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SEC Proposes New Requirements for Offerings of Asset-Backed Securities

On April 7, 2010, the SEC published for comment proposed amendments to Regulation AB and other rules that, if adopted, would significantly modify the existing requirements with respect to offerings of asset-backed securities (“ABS”).

The SEC is proposing to broaden considerably the amount of information presented to investors about the risks inherent in ABS and to more strictly align the interests of ABS issuers with those of investors. The proposals would require in public offerings of ABS, among other things, specific asset-level information in prospectuses, the filing of the “waterfall” computer program, a revised deadline to file prospectuses, and renewed eligibility criteria for participation in a shelf offering (including requiring retention of risk, or “skin in the game”). Notably, the proposals would extend many of the new requirements to private placements of ABS under Rule 144A and Regulation D.

Background

ABS are created by a securitization process through which financial assets are pooled and converted into securities offered to investors. The assets that are pooled include residential and commercial mortgages, automobile loans and leases, student loans and credit card receivables. These assets often are bundled and divided into different securities depending on levels of risks and returns.

ABS are offered in either a public offering or a private placement. In public offerings, asset-backed securities are registered with the SEC generally through the use of shelf registration statements. ABS are also sold in private placements to large institutional investors, known as qualified institutional investors (“QIBs”), or to a limited group of investors in reliance on safe harbors from registration provided in Rule 144A, Rule 144 and Regulation D under the Securities Act of 1933.

In the recent financial crisis, many investors in ABS suffered significant losses as the assets underlying ABS deteriorated. The SEC believes that ABS investors were not fully aware of the risks associated with their investments and relied on credit ratings assigned by rating agencies. In response, the current proposals are designed to provide investors with greater transparency with respect to the structure of ABS and the quality of underlying assets and to promote more efficient ABS markets.

The SEC Proposal

Disclosure Requirements

Asset-Level Information in Prospectuses

The SEC proposes to require ABS issuers to disclose asset-level data in the prospectus **at the time of the public offering and on an ongoing basis** as part of reports under the Securities Exchange Act of 1934 (the “Exchange Act”), subject to certain exceptions. Currently, Regulation AB, which sets forth disclosure requirements in registered offerings of ABS, requires a general description of pool of assets underlying ABS but not individual asset data.

In the SEC’s proposal, each asset would be identified by a number to be tracked through the life of the security. The asset-level data would also be processed on EDGAR and tagged in Extensible Mark-up Language (XML) to enable investors to navigate through the large amount of data.

The asset-level information would be required in offerings of ABS backed by residential mortgages, commercial mortgages, automobile loans and leases, equipment loans and leases, student loans, floorplan financings, corporate debt and ABS backed by other ABS. Types of information required to be disclosed would differ depending on the category of assets. The examples of types of information that would be included are:

- whether a loan asset was made without following the stated loan underwriting standards;
- whether the obligor’s income was verified through actions such as a review of W-2 forms or tax returns; and
- steps taken by the servicer to limit losses on the assets.

This disclosure requirement would not apply to ABS backed by credit card receivables, which would otherwise result in disclosure of information relating to myriad of accounts that may be included in the asset pool. Instead, the SEC proposes to require statistical information about accounts that are similar and grouped by certain characteristics such as credit score range, age of account, payment status and geographic location.

“Waterfall” Computer Program

The SEC proposes to require that ABS issuers file the computer programs that are used to simulate the flow of funds collected on pool of assets underlying ABS, or the “waterfall.” Regulation AB currently only requires a narrative description of the waterfall, and the issuers or underwriters of ABS are not obligated to share the computer programs that they use to compute the waterfall. As a result, investors are forced to create their own computer programs to assess the ABS waterfall, which the SEC perceives to be particularly burdensome for smaller investors.

To prevent investors from making investment decisions without having sufficiently conducted an analysis of the waterfall, the SEC proposes to obligate ABS issuers to file their waterfall computer programs via EDGAR in the form of a downloadable source code in a specific programming language designated by the SEC. By inputting to the filed computer program the information that would be provided under the new requirement to disclose asset-level data, as discussed above, investors would be able to better analyze the offered ABS.

Registration and Offering Process

Timing of Prospectus Filing in a Shelf Offering

Under the current rules on shelf offerings, a registration statement that is initially filed to create a shelf does not contain specific terms of the takedown. When ABS are subsequently offered off the shelf, the prospectus or prospectus supplement containing material terms of the ABS, including specific information about pool of assets, is only required to be filed by the second business day after the document is first used. As a result, the SEC believes that investors may not have adequate time to review all materials before making their investment decisions.

To allow investors ample time to review information about the offered ABS, the SEC proposes to require that an ABS issuer using a shelf registration statement file a preliminary prospectus containing specific transaction terms, except pricing information, at least **five business days prior** to the first sale of ABS.

Shelf-Eligibility Criteria

The existing rules on shelf offering have certain eligibility criteria including the requirement that ABS offered in a shelf offering be backed by “investment grade” securities. A security is considered investment grade for the purpose of determining shelf eligibility when at least one nationally recognized statistical organization has rated the security as investment grade.

As part of its ongoing effort to eliminate reliance on credit agency ratings, the SEC proposes to replace the “investment grade” eligibility requirement with the following four shelf-eligibility criteria:

- **Risk retention (“skin in the game”):** The sponsor of the securitization would be required to hold 5% net economic interest of each tranche of ABS, or have “skin in the game,” and not hedge those holdings. The economic interest would be measured at issuance and maintained on an ongoing basis. The retention would also be disclosed in the prospectus.
- **Depositor CEO certification:** The CEO of the depositor of assets underlying the ABS would be required to certify that there is reasonable basis to believe the assets would generate sufficient cash flow as described in the prospectus.
- **Third party opinion:** When a claim is made that a representation and warranty relating to an underlying asset was breached, the representing party would be required to furnish an unaffiliated third party’s opinion that the asset did not violate the representation and warranty.
- **Ongoing Exchange Act reporting:** The ABS issuer would be required to agree to file ongoing reports with the SEC under the Exchange Act. In other words, the ABS issuers would not be able to cease reporting after one year of ABS issuance, which is the current common practice.

The SEC proposes these criteria to align the interests of the sponsors with those of the investors and to provide investors with reasonable and enhanced assurance that the information provided by the issuer is reliable and current.

Private Placements

The SEC proposes amendments to Rule 144, Rule 144A and Regulation D, which provide safe harbors from registration for issuers selling ABS in a distribution to a limited group of investors, QIBs or “accredited investors.” The revisions would require that investors be given the right to

request information from issuers equivalent to that which they would be entitled to receive in a public offering. The investors would be entitled to such information at the time of issuance and on an ongoing basis in the form of periodic reports.

The SEC also proposes to adopt a provision under which it can bring an enforcement action against issuers who refuse to provide sufficient information to investors in private placements.

In addition, the SEC proposes to require that a public notice be filed with the SEC before the initial placement of ABS made in reliance on Rule 144A.

Other Proposed Amendments

The SEC further proposes to adopt the following revisions to the existing regulatory scheme relating to ABS:

- **Standardize static pool disclosure:** Static pool information is used to evaluate the performance of assets underlying ABS. The proposal would make disclosure of certain static pool information mandatory including, among other things, a general description of static pool and methodology used for the analysis.
- **Amendment to “asset-backed security” definition:** The definition of “asset-backed security” under Regulation AB would be broadened.
- **Originator and Sponsor Information:** Additional information would be required regarding originators and sponsors of ABS or securitization including, under certain circumstances, the amount of their publicly securitized assets and whether they have been subject of a demand to repurchase or replace in the last three years.
- **Form 8-K filing threshold:** The threshold triggering a filing of reports with the SEC on Form 8-K with respect to changes in the material pool characteristics would be lowered from 5% to 1%.
- **Additional disclosure:** With respect to underlying assets that do not meet the underwriting standards as described in the prospectus, the proposal would specify additional information that would be required to be disclosed on an aggregate basis relating to the type and amount of such assets.

Implications

Potential ABS issuers should be mindful that the proposed amendments, if adopted, would significantly increase the amount of information that must be disclosed in public offerings of ABS. Moreover, ABS issuers would be subject to additional exposure and liability as a result of the “skin in the game” and certification requirements as part of shelf-eligibility criteria. ABS issuers should also note that under the SEC’s proposal, they must be prepared to make the same level of disclosure as required in a public offering or in periodic reporting even when selling ABS in private placements. The proposal would not only provide contractual claims for investors, but also allow the SEC to bring enforcement actions against issuers if they failed to furnish such information in private placements.

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This alert is not intended to provide legal advice, and no legal or business decision should be based on its content. Any questions concerning the issues addressed in this alert may be directed to David S. Huntington ((212) 373-3124), Jordan E. Yarett ((212) 373-3126), Tong Yu (+81-3-3597-6306) or Akiko Okuma (+81-3-3597-6307).