begin at the time of the initial offering for all offerings after the effective date of the final rule with periodic reports required every month until the last payment is made under all of the issuer's outstanding asset-backed securities held by non-affiliates. The reporting obligations are not limited to information for asset-backed securities issued on a going-forward basis; initially, issuers must provide such information for all outstanding asset-backed securities held by non-affiliates outstanding as of the effective date with historical information for any such offerings going back five years.

The SEC is also proposing to revise Item 1104 of Regulation AB relating to repurchase demands and repurchase/replacement history to require the disclosures required under proposed Rule 15Ga-1 to be included in both prospectuses and periodic reports for all registered offerings and offerings pursuant to Rule 144A and Regulation D going back three years, regardless of materiality.

The disclosures required of credit rating agencies have remained unchanged from those set forth in the Dodd-Frank Act. The SEC's proposed rule clarifies that such disclosures would have to be made at the time pre-sale reports are issued since that will make such information available to investors prior to the point at which they make an investment decision.

Asset Disclosure and Third Party Reports

On October 13, 2010, the SEC released two proposed rules for comment. Proposed Rule 193, promulgated pursuant to section 945 of the Dodd-Frank Act, would require an issuer of a registered offering of asset-backed securities to perform a review of the assets underlying the securities and disclose the nature of such review and its findings in the prospectus. An issuer may engage and rely upon a third party for purposes of reviewing the pool assets to satisfy its obligations under proposed Rule 193 provided that the third party is named in the registration statement and consents to being named as an "expert" in accordance with Section 7 of the Securities Act and Rule 436 under the Securities Act. The proposed rule is limited to registered offerings only because it relates to section 7 of the Securities Act that governs registration statements filed by issuers of asset-backed securities.

Due to the short period of time that the SEC has to propose rules under the Dodd-Frank Act, proposed Rule 193 does not specify a particular type or level of review that is required. The SEC noted that it realizes that certain types of assets or securitizations will require different types of disclosures. Instead, proposed Rule 193 would require that the issuer disclose the nature of the review in the prospectus so investors will have the ability to evaluate the level and adequacy of the issuer's review of the assets. Although proposed Rule 193 does not require that specific procedures be performed, the SEC stated that the review should contain some of the data points proposed in its April 2010 proposal to revise Regulation AB¹ (the "2010 ABS Proposing Release") in order to meet the requirements under proposed Rule 193.² Asset-level data would be required for most asset classes and should be presented in a standardized, tagged format.

The SEC also proposed amendments to Item 1111 under Regulation AB to require disclosure regarding the nature of the issuer's review of the assets under proposed Rule 193 and the findings and conclusions of the review. The SEC also re-proposed amendments from its 2010 ABS Proposing Release that would amend Item 1111(a)(8) to require disclosure regarding the composition of the pool as it relates to assets that do not meet disclosed underwriting standards, including the entity that made the decision to include such assets, to promote a better understanding of the impact of the review on the composition of the pool assets.

One item to note in the request for comment section of proposed Rule 193 is that the SEC seeks comment as to whether it should condition the safe harbors for an exemption from registration provided in Regulation D and Rule 144A on a requirement that the underlying transaction agreement for the ABS contain a representation that the issuer performed a review that complies with proposed Rule 193, or in the event that the SEC establishes a minimum standard of review, whether the issuer has certified that it has complied with such review.

Proposed Rule 15Ga-2, promulgated pursuant to section 932 of the Dodd-Frank Act, would apply to both registered and unregistered offerings of asset-backed securities, as defined in section 3(a)(77) of the Securities Act, and would require the issuer or underwriter to make publicly available the findings and conclusions of any third-party due diligence report. Proposed Rule 15Ga-2 requirements would be satisfied by issuers of registered offerings if they comply with proposed Rule 193. Proposed Rule 15Ga-2 would require an issuer of an unregistered offering and an underwriter in registered or unregistered offerings to file a new Form ABS-15G to disclose the findings and conclusions of any third party engaged for purposes of performing a review obtained the issuer or underwriter, respectively. Proposed Form ABS-15G would be required to be filed on EDGAR five business days prior to the first sale of the offering to give investors and credit rating agencies adequate time to consider the third-party's findings and conclusions regarding its review of the pool assets prior to making an investment decision or assigning a rating to a transaction. Filing of a Form ABS-15G would not jeopardize an issuer's reliance on a safe harbor from registration provided that the form does not contain more information than required and is not used for marketing efforts.

The SEC's comment request relating to proposed Rule 15Ga-2 include whether the proposed rule should include offshore transactions with minimal US investors and/or limited offerings to US investors by foreign issuers. The SEC is also seeking comment as to whether any types of securities or issuers, such as government entities, be exempt from such requirements.

Section 945 of the Dodd-Frank Act puts the burden of disclosure on the issuer of asset-backed securities. In the European Union, the Prospectus Directive sets out minimum disclosure obligations to be observed by issuers of

¹ Release No. 33-9117.

² For example, in the case of RMBS, the SEC proposed in the 2010 ABS Proposing Release, that the issuer be required to provide, for each loan in the pool, standardized disclosure of, among others, credit score, employment status, and income of the obligor and how that information was verified. Some specific data points that were proposed include: (1) the appraised value used to approve the loan, original property valuation type, and most recent appraised value, as well as the property valuation method, date of valuation, and valuation confidence scores; (2) combined and original loan-to-value ratios and the calculation date; (3) obligor and co-obligor's length of employment, whether they are self-employed and the level of verification (e.g., not verified, stated and not verified, or direct independent verification with a third-party of the obligor's current employment); and (4) obligor and co-obligor's wage and other income and a code that describes the level of verification.

asset-backed securities. In addition, however, under Article 122a of the Capital Requirements Directive (“Article 122a”), credit institution investors who take credit risk in securitization transactions must meet an established level of understanding of all structural features of the transaction that could materially impact their exposure. If such level of understanding cannot be demonstrated, the credit institution investor will be subject to the imposition of additional capital charges against such investment, which could effectively require the investor to make a deduction from its regulatory capital of the full amount of the investment. To assist credit institution investors in complying with such obligation, the CRD states that sponsor and originator credit institutions shall disclose to prospective investors the level of their commitment under the risk retention provision and ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures.

It should also be noted that provisions promulgated by the Basel Committee in July 2009 (which are likely to be reflected in the CRD in due course) will increase the Pillar 3 disclosures that financial institutions will be subject to and will impose detailed disclosure requirements in relation to assets the entity has or intends to securitize, its internal processes in relation to securitized assets, and its relevant hedging and accounting policies.

Conflicts of Interest

The SEC announced in its recent timeline for Dodd-Frank rulemaking that it will propose rules relating to conflicts of interest in securitization transactions in November or December 2010. Section 621 of the Dodd-Frank Act requires the SEC to promulgate conflict of interest restrictions on underwriters, sponsors and others involved in assembling asset-backed securities to prohibit them from profiting from their failure. The Dodd-Frank Act provides that for one year after the date of the first closing of the sale of an asset-backed security, the underwriter, placement agent, initial purchaser, sponsor, and any affiliate or subsidiary thereof are prohibited from engaging in any transaction that would involve a material conflict of interest with respect to any investor in a transaction arising out of such activity. Exceptions to this general prohibition are provided for (i) risk mitigating hedging activities in connection with positions or holdings arising out of and designed to mitigate the specific risks of underwriting, placement, initial purchase, or sponsorship of an asset-backed security; (ii) purchases or sales to provide liquidity for an asset-backed security made pursuant to and in connection with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary thereof; and (iii) bona fide market making in the asset-backed security.

Conflicts with Basel III

On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision (the “Committee”), announced that the Committee had fully endorsed the final terms of the “Basel III” package of capital and liquidity reforms proposed in December 2009 and updated in July 2010. Although the overall structure and most of the key elements of the Basel III reforms remain intact, modifications in several key areas, including the definition of capital, the treatment of counterparty credit risk, elements of the new global leverage ratio, new regulatory capital buffers, mitigation of systemic risk and the new global liquidity standards, have been made. Despite these changes, Basel III still largely relies on credit ratings when determining capital requirements. This reliance on credit ratings is in direct conflict with section 939A of the Dodd-Frank Act’s requirement that regulators remove all references to credit ratings of securities from their rules. Market risk rules were in the process of being drafted by the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision when the Dodd-Frank Act was signed into law. The removal of credit rating references have sent these regulators back to the drawing board and may result in delayed implementation of Basel III in the U.S. as regulators search for another mechanism to rate the financial health of banks. Also, time frames for compliance are different under Basel III and the Dodd-Frank Act, with the Dodd-Frank Act giving smaller banks more time to implement new standards.

Risk Retention Rules

The SEC announced in its recent timeline for Dodd-Frank rulemaking that it will propose rules relating to risk retention in November or December 2010. Section 941 of the Dodd-Frank Act requires regulators to set forth risk retention requirements for originators and/or securitizers. In general, the originator or securitizer will be required to retain five percent of the credit risk for each securitization and will be prohibited from hedging such risk. The Dodd-Frank Act permits exemption from the risk retention requirements for issuances by certain government entities and qualified mortgage loans but otherwise leaves to the discretion of the applicable regulators whether to exempt other issuances from the requirements or to decrease the five percent minimum risk retention requirement for certain securities that are viewed as low risk. The Dodd-Frank Act risk retention provisions would become effective for residential mortgage-backed securities from April 2012 and for other classes from April 2013.

The recent FDIC Safe Harbor Rule also contains risk retention requirements. In an attempt to avoid conflict, the FDIC Safe Harbor Rule contains language that adjusts certain provisions to conform to any rules or regulations promulgated under the Dodd-Frank Act. However, it is not clear if the language is comprehensive enough to address all differences between the two and any unintended conflicts may not become apparent until the Dodd-Frank provisions are finalized.

In addition to possible conflicts with the FDIC Safe Harbor Rule, rules promulgated under section 941 of the Dodd-Frank Act may result in conflicting risk retention standards on the international level. Article 122a requires the originator to maintain a minimum risk retention requirement of five percent which cannot be met by the securitizer retaining a portion of that risk. The Dodd-Frank Act permits regulators to reduce the five percent limit. Article 122a also provides only a limited number of exceptions to the risk retention rules. Article 122a sets forth the alternative methods by which the five percent interest can be retained, including a vertical strip (retention of at least five percent of the nominal value of each tranche), an originator's interest (for revolving deals), randomly selected non-securitized assets of the type that have been securitized where there are at least 100 underlying exposures (provided that the retained assets could have been securitized), or a first loss tranche. The Dodd-Frank Act leaves that determination to the regulators. In contrast to the Dodd-Frank Act, Article 122a deals with matters from the perspective of the investor, providing that financial institutions can only invest in a securitization position if the originator, sponsor or original lender has explicitly disclosed that it will make the relevant retention. Under Article 122a, the retention must be made entirely by one of the originator, sponsor or original lender whereas under Dodd-Frank, it can be allocated between the originator or sponsor and the issuer. Article 122a is currently due to become effective for new securitizations issued on or after January 1, 2011, and from December 31, 2014, in the case of existing securitizations where new assets are added after such date. Since the SEC will not consider risk retention rules until November, it will be a while before we know what the differences will be between the two regulatory schemes and how those differences may impact the international securitization markets.

What's to Come

With final rulemaking implementing the securitization reform measures under the Dodd-Frank Act still months away, it is difficult to predict the impact such rules will have on recently enacted legislations, pending rules and international markets. One thing seems clear though: until such uncertainty can be minimized or eliminated, the securitization market will struggle to make a significant recovery as both issuers and investors are unsure of what the future holds.

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