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News Bulletin

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Historic Changes Proposed for ABS Offering Rules

On April 7, 2010, the U.S. Securities and Exchange Commission (the "SEC") released a proposed rule (the "Proposed Rule") which, if adopted in its current form, would significantly revise Regulation AB[1] ("Regulation AB") and other rules applicable to registration, disclosure and reporting for asset-backed securities[2] ("ABS") and other structured finance products. The Proposed Rule and the SEC's accompanying commentary may be accessed at http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

The Proposed Rule would, among other things, revise the shelf offering process for ABS and require ABS issuers to provide prospective investors with significantly more time to make investment decisions than under the current rules. The proposal would also revise the eligibility criteria that must be satisfied for an issuer to use a shelf registration statement by removing the current rating criteria and adding requirements that issuers retain a 5% vertical slice of every tranche of every securitization they issue off of the shelf and that they deliver certain third-party opinions with regard to repurchase requests.

The Proposed Rule would also include a substantial overhaul of the current ABS disclosure requirements with regard to both cash flows (that is, the "waterfall") and asset pool composition, including detailed disclosure, for most deals, of asset characteristics on an asset-by-asset basis. Finally, the proposal would revise Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), Rule 506 of Regulation D and other rules governing offerings of privately-placed ABS and other structured finance products to require the provision of more information to investors.

The Current State of the ABS Market

The Proposed Rule is being proposed at a time of maximum uncertainty regarding the future of the U.S. securitization market. Since the onset of the global financial crisis in late 2006 and early 2007, securitizations in the U.S. and Europe have practically ground to a halt — especially in the private mortgage sector. While securitization activity has continued in several consumer ABS sectors, including auto loans and credit card receivables, volumes even in these sectors have still dropped precipitously from several years ago. As a result of losses occasioned by the financial crisis, as well as the lack of income resulting from the virtual shutdown of many sectors of the securitization market, a large number of securitization asset originators, aggregators and underwriters have exited the business, some voluntarily but many through bankruptcy or receivership proceedings.

[1] Regulation AB, 17 C.F.R. §§ 229.1100–229.1123, is a sub-part of the SEC's Regulation S-K, 17 C.F.R. §§ 229.10–229.1123.
[2] Regulation AB and the Proposed Rule, and accordingly this bulletin, use the terms "asset-backed securities" and "ABS" expansively to include mortgage-backed securities ("MBS") and securities backed by other types of financial assets, including auto loans, credit card receivables and trade receivables. This contrasts with common industry practice to use "MBS" and "ABS" as mutually exclusive terms.

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In 2009, the Financial Accounting Standards Board (the "FASB") placed an obstacle in the road to securitization's recovery when it adopted new accounting rules, FAS 166 and FAS 167, which make it much more difficult to sell financial assets for an immediate gain, and equally difficult to avoid consolidating the assets even after they are sold. Even if business conditions improve, it is expected that these accounting rule changes will substantially reduce securitization volumes over time, because they deprive issuers of two of their principal incentives to do securitization transactions — to generate an immediate accounting gain and to remove assets from the securitizer's balance sheet and thereby improve capital ratios. These developments alone create significant doubt about the ability of the securitization market to reach a meaningful fraction of its size prior to the financial crisis.

Securitization has been identified by the American public and many politicians as being a contributor or even the principal cause of the global financial meltdown. Accordingly, a number of political and regulatory bodies have targeted securitization for extensive "reform." This has resulted in significant proposals in the U.S. Congress, embedded principally within the pending House and Senate financial reform packages, that would impose further restrictions on securitization. Also, in December 2009, the FDIC issued an advance notice of proposed rulemaking (the "FDIC ANPR") that contains proposed sample regulations that would have a chilling effect on the ABS markets by imposing restrictions on securitization activities of insured depository institutions that go beyond the Congressional proposals.

Each of the Congressional proposals and the FDIC ANPR contains slightly different formulations of a requirement that the issuer retain a risk exposure equal to at least 5% of a securitized asset pool. The FDIC ANPR's sample provisions are more onerous than the Congressional proposals in several respects. Among other things, the FDIC's sample provisions include a requirement that securitized mortgage loans be "seasoned," or in existence, for at least 12 months prior to securitization, essentially precluding the use of the "originate to sell" model by U.S. financial institutions. The FDIC also would prohibit the use of a financial guaranty or bond insurance as a means of credit enhancing securitizations for the benefit of investors, a device which historically lowered the cost of securitization and spread credit risk outside of the banking system.

The SEC's Regulation AB was initially adopted in December 2004 in an environment in which the securitization market was large and still growing rapidly. At that time the SEC's pursuit of Regulation AB was largely grounded in its view that the securitization market had become so significant to the economy that additional regulatory attention was warranted. The SEC's view was well-supported. According to one reputable source of deal statistics, the dollar volume of U.S. ABS (using the industry definition) issuance in 2000 was $316 billion, and rose to $1.026 trillion in 2005. Similarly, the dollar volume of U.S. MBS issuance in 2000 was $248 billion and rose to $1.114 trillion in 2005.[3] While the size and rapid growth of the securitization market were the justifications for instituting comprehensive regulation of the securitization market through Regulation AB in the mid-2000s, the amendments embodied in the Proposed Rule are quite obviously based on a very different set of concerns. ABS issuance volume had declined to $130 billion in 2009, less than 13% of 2005 volume, and MBS volume had fallen to $331 billion in 2009, only 29% of 2005 volume (and many of the 2009 MBS issuances were sponsored or subsidized by the U.S. government).[4] While the year is still young, many observers expect ABS and MBS issuance to fall even more in 2010.

Proposed Changes to Regulation AB

Offering Process. The Proposed Rule would replace Forms S-1 and S-3 insofar as they apply to ABS issuers with new forms specific to registered ABS issuances (proposed Forms SF-1 and SF-3) and revise the shelf offering structure for such offerings. The Proposed Rule would revise the filing deadlines in shelf offerings to provide investors with additional time to analyze transaction-specific information prior to making an investment decision. In current ABS practice, it is not uncommon to file a registration statement with more than one base prospectus,

[3] Statistics are as of February 23, 2010 and are available at http://www.thedeal.com/newsweekly/features/cover-stories/whither-securitization.php (citing Dealogic) (last viewed on April 14, 2010).
[4] Id.

more than one form of prospectus supplement, more than one depositor and covering more than one asset class. The Proposed Rule would change that practice significantly. Under the Proposed Rule, the use of a base prospectus and prospectus supplement format would not be permitted, only one form of prospectus could be filed with a registration statement, each depositor would have to file a separate registration statement and each asset class would require a separate registration statement. For each takedown off of a shelf, a preliminary prospectus would need to be filed at least 5 business days prior to the first sale of securities in the offering or, if used earlier, within 2 business days of first use. The preliminary prospectus would need to be a single prospectus (i.e., not using a base and supplement format) and would need to include all the information omitted from the form of prospectus in the registration statement other than pricing information. In accordance with current practice, a final prospectus that includes the pricing information would need to be filed within 2 business days of the pricing date. Any material change to the information in the preliminary prospectus would require the filing of a new preliminary prospectus and a new 5 business day waiting period. Adding new structural features or new credit enhancement not in the base prospectus filed with the registration statement would require a post-effective amendment and adding a new asset type would require that a separate registration statement be filed.

A computer program that gives effect to the flow of funds, or "waterfall," provisions of the transaction (discussed in more detail below) would need to be filed with the preliminary prospectus and the final prospectus. Asset-level data also would have to be filed with both the preliminary and final prospectuses. In addition, the SEC plans to repeal Rule 15c2-8(b) of the Exchange Act. By reason of the repeal of this rule, broker-dealers will no longer be exempt from the 48-hour waiting period that is required between providing a prospective investor with a preliminary prospectus and sending a confirmation of sale in connection with such offer. This loss of exemption will be applicable to all ABS issuances, regardless of whether the ABS issuer is exempt from filing reports pursuant to Section 12(h) of the Exchange Act.

Shelf Registration Eligibility Criteria. The Proposed Rule sets forth new requirements for registering ABS. Under the current regulation, issuances that meet certain criteria qualify for shelf registration. One such criterion is meeting certain credit rating requirements. All current eligibility criteria other than the credit rating requirements would remain in place under the Proposed Rule. The credit rating requirements would be replaced with the following four requirements:

- The retention of a minimum of 5% of the nominal amount of each tranche of securities issued, net of the hedge positions, both at the time of issuance and maintained on an ongoing basis; or in the case of a revolving trust, retention of the originator's interest of a minimum of 5% of the nominal amount of the securitized exposures, net of the hedge positions, both at the time of origination and maintained on an ongoing basis;
- A certification filed at the time of each offering off of a shelf registration statement, or takedown, by the CEO of the depositor or sponsor, as applicable, that to the CEO's knowledge, the assets in the pool have characteristics that provide a reasonable basis to believe that the assets, taking into account internal credit enhancements, will produce cash flow sufficient to service any payments due and payable on the securities as described in the prospectus;
- A provision in the pooling and servicing agreement ("PSA") that requires the party obligated to repurchase the assets for breach of representations and warranties to furnish quarterly an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the PSA with respect to any loans that the trustee put back to the obligated party for violation of representations and warranties and which were not repurchased; and
- An undertaking by the issuer to file Exchange Act reports so long as non-affiliates of the depositor or sponsor, as applicable, hold any securities that were sold in registered transactions backed by the same pool of assets.

Disclosure Requirements. The Proposed Rule would require issuers to disclose specified data relating to each asset in the asset pool, obligor characteristics, and underwriting of the asset. The Proposed Rule sets forth specific information required by asset class, including but not limited to residential mortgages, commercial mortgages, automobile loans, equipment loans, student loans, resecuritizations and corporate debt. Separate requirements are set forth for credit card securitizations due to their unique master trust structure. Generally, the following data would be required:

- Aggregate and loan-level data relating to the type and amount of assets that do not meet the underwriting criteria that is specified in the prospectus;
- For certain identified originators, 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;
- For the sponsor, information relating to the amount of publicly securitized assets sold by the sponsor that, in the last three years, has been the subject of a demand to repurchase or replace;
- Additional information regarding originators and sponsors;
- Descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of pool performance;
- That static pool information for amortizing asset pools comply with the Item 1100(b) under Regulation AB requirements for the presentation of historical delinquency and loss information; and
- The filing of a Form 8-K for a one percent or more change in any material pool characteristic from what is described in the prospectus (rather than for a five percent or more change, as currently required).

Failure to timely file a Form 8-K upon the occurrence of a change in a material pool characteristic as described above or any Exchange Act report would result in an issuer losing eligibility to file a Form SF-3, with respect to a class of asset-backed securities involving the same asset class, for up to twelve months from the time the report was due.

Asset-level data would have to be filed in a machine-readable, standardized format and would need to be provided at the time of the filing of the preliminary prospectus (using data as of a recent practicable date referred to as the "measurement date"), at the time of filing of the final prospectus (using data as of the transaction's cut-off date), when new assets are added to the asset pool, and on an ongoing basis. In addition to the information required above, issuers must file a computer program (the "waterfall computer program") giving effect to the contractual cash flow provisions of the securities in the form of downloadable source code in Python, a computer programming language that would allow the user to programmatically input information from the asset data file and conduct their own evaluations of ABS. The computer program would need to be filed with the SEC at the same time as the preliminary and final prospectuses, and would be considered part of the prospectuses for liability purposes. The Proposed Rule would require that all information required under Regulation AB must now be submitted to the SEC and posted on EDGAR, rather than maintained on the issuer's or sponsor's website.

Private Offerings of ABS and other Structured Products. The Proposed Rule would require that a provision be included in an issuer's transaction documents requiring the issuer to provide the same level of information to investors upon request as is required of issuers of registered offerings using Forms S-1 or SF-1. This requirement would change the current information requirements under Rule 144A to include information initially required under such forms as well as information required on an ongoing basis under Section 15(d) of the Exchange Act. The type of information required will differ by asset class and a failure to honor any such request would expose the issuer to breach of contract claims by the investor, as well as SEC enforcement action. The new requirements not only affect private ABS issuances but other structured finance product issuances and will impact foreign issuers who have traditionally relied on Rule 144A to issue ABS and structured finance products in the U.S. The Proposed Rule also would require issuers of privately-placed ABS or structured finance product in reliance on Rule 144A or Rule 506 of Regulation D to file a newly-created Form 144A-SF or a Form D notice with the SEC no later than 15 calendar days after the first sale of securities in the offering. Failure to file a Form 144A-SF would preclude the issuer from relying on the exemption for subsequent resales of newly issued structured finance products of the issuer or any affiliate of the issuer until the notice that was required to be filed has been filed.

For purposes of the Proposed Rule, "structured finance product" would be defined as:

- 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:

  (1) an asset-backed security as such term is used in Item 1101(c) of Regulation AB;

  (2) a collateralized mortgage obligation;

  (3) a collateralized debt obligation ("CDO");

  (4) a collateralized bond obligation;

  (5) a CDO of asset-backed securities;

  (6) a CDO of CDOs (sometimes referred to as a "CDO-squared"); or

  (7) any other security that at the time of the offering is commonly known as an asset-backed security or a structured finance product.

Conclusion

As a result of all the challenges the ABS markets already face, the introduction of the Proposed Rule, undoubtedly a major regulatory initiative on the part of the SEC, hits the industry in a vastly different environment than prevailed when the original Regulation AB hit the then booming securitization market in the mid-2000s. To be sure, the securitization industry will become fully engaged in the debate over the many new requirements and procedures included in the Proposed Rule. However, the Proposed Rule will likely not be viewed with the same central importance as the original Regulation AB was when it was first proposed, if only because there are so many other "life-threatening" issues facing the securitization market, many of which are also critical to the nation's economic recovery, that stand in line in front of the Proposed Rule.

Many of the proposed enhanced disclosure requirements included in the Proposed Rule are not unexpected. Indeed, many of the reforms were formulated by the industry itself, principally through the efforts of the American Securitization Forum, or are supported by the industry. In many cases, the proposed reforms represent the inevitable next step in the evolution of ever more sophisticated data gathering and modelling capabilities on the part of all participants in the financial markets. Undoubtedly, many of these enhancements would have been put in place even in the absence of the financial crisis. Once implemented, it is quite likely these provisions will, on the margin, help restore confidence in the ABS market and thereby benefit the industry.

While anything that restores confidence in the market is a welcome development, there are more fundamental issues that will need to be addressed (or forgotten) before the securitization market will resume anything like its prior role in the U.S. housing and consumer finance markets. Other aspects of the Proposed Rule, such as the proposed shelf eligibility criteria and proposed private offering reforms, are likely to create significant debate through the comment process.

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The Proposed Rule is subject to a 90-day comment period beginning on the date that it is published in the Federal Register. If adopted, the Proposed Rule would become effective within a year following adoption, although the SEC most likely would provide for a tiered implementation based on the size of the securitization sponsor and the degree of burden expected to be imposed by certain of the new requirements. The Proposed Rule would apply on a prospective basis only.

Contacts

Melissa D. Beck	Kenneth E. Kohler	Jerry R. Marlatt
(212) 336-4319	(213) 892-5815	(212) 468-8024
mbeck@mofo.com	kkohler@mofo.com	jmarlatt@mofo.com

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