

Development of Note

◆ SEC Approves Final Rule on Disclosure and Registration of Asset-Backed Securities

On December 15, 2004 the SEC approved new rules that will for the first time provide a comprehensive securities regulatory framework for publicly issued mortgage-backed and asset-backed securities (collectively referred to herein as "ABS"). The new rules primarily address four areas of securities regulation: (1) registration requirements under the Securities Act of 1933, as amended (the "1933 Act"); (2) disclosure; (3) communications during the offering process; and (4) ongoing reporting requirements under the Securities Exchange Act of 1934, as amended (the "1934 Act"). They are expected to bring increased transparency and consistency of practice to the ABS markets, replacing the framework of no-action letters and other SEC staff positions that were developed to fit ABS into a regulatory system designed with operating companies in mind rather than asset securitizations.

Registration Requirements Under the 1933 Act

Ever since Form S-3 was amended in 1992 to permit shelf registration of investment-grade ABS, most publicly sold ABS have been registered using this form. The new rules maintain this basic requirement but modify the definition of the term "asset-backed security" and also clarify the eligibility requirements to use Form S-3. ABS that do not satisfy the eligibility requirements for Form S-3 may be registered on Form S-1, but no other form will be available for the registration of ABS. These forms will also be required for the registration of publicly offered ABS by foreign issuers who currently would register such securities on Form F-1 or Form F-3.

Definition of ABS. The term "asset-backed security" is currently defined in Form S-3 to mean 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. The SEC staff has historically interpreted the phrase "convert into cash by their terms" to exclude from the definition most assets that require positive action to be realized upon – such as non-performing assets and physical property. It has also interpreted the "discrete pool" requirement in such a way as to disqualify most securities issued in transactions where the composition of the pool is not set on the date of issuance or can change over time. The new rules modify these existing interpretations in certain respects while codifying them in others.

- *Lease-Backed Securities.* The new rule expands the definition of "asset-backed security" to include lease-backed securities as long as the residual value of the leased property is less than 50% of the original securitized pool balance (or less than 65% in the case of motor vehicle leases). However, such securities may be shelf-registered on Form S-3 only if the residual value of the leased property represents less than 20% of the original securitized pool balance (or less than 65% in the case of motor vehicle leases).
- *Delinquent and Non-performing Assets.* The new rules provide that a security may be considered to be an "asset-backed security" even if the underlying asset pool has total delinquencies of up to 50% at the time of the proposed offering as long as the original asset pool does not include any "non-performing" assets. However, consistent with current practice, shelf registration on Form S-3 will be available only if delinquent assets constitute 20% or less of the original asset pool. An asset is considered to be non-performing if it satisfies the charge-off policies of the sponsor (or applicable bank regulatory agencies) or if it would be considered a charged-off asset under the terms of the applicable transaction documents.
- *Exceptions to the "Discrete Pool" Requirement.* The new rules generally codify the SEC staff's position that a security must be backed by a discrete pool of assets in order to be considered an ABS. However, the new rules establish the following exceptions to address market practices.
 - (1) Any security issued in a master trust structure would meet the definition of "asset-backed security" without limitation.

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Principal author of this Alert:

Anthony R.G. Nolan

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Goodwin Procter Offices:

Exchange Place
Boston, MA 02109
Tel: (617) 570-1000

103 Eisenhower Parkway
Roseland, NJ 07068
Tel: (973) 992-1990

599 Lexington Ave.
New York, NY 10022
Tel: (212) 813-8800

901 New York Ave., N.W.
Washington, DC 20001
Tel: (202) 346-4000

- (2) "asset-backed securities" will also include securities with a prefunding period of up to one year during which up to 50% of the offering proceeds (or, in the case of master trusts, up to 50% of the aggregate principal balance of the total asset pool whose cash flows support the ABS) may be used for subsequent purchases of pool assets.
- (3) The new rules also include within the definition of "asset-backed security" securities with revolving periods during which new financial assets may be acquired. In the case of revolving assets such as credit cards, dealer floorplan and home equity lines of credit, there is no limit to the length of the revolving period or the amount of new assets that can be purchased during that time. For securities backed by receivables or other financial assets that do not arise under revolving accounts, such as automobile loans and mortgage loans, an unlimited revolving period will be permitted for up to three years. However, the new assets added to the pool during the revolving period must be of the same general character as the original pool assets.

Synthetic Securitization and Derivative Instruments. The growth of the credit derivatives market has seen the rapid development of so-called synthetic securitizations, in which derivatives such as credit default swaps or total rate of return swaps are used to create exposure to assets that are not owned by the issuing entity. The definition of "asset-backed security" does not cover synthetic securitizations, reflecting the SEC's view that synthetic securitizations are not consistent with the concept of ABS being backed by a discrete pool of assets that converts into cash by its terms, since the payments on the securities are based on the value of a reference asset that is unrelated to the value of or payments on any actual assets in the pool. As a result of this provision, synthetic securitizations will need to continue to be executed in the Rule 144A market, pending SEC review of the appropriateness of registration of these types of transactions.

The Registration Statement

Reporting History As A Condition to Eligibility. It is currently a condition of eligibility to use Form S-3 that the depositor (the party who transfers and sells the pool assets to the issuing entity) have filed in a timely manner all reports required to be filed by it under the 1934 Act during the twelve months preceding the filing of the registration statement. However, there is nothing in the current rule to stop a sponsor with a non-compliant depositor from sidestepping the requirement by establishing a separate depositor and having it file a new registration statement. The new rules will close this loophole by requiring that a depositor generally may not offer ABS registered on Form S-3 unless it and each affiliate of the depositor shall have timely complied with its reporting obligations under the 1934 Act during the twelve months preceding the filing of the registration statement. The SEC's intention was to ensure that all depositors of a sponsor were subject to the reporting requirement while avoiding a situation where a person's Form S-3 eligibility could be inadvertently linked to an unrelated entity's reporting history in the "rent-a-shelf" context.

Registration of Underlying Pool Assets. The new rules will require separate registration of the underlying securities that are not exempt from registration unless (i) the depositor is otherwise free to publicly resell them without registration and (ii) neither the issuer of the underlying securities nor any of its affiliates has a direct or indirect agreement, arrangement or understanding relating to the underlying securities and the ABS transaction or has a direct or indirect affiliate relationship with the sponsor, depositor, issuing entity or underwriter of the ABS transaction.

Elimination of Market-Making Prospectus. The new rule provides significant relief to the securitization industry by eliminating the requirement that a current prospectus be delivered in secondary sales of ABS by dealers who are affiliated with the depositor. Consequently, there is no longer a requirement to update the prospectus in secondary transactions or comply with 1934 Act reporting obligations after the date on which they could otherwise be suspended. However, the final release indicates that the prospectus would still have to be updated in certain situations, such as a delayed or continuous selling shareholder offering, a registered remarketing transaction or a rescuitization of ABS where the underlying ABS constitute a significant obligor.

Regulation AB: Disclosure Rules

The new rules include Regulation AB, which provides a principles-based set of disclosure rules for ABS transactions. In general, Regulation AB adds substantial new disclosure requirements with respect to various transaction parties as well as historical data for assets related to the pool.

Static Pool Data. One of the most significant and controversial changes in the new disclosure regime is the requirement that static pool data be disclosed. Regulation AB will require disclosure, if material, of up to five years of delinquency and loss data as well as prepayment data, if material. Additional static pool data will be required, to the extent material, with respect to the sponsor's prior securitized pools established before January 1, 2006 and involving the same asset type and with respect to the currently offered pool for periods before January 1, 2006. To the extent material, this information should be presented based on factors such as asset type, term, yield, payment rates, geography or ranges of credit scores or other applicable measures of obligor quality.

Static pool data may be included in the prospectus or a 1934 Act filing that is incorporated by reference. In addition, at least through 2009, the SEC will permit static pool data to be disclosed on a web-site to which there is unrestricted access free of charge and on which the data is retained for at least five years. The information provided through the specified internet web address will be deemed to be part of the prospectus and therefore be fully subject to liability under the 1933 and the 1934 Act.

The requirement to provide static pool disclosure is unprecedented, and with little or no market precedent for this sort of disclosure it will be challenging for sponsors and others to assess “materiality” of any particular items of such data, particularly in light of the potentially large volume of static pool data required to be disclosed.

The SEC has declined to create a liability safe-harbor for static pool information similar to that for forward looking statements. However, it has provided some liability relief for static information for static pool information for prior securitized pools of the sponsor that were established before January 1, 2006 and for static pool information with respect to the currently offered pool for periods before January 1, 2006 (collectively, “Grandfathered Information”). Grandfathered Information may be omitted if and to the extent that it unknown or cannot be obtained without unreasonable effort or expense, and any Grandfathered Information that is disclosed will not be deemed to be part of the prospectus or the registration statement for the ABS. The SEC stated in the adopting release that the Grandfathered Information would remain subject to the anti-fraud provisions of the federal securities laws.

Disclosure of Servicer Information. Regulation AB requires that any unaffiliated servicer with responsibility for 10% or more of the pool assets be identified. It also significantly increases the amount of information required for any servicer affiliated with the sponsor, any unaffiliated servicer with responsibility for 20% or more of the pool assets, any master servicer and any special servicer on whom the performance of the pool assets or the ABS materially depends. Required information includes a general discussion of the servicer’s experience in servicing assets of any type as well as a more detailed discussion of its experience in servicing assets of the type included in the current transaction and its servicing procedures and policies during the preceding three years. In addition, disclosure of the servicer’s financial condition is required where it could have a material impact on the servicing or performance of the asset pool or on the ABS. Arrangements for transfer of servicing to a backup or successor servicer is also required. This requirement may cause aggregators to change the composition of securitized pools in order to limit the number of significant servicers in a deal.

Disclosure Regarding Significant Obligors and Significant Credit Enhancers. Regulation AB requires narrative disclosure of information regarding originators of 10% or more of the pool assets, obligors (or groups or related obligors) responsible for 10% or more of the pool assets and significant credit or liquidity enhancement providers (as defined below). Selected financial data must be provided for a significant obligor and for a significant enhancement provider, except that audited financial statements will be required if the applicable measure of concentration is 20% or higher. This information may be incorporated by reference if certain conditions are satisfied. In general, an enhancement provider (including a credit default swap counterparty) is significant if it is *contingently liable* for 10% or more of the cash flows supporting a class of offered ABS. However, the counterparty on a hedging derivative (such as an interest rate swap or cap or a currency swap) is significant if its *maximum probable exposure* is 10% or more of the cash flows supporting a class of offered ABS.

Communications During the Offering Process; Research

In most ABS transactions “structural term sheets”, “collateral term sheets” and computational materials are distributed to investors prior to delivery of the final prospectus, and broker-dealers frequently publish research reports concerning ABS close to the time of a registered offering of similar ABS. These practices have been sanctioned by the SEC staff in a series of no-action letters issued in the 1990s. Regulation AB creates a single definition of “ABS informational and computational materials” to prescribe all permissible varieties of written materials that may be delivered to investors outside of the prospectus. These materials may include the identity of key parties to a transaction as well as pool level information and the inclusion of other structural information such as servicing terms, ratings, legal investment, tax and ERISA information. The SEC has clarified that the intent of the definition is to cover all communications allowed under the existing no-action letters.

Regulation AB also includes a safe harbor under which broker/dealers may publish research about a particular type of ABS at a time when the same broker/dealer is participating in an offering of similar ABS without the research report being deemed to constitute an illegal offer of ABS or a non-conforming prospectus.

Ongoing Reporting Under the 1934 Act

Through numerous no-action letters the SEC staff has authorized a modified reporting system under the 1934 Act for the securitization industry. Under the current modified reporting system, an ABS issuer is required to file periodic distribution date statements on Form 8-K and to file an annual statement regarding servicing of the underlying assets on Form 10-K. Most ABS issuers’ obligation to file annual reports is suspended after the first year because of the small number of investors in a typical ABS transaction. Under the new rules, reports will be required to be signed by the depositor or by the servicer.

Periodic Reports on Form 10-D; Current Reports on Form 8-K. The new rules will mandate that periodic distribution reports be filed on new Form 10-D rather than on Form 8-K. Form 10-D will mandate disclosure of broad categories of information relevant to ABS, such as information about cash flows received, updated pool composition information and material modifications to or breaches of asset terms. It will also cover legal proceedings, sales of securities and use of proceeds, defaults on senior securities, submission of matters to votes of security holders and certain other matters.

Form 8-K will still be required for the filing of certain material events such as the change of servicer or trustee, the occurrence of certain events that materially affect payments on the ABS, material changes to credit or liquidity support or the creation of

significant obligations. Form 8-K will also be required for the filing of ABS informational and computational materials and for disclosure of the final pool if the composition of the final pool differs by 5% or more from the pool of assets described in the prospectus (other than as a result of pool assets converting into cash in accordance with their terms).

Annual Report on Form 10-K; Sarbanes-Oxley Certification. Each person that is responsible for performance of any servicing functions with respect to more than 5% of the pool assets must provide an assessment of compliance with servicing criteria specified in item 1122 of Regulation AB, which cover both asset-level servicing and transaction-level administration, as appropriate. The assessment is required on a "platform" level -- *i.e.* relating to the servicing of all assets of the same type across transactions. A registered public accounting firm is required to attest to the responsible party's platform-level assessment of compliance. Each assessment and each accompanying accountant's attestation must be filed as an exhibit to the Form 10-K. The report of servicer's compliance and the accountant's attestation codify, with certain modifications, the SEC staff's previous statement regarding Sarbanes-Oxley Act certifications for ABS issuers, and the final regulations contain a new form of certification.

Effective Date

The new rules will apply to any registered offering of ABS initially offered after December 31, 2005. For any such offerings that represent shelf takedown from a registration statement filed after August 31, 2005, the registration statement with respect to such offerings must be amended prior to the offering to comply with the new rules. For any shelf-registered offerings based on a registration statement filed on or before August 31, 2005 the rules will apply to that registration statement commencing with an initial bona fide offer after March 31, 2006.

Other Items of Note

◆ **US District Court Rules Massachusetts Bank Insurance Laws Preempted**

The US District Court for Massachusetts held that federal law preempts certain Massachusetts laws limiting the ability of federally-chartered banks to sell insurance. A summary of the decision will be provided in a future *Alert*.

◆ **OCC Issues Letter Regarding Mall Gift Card Dispute**

The OCC issued a letter in connection with a dispute involving whether the National Bank Act preempted certain state laws in connection with a gift card issued by a national bank and distributed by a mall operator. A discussion of the letter will be provided in a future *Alert*.

Goodwin Procter LLP Financial Services Partners and Counsel

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			Anthony R. G. Nolan	Meryl E. Wiener

To e-mail any of the above attorneys, use first initial of first name followed by last name followed by @goodwinprocter.com. For example, the e-mail address for Gregory J. Lyons would be glyons@goodwinprocter.com.

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