The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24275

April 28, 2010

SEC Proposes Comprehensive Changes to Asset-Backed Security Regulation

[24275]

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TO: SEC RULES MEMBERS No. 40-10
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 14-10
FIXED-INCOME ADVISORY COMMITTEE No. 6-10 RE: SEC PROPOSES COMPREHENSIVE CHANGES TO ASSET-BACKED SECURITY REGULATION

The Securities and Exchange Commission has proposed rules that would substantially revise Regulation AB and other rules regarding the offering process, disclosure, and reporting for publicly-issued asset-backed securities ("ABS"), and impose new disclosure standards for privately-placed ABS. [1] According to the SEC, the proposed rules stem from a year of studying the practices in the securitization market that contributed to the financial crisis, and should enhance investor protection and promote more efficient ABS markets. Specifically, the proposed rules "are intended to provide investors with timely and sufficient information, including information in and about the private market for asset-backed securities, reduce the likelihood of undue reliance on credit ratings, and help restore investor confidence in the representations and warranties regarding the assets." The rules only would apply to issuances of ABS and other structured finance products that are issued after the implementation date of the final rules. [2]

The most significant proposed changes are summarized below.

Comments on the proposed rules are due to the SEC no later than August 2, 2010. We will hold a conference call on Friday, May 14, at 2:00 p.m. Eastern time to discuss the Institute's comments relating to the SEC's proposal. If you plan to participate on the call, please

contact Ruth Tadesse by email at rtadesse@ici.org or by phone at 202-326-5836 to receive the dial-in information.

I. Disclosure and Reporting for Publicly-Issued ABS

In the Release, the SEC states that investors must be given more detailed, ongoing, loan-level data about the characteristics of the pool assets and related obligors and collateral, and the performance of pool assets. The proposed rules therefore would greatly expand the amount of information made available regarding loan-level disclosure and pool assets as a whole.

A. Loan-Level Information

With some exceptions, the proposed rules would require asset-backed issuers to file with the SEC information about the specific loans in the pool, including information relating to the terms of the asset, the characteristics of the obligor, and the underwriting of the asset. The proposed rules identify certain information that must be provided for all subject assets generally and additional information that must be provided based on the types of assets comprising the pool. [3] Specific disclosure requirements also would apply to offerings of residential mortgage-backed securities based on the proposals made by the American Securitization Forum in its Project RESTART. In all cases, the loan-level data would include a unique identifying number for each loan to permit market participants to track performance at the individual level.

The loan-level information would have to be provided at the time of securitization, when new assets are added to the pool underlying the securities, and on an ongoing basis. In addition, it would need to be provided in a standardized, tagged-data format using eXtensible Markup Language ("XML") and filed through the SEC's EDGAR system.

B. Static Pool Information

Under the proposed rules, issuers would no longer be allowed to post static pool information on the Internet. It would have to be filed with the SEC through EDGAR. The SEC, however, would permit the information filed on EDGAR to be incorporated by reference in the prospectus.

C. Waterfall Computer Program

The proposed rules would require asset-backed issuers to file with the SEC a computer program of the contractual cash flow provisions of the transaction that dictate how loan payments of obligors are distributed to investors, how losses or lack of payment on those loans are allocated among investors, and when administrative fees (including servicing fees) are paid to service providers. The computer program is intended to be used by investors to input the loan-level information and other data to model projected cash flows and allocation of losses. The computer program would need to be provided as a

downloadable source code in Python [4] and be tagged in XML.

D. New Forms for Registered ABS Offerings and New Standards for Shelf Eligibility

The proposed rules would replace Forms S-1 and S-3 with new forms – Forms SF-1 and SF-3 – for registered ABS offerings and would revise the shelf eligibility rules to require periodic assessments of the asset-backed issuer's continued eligibility to conduct shelf offerings.

E. 5-Day Review Period

The proposed rules would revise the filing deadlines for shelf offerings to provide investors with additional time to review the offering information, including loan-level data, before making an investment decision. The asset-backed issuer would be required to file a preliminary prospectus with the SEC for each takedown at least five business days prior to the first sale in the offering.

F. Use of Integrated Prospectus in Shelf Takedowns

Instead of preparing a base prospectus and multiple prospectus supplements, the proposed rules would require asset-backed issuers to file: (1) a single form of prospectus at the time of the effectiveness of the proposed Form SF-3 registration statement and (2) a single, final prospectus at the time of each takedown. The rules also would permit only one depositor, one form of prospectus, and one asset class per registration statement. A post-effective amendment would be required to change the asset class or add a different type of credit enhancement or new "structural feature."

G. Use of Credit Ratings

The proposed rules would eliminate the condition that the ABS be rated investment grade as an eligibility criteria for shelf registration and replace it with the following new eligibility criteria:

- Risk Retention: The sponsor or an affiliate would be required to retain at least a 5 percent un-hedged piece of each tranche of ABS issued in the transaction or, in the case of master trusts, at least a 5 percent un-hedged "originator's interest." A sponsor could still conduct a public offering without risk retention, but such an offering would not be eligible for shelf registration, and disclosure would be required in those transactions as to the extent or absence of risk retention.
- Third Party Evaluation of Repurchase Obligations: The pooling and servicing agreement would require that the party obligated to repurchase pool assets following the occurrence of a breach of representations and warranties periodically furnish to the trustee an independent third-party opinion, stating that the obligated party acted in compliance with the pooling and servicing agreement in the case of any pool assets that were put back to it for repurchase but were not repurchased.

- CEO Certificate: At the time of each takedown from a shelf registration statement, the chief executive officer of the depositor would need to certify that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce cash flows to service any payments due and payable on the securities as described in the prospectus.
- Ongoing Reporting Requirement: The issuer would be required to agree to file reports under the Securities Exchange Act of 1934 with the SEC on an ongoing basis so long as its publicly-offered ABS remain outstanding. [5]

II. Disclosure for Privately-Placed ABS

In the Release, the SEC states that investors in the private market for ABS must have access to, and sufficient time and incentives to adequately consider, appropriate information regarding those securities. The proposed rules would require specific disclosures for private offerings of structured finance products as well as additional public information about private structured finance product offerings conducted in reliance upon the safe harbors in Rule 144, Rule 144A and Regulation D. The obligation to provide information under the proposed rules would not be a condition of the safe harbors. Instead, as new conditions of the safe harbors, the underlying transaction agreements would be required to contain the specified representations and covenants to provide information. Failure to comply with these proposed requirements could result in an SEC enforcement action under proposed new Rule 192 as well as investor claims under the transaction agreements.

A. Required Disclosure to Investors in Private Transactions

Under the proposed rules, when an SEC safe harbor is relied upon for the unregistered sale of ABS to an investor (including an “accredited investor” under Regulation D and a “qualified institutional buyer” under Rule 144A), the issuer would be required to provide to such investor, upon request, substantially the same information that the issuer would be required to provide to an investor in a public offering of the ABS. Also, the issuer would need to represent that it will provide such information upon request. This information would be required to be provided both at the time of the offering and on an ongoing basis. [6] The proposed rules would apply to ABS offerings undertaken in reliance on the safe harbors afforded by Rule 144A and Regulation D, but would not apply to structured finance products offered and sold under the private placement statutory exemption of Section 4(2) of the Securities Act of 1933 and the Section 4(1-1/2) exemption for private resales.

The proposed disclosure requirements would apply to a newly defined, broader category of “structured finance products” that would include ABS as defined under Regulation AB as well as include CDOs and synthetic ABS.

B. Public Notice

The proposed rules would require the issuer of a structured finance product to file a public notice, in EDGAR, of the initial placement of any structured finance product that is eligible

for resale under Rule 144A.

C. Undertaking with the SEC

The proposed rules would require the issuer of the structured finance product to undertake to provide offering materials to the SEC upon written request.

III. Definition of Asset-Backed Security

If adopted, the rules would limit the extent to which publicly-issued ABS may deviate from the "discrete pool" requirement in the definition of "asset-backed security" by reducing the amount of prefunding from 50 percent of the offering proceeds to 10 percent.

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endnotes

[1] See SEC Release Nos. 33-9117; 34-61858 (April 7, 2010), available at: http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[2] The proposed rules would apply to resecuritizations (regardless of when the underlying ABS were issued).

[3] In the case of credit card and charge card ABS, the proposed rules would require that the specified information be provided on the basis of distributional account groups rather than on the basis of the individual loans.

[4] Python is a commonly used open source interpretive programming language.

[5] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated March 26, 2009, available at http://www.sec.gov/comments/s7-04-09/s70409-14.pdf.

[6] The proposed rules do not include an ongoing reporting requirement for an offering that relies on Regulation D.