
The SEC recognizes that asset-backed securities and issuers of asset-backed securities differ from corporate securities and operating companies. Many of the existing disclosure requirements and reporting obligations, primarily for corporate issuers, do not elicit relevant information for ABS transactions and investors in these transactions. Through no-action letters and the filing review process, the SEC staff has attempted over the past 20 years to address issues particular to asset-backed securities. The proposed rules codify and consolidate many existing staff practices relating to asset-backed securities and also add extensive additional requirements. See Release 33-8419; 34-49644.

This Securities Update highlights some of the significant changes that may result if the proposed rules are adopted and provides our initial views as to practical considerations for their application.

**Securities Act Registration**

**Definition of Asset-Backed Security**

The proposed rules will apply to any security that falls within the definition of “asset-backed security.” The basic definition of an asset-backed security has been moved out of Form S-3 and is now contained in proposed Item 1101 of Regulation AB:

“a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to securityholders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.”

The proviso relating to leases is new and favorable to issuers, but brings with it additional disclosure requirements discussed below.

In addition to the basic definition, Item 1101 codifies the following additional requirements to be considered an asset-backed security:

- Neither the depositor nor the issuing entity is an investment company or will become one as a result of the ABS transaction; and
- The activities of the issuing entity must be limited to passively owning or holding the pool of assets, issuing the asset-backed securities supported or serviced by those assets and other activities reasonably incidental to these activities.
The SEC states that it intends to exclude synthetic securitizations from the proposed definition because the issuing entity does not actually own the underlying asset. Payments on securities in synthetic securitizations are based on the performance of assets or indices not included in the asset pool.

**Delinquent and Non-Performing Pool Assets**

Securities issued by an entity with non-performing assets in the original asset pool at the time the securities are issued do not satisfy the definition of an “asset-backed security.” Proposed Item 1101 of Regulation AB defines a non-performing asset as an asset that meets either the charge-off policies set forth in the ABS transaction documents or the charge-off policies of the sponsor. The release does not discuss whether a security issued by a structure that does not give credit to non-performing assets – as can occur in master trusts – falls within the definition of an asset-backed security.

Under the proposed rules, delinquent assets may be included in the asset pool as long as they do not constitute 50% or more, as measured by dollar volume, of the original asset pool at the time of issuance of the asset-backed securities. Consistent with prior custom, delinquent assets will be limited to 20% of the original asset pool in order to be eligible for Form S-3. A delinquent asset is defined as an asset that has more than one payment past due. An asset will be considered delinquent if partial payment on the total past due amount has been made, unless the obligor had contractually agreed to restructure the obligation. The proposed rule does not reflect that many financial institutions have a de minimis rule for determining delinquency, such as at least 95% or all but $25 or less of a payment has been made. In adopting its final rules, the SEC may want to reflect this practice.

**Lease-Backed Securitizations**

As noted above, the definition of asset-backed security has been expanded to include securitizations backed by leases where part of the cash flows securing the payments on the securities is derived from the residual value of the physical property underlying the leases. However, the proposed rules set limits on the percentage of the cash flows that the issuer expects to derive from residual values. For automobile leases (which includes motorcycles but not leisure craft), the residual values may not constitute 60% or more, as measured by dollar volume, of the original asset pool at the time of issuance of the asset-backed securities. For all other leases, the residual values may not constitute 50% or more of the original asset pool. In order to be eligible for Form S-3, the residual values of lease-backed securitizations other than auto leases are further restricted to 20% or more, as measured by dollar volume, of the original asset pool at the time of issuance.

In addition to satisfying these bright line tests, ABS issuers must provide additional disclosure regarding residuals as follows:

- Statistical information on historical realization rates;
- The manner and process in which residual values will be realized; and
- The entity that will convert the residual values into cash.

The release uses a number of bright line tests for eligibility for Form S-3 as well as eligibility to use Regulation AB. In the past, the bright line tests of the SEC staff were used only in connection with S-3 eligibility. It is not clear whether a securitization that fails the bright line tests could still use Form S-1 without the detailed financial statement disclosures of an operating company typically found in Form S-1.

**Discrete Pool Requirement**

Securities issued by master trust structures and, to the extent outlined by Item 1101, transactions with prefunding and revolving periods are permissible exceptions to the “discrete pool of assets” requirement in the definition of asset-backed security.

**Master Trusts.** Master trusts are discrete pools if the offering contemplates adding additional assets to the pool “in connection with future issuances of asset-backed securities.” The proposed definition codifies existing practice that the balance of a pool asset may revolve (as, for example, in a credit card account, home equity loan or dealer floorplan loan). The proposed rule does not reflect the fact that receivables may be acquired by master trusts on an ongoing basis and not only in connection with a new issuance of securities. In adopting its final rules, the SEC may want to reflect this practice.

**Prefunding Periods.** The amount of proceeds that may be used for prefunding may not exceed 50% of the offering proceeds, and the prefunding period may not exceed one year. In order to be eligible for Form S-3, the amount of
proceeds that may be used for prefunding is restricted to 25% of the offering proceeds over a one-year period. These limits on prefunding are generally consistent with prior staff positions. However, on a case-by-case basis the SEC staff has permitted use of Form S-3 for deals with as much as 50% prefunding. Given the additional disclosures required for prefunding, the SEC staff may want to consider retaining this additional flexibility to permit prefunding.

**Revolving Periods.** Structures with revolving periods permit the use of cash flows from the asset pool to acquire new pool assets instead of being used to make payments on the asset-backed securities. With respect to transactions with revolving periods where the assets do not themselves revolve (e.g., auto loans), the amount of additional assets acquired during the revolving period may not exceed 50% of the offering proceeds, and the revolving period may not exceed one year. In order to be eligible for Form S-3, the amount of additional assets that may be acquired is restricted to 25% of the offering proceeds over a one-year period, which codifies the SEC staff’s existing policies for revolving periods for non-revolving assets. As discussed below, additional disclosure in both prospectuses and Exchange Act reports relating to the operation of revolving period structures and changes to the asset pool will also be required.

**Securities Act Registration Statements**

**Forms S-1 and S-3.** ABS offerings must be registered on either Form S-1 or Form S-3. ABS offerings that fall within the definition of asset-backed security and the restrictions stated above but do not meet Form S-3 eligibility requirements must be filed on Form S-1.

Disclosure requirements for both Form S-1 and Form S-3 have been modified for ABS offerings. In addition to the general information required by the forms applicable to all issuers in the past, the registrant must furnish the disclosures set forth under new Regulation AB.

**“Issuer” and Required Signatures.** Proposed Rule 191 under the Securities Act and Rule 3b-19 under the Exchange Act would clarify that the depositor must sign registration statements and periodic reports for ABS offerings. The issuing entity would no longer be required to sign the registration statement if formed prior to effectiveness.

Under the proposed rules, the depositor is the entity who “receives or purchases and transfers or sells the pool assets to the issuing entity.” The depositor, acting solely in its capacity as depositor to the entity issuing asset-backed securities, is the “issuer” for these securities. A depositor acting in its capacity as depositor for an issuing entity will be a different “issuer” from the same depositor acting as a depositor in another transaction. If there is no intermediate transfer of assets between the sponsor and the issuing entity, than the sponsor will be deemed to be the depositor. As discussed in Section IV below, defining the depositor as a separate issuer for each transaction will increase the depositor’s Exchange Act filing obligations.

**Foreign ABS.** The new rules do not contain a separate form for ABS offerings issued by a foreign issuer or backed by foreign assets. Foreign ABS offerings must be filed on either Form S-1 or Form S-3. Foreign ABS issuers will, however, be required under Item 1100(e) of Regulation AB to provide additional disclosure relating to “any pertinent governmental, legal or regulatory or administrative matters” of their home country as well as tax matters, exchange controls, currency restrictions or other economic factors that could materially affect payments or performance of the asset-backed securities. ABS transactions involving the issuance of securities backed by foreign assets or that have credit enhancement or other support provided by a foreign entity will also have to provide these additional disclosure. Item 1100(e) refers to the disclosures currently required by Item 202 of Regulation S-K with respect to foreign registrants, including any foreign law limits on voting or affecting dividends or interest and an outline of taxes, including withholding taxes and tax treaties, to which U.S. securityholders are subject. Item 101(g) of Regulation S-K also currently requires a description of the enforceability of civil liabilities against foreign persons. The new rules specify that Exchange Act filings must describe any material impact caused by foreign legal and regulatory developments during the period covered by the report.

Since the proposed rules will permit some foreign ABS issuers to register on a shelf basis on Form S-3, the proposals should make it easier for foreign issuers to issue ABS securities in the United States. However, the SEC comments that some foreign issuers may be intending to off-load poorly performing assets and states that they may require some foreign issuers to register first on a Form S-1 or S-11 that is fully reviewed by the staff. The staff warns that delays and
possible impediments to access the U.S. public markets may be met by new issuers or jurisdictions. It is not clear which foreign ABS transactions will elicit this fuller review but the release recommends pre-filing conferences with the staff to discuss appropriate procedures. In footnote 99, the SEC warns foreign issuers that registrants should expect the SEC review process to be time-consuming. Foreign issuers should also expect to provide the SEC staff with representative prospectus supplement disclosure, including statistics as to a hypothetical pool of assets to be securitized.

Two other questions arise for foreign issuers. First, foreign ABS issuers do not all use depositors because of the unique characteristics of their various legal systems. In addition, where legal regimes are similar (such as in the United Kingdom and Australia) and the structure of the ABS transaction is substantially similar, it seems unnecessary to require a separate prospectus for each separate country as discussed below. Mayer, Brown, Rowe & Maw LLP will be preparing a separate memorandum with respect to foreign ABS under the rule proposals.

**Changes to Form S-3.** In addition to the current eligibility requirements, ABS offerings on Form S-3 will have to comply with the bright line tests for delinquency concentration levels and the prefunding account and revolving period restrictions discussed above. As is currently the custom, transactions with multiple asset classes must use separate base prospectuses and forms of prospectus supplements for each asset type. The release also adds that separate base prospectuses and forms of prospectus supplements must be prepared for each country in a transaction that has assets with different countries of origin or the property securing the pool assets is located in different countries.

To be eligible for Form S-3, the sponsor and depositor must have complied with Exchange Act reporting obligations with respect to all other ABS transactions for which they are a sponsor or depositor in the last 12 months. A sponsor will no longer be able to avoid Form S-3 eligibility problems arising from defects in its Exchange Act filings by filing a new Form S-3 for a new issuer. If reporting obligations are suspended under Section 15(d) of the Exchange Act, the depositor and the sponsor must comply with all prior reporting obligations up until those obligations were suspended.

**48-Hour Prospectus Delivery.** Asset backed securities registered on Form S-3 will continue to be exempt from the 48-hour prospectus delivery requirement under Rule 15c2-8(b) of the Exchange Act.

**Registration of Underlying Pool Assets (Resecuritization)**

If securities of another issuer are being securitized – often called resecuritization – these securities must also be registered under the Securities Act or exempt from registration, unless the following conditions in proposed Rule 190 under the Securities Act are met:

- The depositor would be free to publicly resell the underlying securities without registration (e.g., the underlying securities are not restricted securities under Rule 144(k) under the Securities Act and are not part of the original distribution of the securities);
- Neither the issuer of the underlying securities nor any of its affiliates has any direct or indirect agreements or understandings relating to the underlying securities or the ABS transaction; and
- Neither the issuer of the underlying securities nor any of its affiliates is an affiliate of the sponsor, depositor, issuing entity or underwriter of the ABS transaction.

If these conditions are not met, the underlying securities must be registered in accordance with the disclosure and delivery conditions set forth in Rule 190. However, Rule 190 also provides relief to “issuance trust” structures, which are designed to facilitate securitization transactions but would trigger registration of the underlying securities. Common examples include master owner trust structures used by credit card issuers and titling trusts used by auto lease securitizations. If the financial asset was created solely to satisfy legal requirements and not as a scheme to avoid registration or to circumvent the proposed rules, issuance trust structures would not be required to comply with the disclosure and delivery requirements that would otherwise apply under the proposed rules and would not be subject to an additional registration fee.

**Practical Considerations**

- Securities issued by securitization structures that do not meet the requirements of an asset-backed security under the proposed rules would not be eligible to use the modified disclosure and reporting requirements under Regulation AB and would be required to comply with
more extensive disclosure and reporting requirements. It remains unclear whether securitization structures that do not meet the asset-backed securities definition can still file a registration statement without the extensive financial disclosures of operating companies.

- Consideration should be given to the restrictions imposed by bright line tests for delinquency concentration levels, percentage limits for residual values in lease-backed securitizations and limits on transactions with pre-funding periods and revolving periods. These bright line tests might be more appropriate as safe harbors for use of Regulation AB or eligibility requirements for registration on Form S-3 rather than prohibitions against reliance on Regulation AB.

- Eligible auto lease issuers should begin converting their Forms S-1 to S-3 and preparing the additional disclosures required by Regulation AB on residual value realization.

- Foreign ABS issuers and issuers that issue securities backed by foreign assets or have credit enhancement or other support provided by a foreign entity should begin considering what additional information they will need to prepare in connection with the proposed requirements under Regulation AB, and should focus on qualifying for Form S-3.

- Failure to comply with Exchange Act reporting obligations will prevent Form S-3 shelf eligibility for other transactions established by the sponsor or depositor until the sponsor or depositor has complied with their Exchange Act filing obligations for one year. Loss of Form S-3 eligibility will also prevent the use of ABS informational and computational materials and the ability to incorporate by reference. Public issuers should confirm that their Exchange Act filings comply with SEC policy as soon as possible and set up an internal compliance infrastructure that ensures that Exchange Act requirements will be met.

- The manner of calculating delinquencies differs among issuers and asset types. The SEC is suggesting a uniform method of calculating delinquencies and uniform disclosure based upon that definition. Issuers may have to consider changing their delinquency calculations and the related information required to be captured in order to report in accordance with the new presentation requirements.

### Disclosure under Regulation AB

Because none of the existing disclosure requirements in the Securities Act are specifically tailored to address ABS offerings, the SEC is concerned that the informal disclosure practices that have developed through the SEC comment process and industry practice are not fully transparent to issuers and investors. To address this, the SEC has proposed a new disclosure regime in Regulation AB. This new regime is intended to be principles-based, rather than an exhaustive list of disclosure items required for each asset class, and to govern not only existing asset classes but also new asset classes that may develop in the future. The proposals are also intended to bring greater uniformity to the disclosure process. Regulation AB will be a sub-part of Regulation S-K and form the basis of ABS disclosure in registration statements under the Securities Act and periodic reporting under the Exchange Act. The proposed structure of Regulation AB is as follows:

- Item 1100 sets forth items of general applicability for Regulation AB;
- Item 1101 provides definitions;
- Items 1102-1108 provide the basic disclosure required in ABS registration statements and periodic reporting;
- Item 1119 forms the basis for disclosure in distribution reports on proposed Form 10-D (the proposed form on which periodic servicer’s reports would be filed);
- Item 1120 specifies the form of report on compliance with servicing criteria based on an assessment by the depositor or servicer; and
- Item 1121 specifies the form of servicer compliance report to be executed by the servicer with respect to its compliance with the particular servicing agreement.

### Forepart of Registration Statement and Prospectus

Existing Items 501 to 503 of Regulation S-K will continue to provide the basic disclosure requirements for the forepart of registration statements and prospectuses. Proposed Items 1102 and 1103, however, would amplify those requirements
for ABS offerings for the cover page and summary in a manner substantially consistent with current practice.

Additional disclosures required in the summary that may go beyond current practice include:

- Diagrams of parties, flow of funds and other material features;
- Identification of 10% originators and any significant obligors; and
- A description of fees and expenses to the extent necessary to understand the payment characteristics of the offered securities.

To discourage boilerplate disclosure, Regulation AB does not specify risk factors that must be disclosed in an ABS transaction. Instead, the release encourages thoughtful analysis and disclosure of the most significant factors that make the transaction speculative and risky.

**Transaction Parties**

**Sponsor.** The proposed rules define “sponsor” as the person “who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” Proposed Item 1104 requires more detailed disclosure about the sponsor than is the current practice, including the following:

- A description of the sponsor’s securitization program, the length of time for which the sponsor has been involved in securitization and the sponsor’s experience in, and overall procedures for, originating or acquiring and securitizing assets of the type included in the current transaction;
- The size, composition and growth of the sponsor’s portfolio of assets of the type to be securitized, to the extent material;
- Information related to the sponsor material to an analysis of the origination or performance of the pool assets, including whether any prior securitizations organized by the sponsor have defaulted or experienced an early amortization triggering event, to the extent material; and
- The sponsor’s roles and responsibilities in its securitization program and its participation in structuring the transaction.

The text of the release also requires disclosure of:

- Any action taken outside the ordinary performance of the transaction to prevent a default, early amortization or trigger event;
- Outsourcing of the origination or purchasing function; and
- Reliance on securitization as a funding source.

**Static Pool Data of Sponsor.** Static pool data must also be disclosed, to the extent material, under proposed Item 1104. Item 1104 requires presentation of three years of delinquency and loss information for the sponsor’s portfolio with respect to the asset type being securitized (or for so long as the sponsor has been making originations or purchases if less than three years). The proposed rule would also require, to the extent material, disclosure on a pool level basis with respect to prior securitized pools involving the same asset type for the past three fiscal years. Static pool data should be presented separately according to factors relevant to the transaction, such as asset term, asset type, yield, payment rates, geography or ranges of credit scores and should be presented in tabular or graphic format where such presentation will aid understanding. If material, static pool data as to a seasoned pool being securitized should be provided.

Requiring static pool data is one of the more significant changes made by Regulation AB. Although some issuers may find the new disclosures burdensome, we understand that static pool data is regularly supplied to rating agencies, and investors often ask for it. The real issue may be the cost of getting an accountants’ comfort or agreed upon procedures letter with respect to the data since underwriters will continue to seek accounting comfort on all numbers in the prospectus.

**Depositor.** Item 1101 defines “depositor” as the entity who receives or purchases and transfers or sells the pool assets to the issuing entity. If the depositor is different from the sponsor, proposed Item 1105 would require disclosure of the same types of information about the depositor’s securitization experience and prior transactions as required for the sponsor above. In addition, Item 1105 requires the following information:

- Ownership structure of the depositor;
- Activities of the depositor and the time period during which the depositor has been so involved; and
• Continuing duties of the depositor in the current securitization.

**Issuing Entities.** Item 1101 defines the “issuing entity” as “the trust or other entity created at the direction of the sponsor or depositor that owns or holds the pool assets and in whose name the asset-backed securities supported or serviced by the pool assets are issued.” If the issuing entity has executive officers or directors, Item 1106 expands existing practice by requiring information under Regulation S-K, Item 401 (identification of and information regarding these persons), Item 402 (compensation information) and Item 404 (information about affiliated transactions). In addition to disclosure customary in the industry, proposed Item 1106 requires the following new disclosures about the issuing entity:

- The amount or nature of any equity contribution by the sponsor, depositor or other party;
- The amount paid by the issuing entity for the pool assets and how determined; and
- The amount of expenses incurred in selecting and acquiring the pool assets that are payable out of offering proceeds and amounts paid to each transaction party.

**Servicers.** Item 1101 defines “servicer” as “any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed securities.” The definition also includes a party referred to as an “administrator,” but does not include a trustee for an issuing entity that distributes funds received from a servicer and otherwise performs no servicing functions.

In proposed Item 1107 of Regulation AB, the SEC states that it intends to elicit additional information regarding a servicer’s function, experience and servicing practices than is currently the practice. In addition, Item 1107 applies to any servicer that services 10% or more of the pool assets or on whom the performance of the pool assets is materially dependent. Required disclosures include:

- General character of the servicer’s business and length of time the servicer has been involved in securitization, including (1) a general discussion of servicer’s experience servicing assets of the type to be securitized, (2) the size, composition and growth of the servicer’s portfolio of serviced assets of the type to be securitized, and (3) factors material to an analysis of the servicing of the pool assets;
- Material changes to the servicer’s servicing policies or procedures in servicing assets of the same type during the past three years;
- To the extent material, the servicer’s financial condition;
- Any special factors involved in servicing particular assets (e.g., subprime assets) and procedures to address these factors;
- If material, statistical information on advances on pool assets and on servicer’s overall portfolio for the past three years;
- If material, whether prior securitizations involving the servicer have defaulted or experienced an early amortization or other performance trigger because of servicing; and
- Previous material noncompliance with servicing criteria with respect to other securitizations.

**Trustees.** Proposed Item 1108 requires disclosures currently found in ABS transactions for trustees as well as some incremental requirements as follows:

- General character of the trustee’s business and any prior experience in similar ABS transactions; and
- Whether the trustee independently verifies distribution calculations, access to transaction accounts, compliance with covenants, use of credit enhancement, addition or removal of pool assets and underlying data.

**Originators.** Similar to the disclosure provisions applicable to servicers, proposed Item 1109 requires an originator to provide disclosure if the originator has originated, or is expected to originate, 10% or more of the pool assets. The proposed disclosure requires a description of the originator’s origination program, the originator’s experience in originating assets of the type being securitized, the size and composition of the originator’s portfolio and other information material to an analysis of the performance of the pool assets.
Pool Assets

The release proposes broad disclosure guidelines capable of being tailored to any particular asset type. Item 1110 requires disclosure of the following:

- The assets to be securitized;
- Material terms of the pool assets;
- Solicitation, credit-granting or underwriting criteria used to originate or purchase the pool assets;
- Selection criteria, cut-off date and material legal or regulatory provisions;
- Static pool data, to the extent material;
- Delinquency and loss information in 30-day increments through the point that assets are written off or charged-off as uncollectible; and
- The ways in which prefunding or a revolving period might change the composition of the asset pool, to the extent material.

Issuers typically seek to disclose delinquency and loss information in the manner most relevant to the asset class, which may not include 30-day increments for delinquency above, for example, 90 days because delinquent assets above 90 days may be immaterial. Item 1110 contains disclosures for amortizing loans, revolving loans and commercial mortgages. Many items contained in the release are customary but others, such as disclosing credit scores of obligors, are less commonly seen. If more than 10% of the assets are in a particular state or region, factors specific to that state or region must be disclosed.

Sources of Pool Cash Flow. If the asset pool includes leases or other assets that are supported by more than one source of cash flows (such as lease payments and the residual value of an underlying physical asset), the following must be disclosed:

- Source of funds for payments on the asset-backed securities and the relative amount and percentage of funds to be derived from each source, including any assumptions or methodology used to derive these amounts;
- How residual values were estimated and who selected any material discount rates, models or assumptions;
- Material procedures or requirements to preserve residual values during the term of the lease;
- Procedures by which residual values are realized and experience of the entity that is realizing on residuals and its compensation;
- Statistical information on estimated residual values, historical turn-in rates and residual value realization rates over the past three years; and
- Whether any provisions address what happens if there is not enough cash flow to cover residuals.

Transaction Structure

Existing Item 202 of Regulation S-K continues to provide the basic disclosure requirements for all offered securities, with Item 1112 requiring additional disclosure for ABS transactions as follows:

- Description of the securities and transaction structure, including a description and diagram of the flow of funds;
- Description of distribution frequency and cash maintenance;
- Description of the distribution and ownership of excess cash flows;
- To the extent material, a description of other securities issued under a master trust, including their relative priority and allocation of funds;
- Optional or mandatory redemption or termination provisions; and
- Prepayment, maturity and yield considerations.

Proposed Item 1112 requires greater disclosure of fees and expenses involved in ABS transactions, including a separate table itemizing all estimated fees and expenses to be paid or payable out of the cash flows from the pool assets. The table must disclose the amount of fees, the parties receiving fees, the source of funds for fees and the distribution priority for fees.

Significant Obligors. Entities meeting one of the following requirements under proposed Item 1101 will be “significant obligors” for which additional disclosure is required:
• An obligor or group of affiliated obligors on any pool asset or group of pool assets if the pool asset or group of pool assets represents 10% or more of the asset pool; or
• A single property or group of related properties securing a pool asset or a group of pool assets if the pool asset or group of pool assets represents 10% or more of the asset pool; or
• A lessee or group of affiliated lessees if the related lease or group of leases represents 10% or more of the asset pool.

Required additional disclosure consists of descriptive information such as names, organization and character of the obligor’s business, the nature of the asset pool concentration and the material terms of any agreements with the obligor involving the pool assets. In addition, selected financial information meeting the requirements of Item 301 of Regulation S-K is required for obligors representing 10% or more but less than 20% of the asset pool while full financial statements meeting the requirements of Regulation S-X must be provided for obligors representing 20% or more of the asset pool.

Credit Enhancement

As with significant obligors, proposed Item 1113 requires descriptive and financial information for third party credit enhancement providers who are liable or contingently liable to provide payments representing from 10% to 20% or 20% or more of the cash flow supporting any offered class of asset-backed securities. Unlike current practice, Item 1113 triggers disclosure based on payments that the enhancement provider is liable or contingently liable to provide. Valuation of the enhancement – including for swaps or derivatives – is no longer the relevant test.

The proposed rules make it more likely that a standard interest rate derivative priced at market will trigger the 10% or 20% tests. If applicable, the additional disclosures for a counterparty may deter counterparties from participating in public ABS transactions and will raise the cost of their participation.

Affiliations and Certain Relationships and Related Transactions

Proposed Item 1117 adds disclosures typically found in non-ABS offerings, but these disclosures are less common in securitizations. To the extent material to an investor’s understanding of the asset-backed securities, Item 1117 requires disclosure of any affiliations among the servicer, trustee, originator of at least 10% of the pool assets, significant obligors, significant enhancement providers, underwriters or other material party involved in the securitization transaction.

In addition, proposed Item 1117 requires disclosure of any business relationship, agreement, arrangement, transaction or understanding entered into (1) outside the ordinary course of business, (2) on a non-arm’s length basis, and (3) with a party unrelated to the ABS transaction and any of the parties mentioned above that are material to the ABS transaction. An example would be if an underwriter or its affiliate provides a warehouse line of credit to fund originations or acquisitions pending securitization.

Practical Considerations

• The SEC staff seems particularly concerned with actions by the sponsor, depositor or servicer outside the ordinary course or not in compliance with the transaction documents. Public registrants must be prepared to dedicate the resources necessary to service their deals as required by the documents or risk embarrassing disclosures. In addition, it appears that sponsors must disclose any voluntary actions taken to “rescue” deals, such as adding new money to reserve funds, repurchasing defaulted assets or leaving money in transactions that should otherwise be paid out to the sponsor or its affiliates.

• Issuers may want to actively manage concentrations in their ABS transactions to avoid triggering increased disclosure obligations.

• Issuers should begin considering whether they can obtain accounting comfort or agreed upon procedures letters on static pool data and the cost of the letters. Issuers should also begin considering what static pool data is most relevant to investors, including a consideration of what static pool data is typically requested by the rating agencies.

• Master servicers and issuers in transactions with multiple servicers – most commonly found in mortgage-backed transactions – should begin considering the cost
and timing to comply with the extensive new requirements of proposed Item 1107.

- Liability for misstatements of third parties such as trustees and subservicers will need to be negotiated between the issuer and the third parties. However, issuers should be aware that the SEC views indemnification for securities law violations as unenforceable as against public policy.

- The additional information required by single obligors and credit enhancement providers may subject issuers to liability for third party information. Here again, issuers will want to negotiate for indemnification. The requirement to disclose additional information for single obligors should be carefully considered. If a single obligor’s receivables constitute greater than 10% at the beginning of a revolving trust but get paid off, then the original disclosure relating to any such single obligor may become obsolete.

- The release suggests that variables such as default frequency and loss severity of pool assets, historical exchange rate volatility and historical prepayments may no longer be used to determine whether a third party credit enhancement provider will be liable or contingently liable to provide 10% or 20% or more of the cash flows. If this is true, additional financial disclosure relating to mortgage insurers and swap counterparties will be required.

- Trustees will need to consider carefully how they describe their verification role in an ABS transaction.

**Communications During the Offering Process**

**ABS Informational and Computational Material**

**Definition.** In order to streamline current practice regarding the distribution of term sheets during the period in which a registration statement has been declared effective but before a final prospectus has been delivered in connection with the offering of shelf registered asset-backed securities, the proposed rules combine the concepts of structural term sheets, collateral term sheets and computational materials into the single definition of “asset-backed securities informational and computational material.” Under proposed Rule 167 under the Securities Act, the distribution of ABS informational and computational materials would be permissible after the shelf registration of an offering of asset-backed securities has become effective but before the delivery of a final prospectus meeting the requirements of the Securities Act.

ABS informational and computational material is defined in proposed Item 1101 of Regulation AB as written communications consisting of one or more of the following:

- a brief summary of the structure of an offering of asset-backed securities;

- descriptive factual information regarding the pool assets of an offering of asset-backed securities (e.g., weighted average coupon, weighted average maturity and other factual information regarding the type of assets comprising the pool);

- static pool data relating to the sponsor’s portfolio, prior transactions or the asset pool; or

- statistical data for a particular class of asset-backed securities, the yield, average life, expected maturity, interest rate sensitivity, cash flow characteristics or other financial information under specified prepayment, interest rate, loss or other hypothetical scenarios.

ABS informational and computational material may provide information at the individual pool asset level, as is often desired in commercial mortgage-backed securities transactions. Information provided by the issuer or the underwriter to investors or third party services to perform their own calculations would also fall within the scope of these materials. However, in the case of third party services, the resulting analysis or calculations of this information may be ABS informational and computational materials if the issuer or underwriter are affiliates of the service provider. The use of ABS informational and computational material would not be available to ABS offerings registered on Form S-1.

While the release makes it clear that the proposed definition is not intended to change the scope of the information currently included in structural term sheets, collateral term sheets and computational materials, the staff states that it is currently developing reforms to the communications restrictions of the Securities Act for all types of offerings.

**Filing Requirements.** Proposed Rule 167 lists required information for the cover page of a term sheet and clarifies that legends disclaiming liability are inappropriate.
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ABS informational and computational materials delivered to (1) a prospective investor who indicated to the underwriter that it would purchase asset-backed securities, and (2) a prospective investor after the final terms have been established for all classes of offering, must be filed with the SEC. Proposed Rule 426 under the Securities Act clarifies and unifies current filing practice by stating that term sheet materials must be filed on Form 8-K by the later of the filing deadline for the final prospectus or two business days after first use. Materials relating to abandoned structures or materials delivered to prospective investors who have not expressed an interest in purchasing the securities need not be filed. ABS informational and computational material may be aggregated and filed in consolidated form, as long as the information in that form would not make the information misleading or result in the omission of any material information. All filings must be made in electronic format through EDGAR. Prior policies permitting paper filings of computational materials have been eliminated.

ABS informational and computational materials filed in accordance with the proposed rules will be exempt from liability for use of a non-conforming prospectus under Section 5 of the Securities Act. However, materials containing untrue or misleading statements will not be exempt from liability under Sections 11 and 12 of the Securities Act because they are considered to be prospectuses and, once filed on Form 8-K, will be incorporated into the Form S-3 registration statement by reference.

Research Reports

The proposed rules codify a 1997 no-action letter that the safe harbors provided by Rules 137, 138 and 139 under the Securities Act relating to the publication of research reports during registration by brokers or dealers apply to asset-backed securities registered on Form S-3. Proposed Rule 139a follows the current treatment of research reports with a few minor changes to accommodate asset-backed securities. The safe harbor applies only to registered offerings of investment grade asset-backed securities that meet the requirements of Form S-3. Research reports published regarding securities of this type will not violate the communication restrictions of the Securities Act if the conditions set forth in Rule 139a are met, including that the broker or dealer must have previously published with reasonable regularity information, opinions or recommendations relating to asset-backed securities with substantially similar collateral. The research report may not contain ABS informational and computational material.

Practical Considerations

- For issuers and underwriters, the potential liability for incorrect ABS informational and computational materials underscores the need to establish reliable procedures to insure the correctness of this information.
- The SEC’s express consent to the use of ABS informational and computational materials provided to third party analytical service providers allows issuers and underwriters to give investors transaction information in a format that they prefer. The challenge will be figuring out what material needs to be filed.
- For broker-dealers, the proposed rules provide clear guidelines for the distribution of research reports about asset-backed securities during registration.

Exchange Act Reporting

The SEC has proposed a new scheme for Exchange Act reporting by ABS issuers. The new rules are intended primarily to codify the existing modified reporting practices established by many SEC no-action letters. The release also expands existing practice by adding new features to the reporting regime, including a new Form 10-D for issuers’ periodic distribution reports and establishing minimum universal servicing standards. The new rules also provide clear guidelines as to which entities must file the reports and which reports must be filed.

Determining the Issuer for Exchange Act Reports

The “issuer” for purposes of the Exchange Act reporting will be the “depositor” or the transferor that transfers the assets to the issuing entity. A depositor that transfers assets to multiple issuing entities in different transactions is considered to be a separate “issuer” for Exchange Act reporting purposes for each issuing entity. This definition of “issuer” would result in separate Exchange Act filing obligations for each securitization by the same depositor. The depositor’s Exchange Act reporting obligations with respect to ABS transactions are also separate from any reporting requirements or exemptions from reporting related to any issuance of the depositor’s own securities. The SEC has noted that
investors want to see periodic report information separately by the issuing entity using separate EDGAR CIK codes for each issuer, which would allow investors to search filings by the depositor for information about a particular deal.

To aid in establishing the separate issuer identity of the depositor for each set of Exchange Act reports filed, the depositor must obtain a new CIK number for each issuing entity. All Securities Act and Exchange Act filings with respect to the issuing entity would then be filed under the new CIK number, rather than under the depositor’s own CIK number.

The release also clarifies the rules for transactions that use an “issuance trust” structure. In this structure, if the intermediate trust is issuing a financial asset to an issuing trust, both trusts are established under the direction of the same sponsor and the transaction meets the other structural requirements set forth in the release, proposed Rule 15d-23 under the Exchange Act will not require the intermediate trust to file separate Exchange Act reports.

For purposes of determining an issuer’s ability to suspend its Exchange Act reporting under Section 15(d) of the Exchange Act, the depositor is considered a separate issuer for each issuing entity. Therefore, if at the beginning of a fiscal year an issuing entity’s securities are held by fewer than 300 persons, that depositor may still suspend its Exchange Act reporting with respect to that issuing entity, even though the same depositor may continue to have Exchange Act reporting requirements resulting from its sponsorship of other issuing entities.

**Periodic Reports**

**Form 10-D.** Issuers must file their periodic distribution statements on new Form 10-D, rather than on Form 8-K as is currently the practice. Form 10-D would also require issuers to disclose certain non-financial items that might otherwise have been included in a Form 10-Q filing, including defaults of senior securities, votes of security holders, legal matters and other similar items.

Form 10-D must be filed via EDGAR no later than 15 days after each scheduled periodic distribution date for the ABS transaction. It must be signed by the depositor or the servicer and may not be filed by the trustee. Consistent with its position for ABS informational and computational materials, the SEC proposes to eliminate any paper filing exemptions previously available to ABS issuers.

A depositor that sponsors multiple issuing entities would be required to prepare a separate Form 10-D for each issuing entity: depositors may no longer file one report that lists the distribution statements for all of its outstanding transactions.

**Distribution Statements.** The new rules will not mandate any particular format for an issuer’s periodic distribution statements. The SEC acknowledges that these reports need to be tailored for each transaction based on the nature of the underlying assets, particular transaction structure and the demands of investors. However, in Item 1119 of Regulation AB, the SEC provides examples of material categories of information that should be included in periodic distribution statements filed under Form 10-D. Many of these items are quite common while others may appear less frequently, such as the following:

- Updated pool composition information for the period, such as weighted average coupon, weighted average life, weighted average remaining term, pool factors, prepayment amounts, current payment/prepayment speeds and other prepayment or interest rate sensitivity information; for lease securitizations, this information should include turn-in rates and residual value realization rates;
- Delinquency and loss information for the period;
- Amounts, terms and purpose of any advances made or reimbursed, including the use of funds advanced and the source of funds for reimbursements;
- Material modifications, extensions, waivers to pool asset terms, fees, penalties or payments;
- Breaches of material pool asset representations and warranties or transaction covenants; and
- Information regarding any new issuance of asset-backed securities backed by the same asset pool, any pool asset additions, removals, substitutions and repurchases, such as through a prefunding or revolving period, and cash flows available for future purchases, including (1) any material changes in the solicitation, credit-granting, underwriting, origination or pool selection criteria to select new pool assets and (2) if the addition, removal or substitution of pool assets has materially changed the composition of the asset pool taken as a whole, revised pool composition information under
Items 1104 (sponsors), 1107 (servicers), 1109 (originators), 1110 (pool assets) and 1111 (significant obligors).

The SEC recommends that issuers include appropriate introductory and explanatory information to explain information in distribution reports and tables and graphs if helpful. The SEC acknowledges that the proposed periodic disclosures for prefunding periods, revolving periods and master trusts are more expansive than is currently the case.

**Form 10-K.** The main items of Form 10-K reporting for ABS issuers would remain consistent with the system of modified reporting currently utilized. The cover page of Form 10-K would need to include the names of the issuing entity, the depositor and the sponsor, if different than the depositor. Form 10-K must be signed by the same individual who signs the Sarbanes-Oxley certification as discussed below, which may be either (1) on behalf of the depositor by the senior officer in charge of securitization of the depositor or (2) on behalf of the issuing entity by the senior officer in charge of the servicing function. If multiple servicers are servicing the pool assets, the master servicer must sign if the servicer is the signatory.

The release proposes to add specific disclosures to Form 10-K for ABS issuers as follows:

- Financial information relating to significant obligors in the asset pool (Item 1111(b));
- Financial information relating to significant enhancement providers (Item 1113(b)(2));
- Legal proceedings against any of the transaction parties that is material to security holders (Item 1115);
- Affiliations of transaction parties and certain related transactions (Item 1117);
- Attestation of compliance with applicable servicing criteria as described below (Item 1120); and
- A servicer compliance statement as described below (Item 1121).

**Compliance with Servicing Criteria.** Perhaps the most significant proposal in the release is an extensive new set of standard servicing criteria. The release cites recent events as demonstrating the need for “a single set of transparent and comprehensive servicing criteria, attested to by an independent third party under recognized professional standards.” The SEC has determined that the Uniform Single Attestation Program for Mortgage Bankers (USAP), developed for residential mortgage loan servicing, is not consistently applied and does not adequately establish minimum servicing levels for all ABS transactions. The release proposes a uniform set of criteria that would be the basis for evaluation of servicing activities. The servicer’s compliance with these standards must be attested by an independent accounting firm and certified by a senior officer of the servicer or the master servicer, if multiple servicers are involved in a transaction. The compliance attestation and servicer certification may be made on a platform level, rather than for each individual transaction, if the assets backing those transactions are all on the same servicing platform.

Proposed Item 1120 of Regulation AB will require as a new Exhibit 33 to Form 10-K a report of a “responsible party” on an assessment of compliance with proposed servicing criteria. The “responsible party” is the entity signing the Form 10-K: either the depositor or the servicer. The statement required by Item 1120(a) must include disclosure that:

- The responsible party is responsible for assessing compliance with servicing criteria;
- The responsible party used the servicing criteria to assess compliance with the servicing criteria;
- An assessment of compliance with servicing criteria for the fiscal year, including disclosure of any material instance of noncompliance; and
- A registered public accounting firm has issued an attestation report on the responsible party’s assessment of compliance with servicing criteria for the fiscal year.

The new accountants’ attestation report must be filed as Exhibit 34 to Form 10-K. The responsible party must use reasonable means to assess whether parties performing servicing functions (e.g., servicers, master servicers, trustees and paying agents) are complying with servicing criteria in all material respects, and can reasonably rely on information provided to it by unaffiliated parties.

The proposed servicing criteria in Item 1120(d) include:

- General servicing criteria, including use of policies and procedures to monitor performance or other triggers or events of default under the transaction agreements,
monitoring of subservicers, and maintenance of backup servicers and fidelity bonds;

• Cash collection and administration criteria, including that payments on pool assets are deposited into custodial accounts no more than two business days after receipt, wire transfers are monitored, advances or collection guarantees are made in accordance with the transaction documents, custodial accounts are separately maintained as set forth in the transaction agreements, and reconciliations are prepared on a monthly basis for all bank accounts related to the transactions;

• Investor remittance and reporting criteria, including that (1) SEC and other investor reports are prepared in accordance with required timeframes and other terms in the transaction documents, provide information calculated in accordance with the transaction documents, are filed with the SEC as required and agree with the investors’ and trustee’s records as to unpaid principal balance of the securities and the balance and number of pool assets serviced by the servicer, (2) amounts due investors are allocated and remitted in accordance with the transaction documents, (3) distributions are posted within two business days to investors and (4) amounts remitted to investors agree with bank statements; and

• Pool asset administration criteria, including maintenance of collateral as required, safeguarding of pool assets and related documents, review and approval of pool asset removal, addition or substitution, payments on pool assets are posted to obligor’s records no more than two business days after receipt, servicer records agree with obligor records, changes to pool asset terms are reviewed and approved by authorized personnel and loss mitigation or recovery actions are properly conducted, maintenance of collection records, interest rates adjustments are made and escrow accounts maintained in accordance with the transaction agreements and many similar provisions.

Sarbanes-Oxley Certification. The release generally codifies the February 2003 SEC statement regarding certifications under Section 302 of the Sarbanes-Oxley Act for ABS issuers (Rule 13a-14 or Rule 15d-14 under the Exchange Act, as applicable). The senior officer of the depositor in charge of securitization or the chief executive of the servicer must provide the Sarbanes-Oxley certification, which must be filed as Exhibit 31 to Form 10-K. The revised certificate contains certifications in Items 3, 4 and 5 to reflect the new Exchange Act proposals on servicer compliance:

• All distribution, servicing and other information required to be provided under Form 10-D are included;

• Based on the compliance review required by Item 1121, the servicer has fulfilled its obligations; and

• The report discloses all material instances of noncompliance with servicing criteria as provided in Item 1120 based on an assessment of compliance with such criteria.

The same person that signs the 10-K must sign the Section 302 certification. Trustees are no longer permissible signatories. As is currently the case, signers may reasonably rely on information that unaffiliated trustees, depositors, servicers or subservicers provide.

Form 8-K. The release proposes that ABS issuers file current reports on Form 8-K with additional events added for asset-backed securities, including:

• Bankruptcy of the sponsor, depositor, servicer, trustee, significant obligor, enhancement provider or other material party;

• Occurrence of an early amortization event, performance trigger or other event, including an event of default, that would materially alter the payment priorities or cash flows;

• ABS informational and computational materials (term sheets);

• Change of servicer or trustee;

• Change in credit enhancement or other support;

• Failure to make required distributions; and

• Sales of additional securities (such as in a master trust).

Practical Considerations

• As a result of the creation of a written set of rules applicable to all ABS issuers, it will be easier for the SEC to bring an enforcement action against issuers, sponsors, depositors, trustees, etc. that do not comply with the new rules. If the proposed rules do not work for an industry participant, it is important that comments be
raised to address the situation before final rules are adopted. The SEC requests that comments be submitted on or before July 12, 2004.

- Issuers and servicers will likely need to undertake a complete review of their servicing and compliance procedures in order to comply with the new rules. Given the extensive new compliance burden, the proposals will likely make it more difficult for smaller and start-up issuers to issue public securities. The cost of complying with Regulation AB may push cost-sensitive issuers out of the public markets altogether.

- Accountants will need to assess the cost and timeframe for the new attestation report required by proposed Item 1121, and what issues they see in complying with Regulation AB.

- Issuers and master servicers will need to negotiate with subservicers and allocate responsibility for compliance of subservicers with servicing criteria. The SEC staff clearly wants one party responsible for compliance – the entity that files reports with the SEC.

- The SEC staff seems particularly concerned that servicers are not complying with servicing standards in transaction documents. Failure to comply with transaction documents may now result in embarrassing disclosures.

- We recommend that industry participants review the proposed rules carefully and actively comment on them. There is a massive amount of detail in both the text of the release and the rules themselves, which should be carefully considered.
If you have any questions regarding the release, we would be pleased to provide additional details or advice about specific situations. For more information, please contact any of the attorneys listed below or any other member of our securitization group. If you would prefer to receive distributions electronically and are not receiving them that way now, please send your e-mail address to cblackmond@mayerbrownrowe.com.

Mary R. Barry ........................................... +1.312.701.8460
Christopher J. Brady ......................................... +1.704.444.3511
Diane Citron .................................................. +1.212.506.2520
Mary C. Fontaine ........................................... +1.312.701.7106
J. Paul Forrester ........................................... +1.312.701.7366
Michael L. Hermsen ........................................ +1.312.701.7960
Carol A. Hitselberger .................................... +1.312.701.7740
Robert F. Hugi ............................................. +1.312.701.7121
Paul Jorissen ............................................. +1.212.506.2555
Marc L. Klyman ........................................... +1.312.701.8053
Kenneth E. Kohier ........................................ +1.213.229.9567

Jason H.P. Kravitt .......................................... +1.312.701.7015
Jean-Pierre Lee ........................................... +1.33.1.53.53.0350
Stuart M. Litwin ........................................... +1.312.701.7373
Mark C. Nicolaides ........................................ +1.44.207.246.6232
Keith F. Oberkfell ........................................ +1.704.444.3549
George A. Pecoulas ........................................ +1.312.701.7956
Elizabeth A. Raymond .................................. +1.312.701.7322
Drew Salvest .............................................. +1.44.207.246.6255
John M. Timperio ........................................ +1.704.444.3516
Jon D. Van Gorp ........................................... +1.312.701.7091
Dr. Jörg Wulfken ........................................+1.49.69.79.41.2951

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