

MEMO# 17574

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SEC PROPOSES RULES FOR REGULATION OF ASSET-BACKED SECURITIES

[17574] June 3, 2004 TO: FIXED-INCOME ADVISORY COMMITTEE No. 7-04 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 8-04 SEC RULES MEMBERS No. 81-04 RE: SEC PROPOSES RULES FOR REGULATION OF ASSET-BACKED SECURITIES The Securities and Exchange Commission has published for comment proposed rules governing the issuance of asset-backed securities ("ABS").¹ The proposed rules largely codify SEC staff no-action letters and other interpretive guidance under the Securities Act of 1933 and the Securities Exchange Act of 1934. Specifically, the proposed rules would: (1) provide tailored disclosure guidance and requirements for Securities Act and Exchange Act filings involving ABS; (2) update and clarify the Securities Act registration requirements for ABS offerings; (3) streamline and codify existing interpretive positions that permit the use of written communications in a registered offering of ABS in addition to the statutory registration statement prospectus; and (4) consolidate and codify existing interpretive positions that allow modified Exchange Act reporting that is more tailored and relevant to ABS. The most significant aspects of the proposed rules are summarized below.

I. Disclosures About ABS Offerings The SEC is proposing new Regulation AB, a "principles-based" set of disclosure items that would form the basis for disclosure in Securities Act registration statements and Exchange Act reports for ABS.² Although the disclosure items are based on the current disclosure regime, the SEC proposes to add substantial disclosure requirements relating to the background, experience, performance and roles of various parties involved with an ABS transaction, such as the sponsor, the depositor, the servicer, and the trustee.³ The SEC also is proposing to require disclosure regarding historical performance data, or "static pool data," relating to the sponsor's 1 Securities Act Release No. 8419 (May 3, 2004) ("Release"). The Release can be found on the SEC's website at <http://www.sec.gov/rules/proposed/33-8419.htm>. Comments on the proposed rules are due to the SEC no later than July 12, 2004.

2 The SEC requests comment on its proposed principles-based approach for Regulation AB and, specifically, whether it should instead provide detailed disclosure guides by asset type.

3 The SEC also proposes specific definitions for each of the key transaction parties. The SEC requests comment on its proposed disclosure regarding transaction parties, including its proposed definitions.

2 portfolio and individual securitized pools, and, where relevant, assets proposed to be securitized. The Release explains that such data, if material, can indicate how the performance of groups, or static pools, of assets, such as those originated at different intervals, are performing over time. The SEC, citing a 1996 Institute letter to the SEC as an example, acknowledges that it has previously received requests that disclosure of such data should be required because investors view static pool data regarding delinquency and loss experience as important information in evaluating an investment in ABS.⁴ Finally, the proposed rules would require that the solicitation, credit granting or underwriting criteria

used to originate or purchase the pool assets be described, as well as the selection criteria for the asset pool. Specifically, the proposed rules would consolidate and codify current staff positions on when financial or other information would be required regarding certain third parties, such as obligors of financial assets that reach pool concentration levels (i.e., 10%) or significant providers of credit enhancement or other support for the ABS. In addition, to address the increased emphasis in the ABS market on the level of fees and expenses involved in ABS transactions, the proposed rules would require a separate table itemizing all estimated fees and expenses to be paid out of the cash flows for the transaction.

II. Securities Act Registration Under current rules, investment-grade securities that meet the SEC's definition of "asset-backed security" may be registered on a shelf-registration basis on Form S-3.⁵ In the proposed rules, the SEC retains the same basic definition of asset-backed security, with one modification with respect to leases.⁶ The proposals also would codify two staff interpretations concerning the nature of the issuing entity as conditions to the definition of "asset-backed security." The first condition is that neither the depositor nor the issuing entity is an "investment company" under the Investment Company Act of 1940, nor will either become one as a result of the ABS transaction. The second condition is that the issuing entity must be passive and its activities must be restricted to acting in a single ABS transaction. The proposed rules would limit the registration of ABS offerings to two forms: Forms S-1 or S-3. The proposed rules also would require that, as a condition for continued use of Form S-3 for registrations of new ABS transactions, the reporting obligations regarding other ABS transactions established by the sponsor and the depositor have been complied with for the prior 12 months.⁷

⁴ See Letter from Alexander C. Gavis, Assistant Counsel, Investment Company Institute to Michael H. Mitchell, Special Counsel, Division of Corporation Finance, dated Oct. 29, 1996. A copy of the Institute's letter can be found on the SEC's website at <http://www.sec.gov/rules/proposed/s72104/s72104-2.pdf>.

⁵ Form S-3 defines an "asset-backed security" as "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 the security holders." ⁶ The proposed rules would extend shelf registration to securities backed by leases with the addition of a proviso to the definition to the effect 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." ⁷ The SEC requests comment on whether it should continue to require the current investment grade requirement for Form S-3 eligibility, whether there are any additional conditions, other than the ones listed in the Release, that should.

Finally, the proposed rules would codify a series of no-action letters that do not require broker-dealers under Exchange Act Rule 15c2-8(b) to deliver a copy of a preliminary prospectus to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of the confirmation.⁸ The Release acknowledges previous concerns from investors, including the Institute, that relief from Rule 15c2-8(b), among other things, has reduced the amount of time and information investors have to make informed investment decisions.⁹ The SEC, therefore, requests comment on whether it should codify the exclusion from the preliminary prospectus delivery requirements, whether investors have enough time and information before an offering to make fully informed investment decisions, and what alternatives might exist to Rule 15c2-8(b) to address this concern.

III. Communications During the Offering Process The proposed rules would permit the use of "ABS informational and computational material" after the effectiveness of a registration statement for an offering of ABS registered on Form S-3 but before the delivery of the final prospectus under Section 10(a) of the Securities Act. Under the proposed rules, materials currently classified as "computational materials," "collateral term sheets" or

“structural term sheets” would be combined under the heading “ABS informational and computational material” and subject to a single filing deadline.¹⁰ The proposed rules also would modify the current EDGAR rules to eliminate the ability of issuers to file computational materials in paper form rather than electronically. The proposed rules further make clear that loan-level data may be provided to investors, and that raw data may be provided to third-party analytics firms that permit investors to run their own calculations. Finally, the SEC proposes new Rule 139a. Rule 139a would provide a safe harbor under which the publication or distribution by a broker-dealer of research reports with respect to ABS eligible to be registered on Form S-3, at a time when such broker-dealer is participating in an offering of such ABS, would not be deemed to constitute an offer for sale of the ABS. be required to qualify for S-3 eligibility, and whether the proposed requirement regarding prior reporting obligations be limited to prior transactions by the same sponsor and depositor involving the same asset class. ⁸ The Release states that without these no-action letters, most broker-dealers would be required to deliver a preliminary prospectus in ABS offerings because Rule 15c2-8(b) requires delivery if the issuer has not previously been required to file reports with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act, which most ABS issuers at the time of the ABS offering are not required to do. ⁹ See *supra*, note 4. ¹⁰ “ABS informational and computational material” would include, among other things, a brief summary of the proposed structure of the securities; information regarding the proposed underlying assets; static pool data for the sponsor’s portfolio, prior transactions or the asset pool itself; and statistical data displaying for a particular class of asset-backed securities the yield, average life, expected maturity or other such information under specified prepayment, interest rate, loss or related scenarios. ⁴

IV. Ongoing Reporting Under the Exchange Act

The proposed rules would codify the modified reporting system under the Exchange Act that is currently in place for ABS issuers. Specifically, the SEC would require ABS issuers to file periodic distribution and pool performance reports on new Form 10-D (this information is currently filed under Form 8-K). Form 10-D would require disclosure of a number of items, including, among other things, cash flows received, updated pool composition information, delinquency and loss information, amounts drawn on any credit enhancements or other support, material modifications, extensions or waivers to pool asset terms, and breaches of material pool asset representations or transaction covenants.¹¹ The SEC also proposes to add a general instruction to Form 10-K to specify how that form is to be used for an annual report with respect to ABS. For instance, the general instruction would identify the existing items in the form that may be omitted as well as substitute items from proposed Regulation AB that would be required. Finally, similar to Form 10-K, the SEC proposes to add a general instruction to Form 8-K to specify how that form is to be used with respect to ABS. The SEC proposes to clarify that a reportable event for an ABS issuer would include, among other things, an early amortization, performance trigger or other event, including an event of default, that would materially alter the payment priority, distribution of cash flows or amortization schedule for the ABS. The new items proposed to be reported on Form 8-K for ABS issuers include ABS informational and computational material, change of servicer or trustee, change in credit enhancement or other external support, failure to make a required distribution, sales of additional securities, and Securities Act updating disclosure. Jane G. Heinrichs Assistant Counsel

¹¹ The SEC requests comment on whether proposed Form 10-D would be beneficial or whether there are alternatives to such a form, such as requiring that distribution reports be posted on a specified party’s website within a certain time period and not filed with the SEC until the Form 10-K.

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