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SEC Proposes Major Overhaul of Asset-Backed Securities Rules; Significant Impact on Private Placements of CLOs, CDOs and Other Structured Finance Products

On April 7, 2010 the Securities and Exchange Commission (the "SEC") released for comment proposed rules that would dramatically change the disclosure, reporting and offering process for asset-backed securities ("ABS").[1] The proposed regulations (collectively the "ABS Proposals") establish extensive new requirements for ABS offered publicly pursuant to Regulation AB. At the same time, through modifications to Rule 144A, Rule 144 and Regulation D, the ABS Proposals would indirectly impose most of the disclosure and reporting requirements of Regulation AB even on structured finance or synthetic securities sold only in non-registered transactions. Part I of this memorandum summarizes the principal features of the proposed amendments to Regulation AB, Parts II and III outline the major effects of the ABS Proposals on privately placed and Rule 144A transactions and Part IV discusses timing of implementation of the ABS Proposals.

The SEC is soliciting comments on its proposal. Comments on the proposal are due on or before 90 days after publication of the SEC's Notice of Proposed Rulemaking in the Federal Register. The SEC's full release, including text of the proposed rules, is available at http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

I. Changes to Existing Regulation AB Requirements

Much of the bulk of the 667-page release setting forth the ABS Proposals is devoted to specifying new required items for disclosure and reporting in relation to specific types of ABS. The ABS Proposals depart from previous SEC policies and guidance regarding securitization disclosure – many of which were codified only five years ago with the adoption of Regulation AB in 2005 – to require vastly more granular detail with respect to the assets being securitized. For most securitizations, extensively detailed, loan by loan level reporting would be required, irrespective of loan concentrations or principal amounts.

Importantly, in the case of shelf-registered ABS transactions the ABS Proposals would extend periodic Exchange Act reporting for the life of an ABS transaction. A

[1] Release Nos. 33-9117; 34-61858; File No. S7-08-10 (the "Release").

depositor[2] registering ABS on Form SF-3 (a new form for ABS transactions which replaces Form S-3) will be required to undertake to make continued Exchange Act reporting even where such reporting would otherwise terminate or be suspended for securities of a non-ABS issuer under the Exchange Act. Since most ABS transactions do not currently file Exchange Act reports for more than approximately one year, this constitutes a substantial change, especially since the proposed asset-level disclosures are required in ongoing reporting as well as the initial registration.

A. Asset-Level Information

The proposed revisions to Regulation AB would require issuers of ABS to file at the time ABS are issued, and on an ongoing basis thereafter, standardized, computer-readable asset-by-asset level data. Such data would be an exhibit to the SEC filings (generally to a filing on Form 8-K in case of an initial registered offering or to the appropriate Form 10-D in case of a periodic distribution report). This information would be in addition to the disclosure currently required about the pool as a whole.[3]

To ensure that the data is standardized, the proposed rules require certain attributes of the assets, referred to as data points, to be disclosed. The data points include general data requirements that have to be disclosed for each asset, regardless of its type, and specific data points that differ based on the asset group to which an asset belongs. The proposed rule includes several asset groups, with particular data points relevant to each group. The asset groups proposed are residential mortgages, commercial mortgages, automobile loans, automobile leases, equipment loans, equipment leases, student loans, floorplan financing, corporate debt, and resecuritizations. The number of data points is quite extensive. For example, residential mortgage-backed securities would have 137 asset level data points at initial offering, with 151 data points for purposes of ongoing reporting. More than 30 specific data points are proposed for automobile loans and leases; only nine are proposed for corporate debt securities. Asset-level data would be filed and tagged in Extensible Mark-Up Language ("XML") on EDGAR.

[2] Under Regulation AB, the requirements of the Securities Act and the Exchange Act applicable to issuers of securities are divided among the "depositor," the "sponsor" and the "issuing entity." The depositor is the entity "who receives or purchases and transfers or sells the pool assets to the issuing entity." A depositor is frequently the Securities Act registrant for a public offering of ABS. The "sponsor" is the person "who organizes and initiates an asset-backed securities transaction by selling or transferring assets . . . to the issuing entity." See Item 1101(l) of Regulation AB. The "issuing entity" is "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 ABS are issued. See Item 1101(f) of Regulation AB.

[3] The data points and asset groups can be found in Schedule L and Schedule L-D of the Release, beginning on page 547. Note that the issuer is required to disclose different data points for ongoing reports versus data points disclosed as part of the initial offering. Schedule L applies to disclosure of asset-level data as part of the initial offering, while Schedule L-D applies for disclosure in periodic reports.

Aside from the substantial additional reporting burdens created by the new requirements – again, loan by loan level detail is required irrespective of asset concentrations (though an exception is made for credit card securitizations) – the very specific reporting on loans to individuals raises privacy concerns. Given the extensive data points for certain asset groups, which can include information on the income, credit score and debt of the borrower as well as the general location of the collateralized property, there is a concern that such loan level data could be used to identify particular borrowers. These privacy concerns may be especially significant for European issuers under home country data protection rules. To address privacy concerns, the SEC proposes to require ranges or categories of coded responses instead of exact information for data points covering specific geographic areas, credit scores or income and debt amounts. The SEC invited comment on this issue in the Release.

B. Additional Pool-Level Information

The proposed rules would also require enhanced pool-level information by amending Item 1111 of Regulation AB. Among the additional pool-level information the SEC would require is specific data about the amount and characteristics of the underwritten assets that deviate from the disclosed origination standards, the number of assets that meet particular compensating factors (if such factors are disclosed), and the number of such assets not meeting such factors. In addition, the rules would require disclosure of the steps undertaken by the originator or originators to verify the information used in the solicitation, credit-granting or underwriting of the pool assets. The proposed rules would also require a description of the provisions in the transaction agreements governing modification of assets, disclosure on how modification may affect cash flows from the assets and disclosure of whether or not a fraud representation[4] is included among the representations and warranties. Finally, the SEC is seeking to clarify that Item 1111 requires disclosure of statistical information in the prospectus regarding an originator's "risk-layering practices"; i.e., the manner and extent to which multiple "non-traditional"[5] features of a loan are bundled into one instrument.

C. Waterfall Computer Program

In addition to granular asset-level data and enhanced pool-level information, the proposed rules would also require most ABS issuers to file a computer program that gives effect to the flow of funds or waterfall provisions of the transaction. This computer program would be filed as an exhibit to Form 8-K on EDGAR at the time of the offering in a

[4] The SEC described a fraud representation as a representation made that no fraud has taken place in connection with the origination of the assets on the part of the originator or any party involved in the origination of the assets.

[5] See, e.g., footnote 127 on page 59 of the Release.

downloadable program language called Python. The waterfall computer program would then be available to investors and other market participants.

The goal of requiring an open source waterfall computer program is to provide an investor with the ability to input the user's own assumptions regarding the future performance and cash flows from the pool assets, including but not limited to assumptions about future interest rates, default rates, prepayment speeds and loss-given-default rates. The waterfall program must allow the use of the proposed asset-level data file that will be filed at the time of the offering and on a periodic basis thereafter as described above. In addition, the program must produce a programmatic output, in machine-readable form, of all resulting cash flows associated with the ABS, including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities, and each other person or account entitled to payments or distributions in connection with the securities, until the final legal maturity date. The issuer will be required to file as part of the waterfall computer program a sample expected output for each ABS tranche based on sample inputs provided by the issuer so that users may test the accuracy of their own models. Lastly, the prospectus must include a statement that the waterfall is provided as a downloadable source code in the Python programming language filed on the SEC website.

D. Static Pool Disclosure

Under Regulation AB, the SEC requires disclosure of "static pool information," or historical performance information – such as losses, delinquencies, charge-offs, prepayments, etc. – for prior securitized pools of the sponsor for the same asset class, if the information is material to the transaction. The ABS Proposals would require four types of additional static pool disclosure. First, a snapshot description of the relevant static pool is required; e.g., for a pool of RMBS, the disclosure would note the number of assets, types of mortgages (conventional, home equity, Alt-A, etc.) and the number of loans that were exceptions to standardized underwriting criteria. Second, the methodology used to determine the characteristics of the pool and any terms or abbreviations used must be described. Third, the depositor must describe the differences between the assets in the relevant static pool and the pool assets underlying the offered securities. Fourth, if the depositor does not disclose static pool information or disclose information that is intended to serve as alternative static pool information, it would be required to explain why it did not do so. The ABS Proposals would repeal the temporary website accommodation permitting presentation of static pool information on sponsor websites, and require all static pool information to be filed on EDGAR. The ABS Proposals would allow static pool information to be filed on Form 8-K and be incorporated by reference into the prospectus filed on the same date.[6]

[6] In addition to the disclosure required for all static pools described above, for amortizing asset pools, the SEC would require issuers to disclose information related to delinquencies and losses associated with the pools in accordance with Item 1100(b) of Regulation AB. Item 1100(b) requires information to be provided in a certain

E. Modified Undertakings for ABS Shelf Offerings

The ABS Proposals also seek to modify the eligibility criteria for shelf registration of publicly offered ABS. Under the proposed rules, ABS shelf eligibility would no longer be conditioned on the offered securities being rated investment grade by a nationally recognized statistical rating organization. Instead, reliance on credit ratings would be superseded by the requirements and additional undertakings described below.

1. *CEO Certification*. The CEO of the depositor must certify that the assets have characteristics that provide a reasonable basis to believe they will produce cash flows at times and in amounts necessary to service payments on the securities as described in the prospectus. The certification would follow a prescribed text and would not be allowed to deviate from this language. Rather, any issue in providing the certification, such as the risks of non-payment or other risks related to the cash flows or payments, would need to be addressed through risk factors or qualifications to the description of expected payments in the prospectus. The stated purpose of the certification is to induce a senior officer to more carefully review the disclosure and participate more extensively in the oversight of the ABS transaction. The CEO certification would be an additional exhibit requirement for the shelf registration statement and would have to be filed by the time the final prospectus is required to be filed. A CEO providing a false certification could be subject to liability under Section 17 of the Securities Act.[7]

2. *"Skin in the Game" Requirement*. The sponsor or its affiliates must retain at least a 5% exposure to each tranche of securities publicly offered.[8] This requirement will be tested quarterly, and if not met, use of the related shelf would be suspended. Under this proposed eligibility requirement, the net economic interest would be measured at issuance (or at origination in the case of the originator's interest) and then maintained on an ongoing basis. The retained exposure may not be the subject of a direct hedging transaction, though the ABS Proposals indicate that certain general hedges (e.g. interest rate or currency hedges,

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manner – e.g., delinquency information must be provided in 30-day increments until the assets are written or charged off as uncollectible. The proposed rules would require graphical presentation of delinquencies, losses and prepayments for amortizing asset pools. If the SEC's proposed amendments to Item 1121(b)(9) of Regulation AB were adopted, all issuers would have to provide delinquency and loss information in accordance with Item 1100(b) as part of the proposed requirement for periodic reporting.

[7] The chief executive officer of the depositor is already responsible as signatory of the registration statement for the issuer's disclosure in the prospectus and can be liable for material misstatements or omissions under the federal securities laws.

[8] In the case of revolving asset master trusts, the sponsor has the option of retaining an unhedged "originator's interest" of 5% of the securitized exposure. For offerings registered on Form SF-1, the issuer would have to provide clear disclosure that the sponsor is not required by law to retain any interest in the securities and may sell any interest it may have retained at any time.

or hedging an exposure to an RMBS tranche by purchasing protection on a similar ABX derivative tranche) would not run afoul of this requirement.

In the release setting forth the ABS Proposals, the SEC notes the controversial nature of this requirement. Critics of the "skin in the game" requirement note that originators and other financial institutions active in the ABS market suffered massive losses in the financial crisis from direct and indirect exposure to asset underperformance, and that skin in the game would only expose such parties to risk beyond that which they already incur by participating in the market. Other critics suggest that other risk reduction techniques, such as more stringent representations and warranties regarding the assets in the pool or minimum underwriting standards, may be preferable to outright retention of an economic interest in the securities. At the open meeting on the ABS Proposals, Commissioners Casey and Paredes both expressed skepticism as to the wisdom and efficacy of the 5% "skin in the game" requirement. Both questioned whether the one-size-fits-all approach of the 5% rule makes sense, and Commissioner Parades expressed doubt as to whether the SEC should mandate any "skin in the game" requirement when the data supporting the effectiveness of risk retention was unclear.[9]

3. *Opinion Requirement in Relation to Representation and Warranties.* If the trustee of an ABS transaction asserts that a representation or warranty with respect to an asset has been breached, such that an obligation to repurchase or replace that asset is triggered, the party obligated to repurchase or replace the asset would be required to deliver a third party opinion to the effect that any asset not repurchased or replaced by the obligated party complied with the representations and warranties. The SEC invited comment on whether the opinion could be that of a law firm, a third party loan evaluator, or some other unaffiliated third party.

4. *Life of Transaction Exchange Act Reporting*. As noted above, the depositor must undertake to report under the Exchange Act on an ongoing basis even where the requirements to make such reporting would otherwise terminate under the Exchange Act. Most registered ABS transactions have not been listed on a stock exchange, meaning that Exchange Act reporting has generally been terminated for an ABS transaction after approximately one year pursuant to Section 15(d) of the Exchange Act and related rules. However, new Form SF-3 will include an undertaking whereby the depositor will continue to report even where otherwise not required to do so under the Exchange Act, except at such

[9] Indeed, while Chairman Dodd's draft financial regulatory reform bill would direct the SEC and Federal banking agencies to prescribe regulations that require sponsors to retain at least 5% of the credit risks they securitize, it would also direct them to permit less than 5% retention if the originator observes prescribed asset underwriting standards, and to provide for allocation of the risk retention obligation between the sponsor and the asset originator. In the Release, the SEC states that it considered requiring risk retention by originators but decided that imposing the requirement solely on sponsors was more appropriate; however, the Release solicits comments on that decision. The ABS Proposals also do not provide any lowering of the risk retention requirement based on underwriting quality.

times as the securities issued in the ABS transaction are held only by affiliates of the depositor.

5. *Shelf Suspension for Late Reporting*. Under the ABS Proposals, any instance of late reporting would prevent use of the shelf registration statement by a depositor and its affiliates (and the filing of any new shelf registration statement in the same asset class) for at least one year after the untimely reporting is corrected. This is in contrast to the current practice where the staff has specified that shelf eligibility would be tested only on the date of filing.

Each of the above criteria (i.e. under E.1-5 above) is only applicable for shelf registered offerings. Offerings may be registered on new proposed Form SF-1[10] without having to comply with these criteria, and these criteria are also not among the new conditions on Rule 144A and Regulation D private offerings of structured finance products. Like securities registered on Form S-1, however, an ABS registration on Form SF-1 would likely encounter a significantly longer wait before becoming effective.

F. Prospectus Form and Delivery Changes; Five Business Day Rule

Under the ABS Proposals, an issuer involved in a public offering of ABS (whether or not a shelf registration) would be required to file a form of preliminary prospectus for each issuance of ABS at least five business days before the first sale in connection with such issuance. Such preliminary prospectus would include or incorporate the asset-level information and the waterfall computer program in relation to the particular ABS being issued, and all other information except offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds and other matters dependent on the offering price. If any material change is made in the information in the prospectus supplement (for example, in response to any investor comment) following the filing of a preliminary prospectus, a revised preliminary prospectus would be required and five additional business days must also elapse before the first sale.[11]

In contrast to the current practice of specifying a range of possible asset and transaction types in a base prospectus accompanying the shelf registration statement, and

[10] Form SF-1 is a new form proposed by the SEC to distinguish the registration of ABS from the registration of other securities. Form SF-1 would largely track the current Form S-1 except it would not include instructions on summary prospectuses as the SEC does not believe they are relevant for ABS offerings. Instructions in Form S-1 regarding incorporation by reference of previously filed Exchange Act reports and documents would be replaced with a more limited instruction on incorporation by reference. The SEC is also proposing to permit ABS issues structured as revolving asset master trusts to incorporate by reference certain asset-level disclosures that would have been provided in previously filed Form 10-Ds.

[11] The ABS Proposals would also eliminate the exemption from the "48-hour rule"; i.e., the requirement for delivery of a preliminary prospectus under Rule 15c2-8 under the Exchange Act, but the practical effect of this change appears to be eclipsed by the five business day requirement under new proposed Rule 430D.

then specifying the details of each actual transaction in a prospectus supplement, ABS issuers will be required to produce a single stand-alone prospectus for each shelf takedown of ABS. As contemplated by new proposed Rule 430D,[12] the form of prospectus filed with the registration statement may still omit information "unknown or not reasonably available to the registrant,"[13] so long as such information is included in a form of prospectus filed five business days prior to the first sale of the relevant issuance as described above. However, Rule 430D would specify that information "that adds a new structural feature or credit enhancement" must be specified by a post-effective amendment to the registration statement,[14] rather than through a prospectus supplement.

G. Other Additional Disclosure Requirements

The ABS Proposals also include additional disclosure requirements in relation to various thresholds for reporting already applied under Regulation AB. For example, under current Regulation AB, non-affiliated originators of less than 10% of the pool assets are not required to be identified in the disclosure. The ABS Proposals would require each originator to be identified even where it had originated less than 10% of the pool assets, if the aggregate amount of assets originated by parties other than the sponsor (or its affiliates) comprised more than 10% of the total pool assets. In the case of a 20% originator, i.e. an originator who has originated or is expected to originate more than 20% of the assets in the pool, the ABS Proposals would require disclosure of the financial condition of such 20% originator if either (i) there is a material risk that its financial condition could have a material impact on its ability to comply with its asset repurchase obligations or (ii) its financial condition had a material impact on the origination of its assets in the pool. Disclosure of the financial condition of a sponsor is similarly required if there is a material risk that its financial condition could have a material impact on its ability to comply with any asset repurchase obligations applicable to it or otherwise have a material impact on the pool.

The proposed rules would also expand disclosure regarding obligations to repurchase assets. Specifically, the rules would require disclosure, on a pool by pool basis, of the amount, if material, of publicly securitized assets originated or sold by the sponsor or an identified originator that were the subject of a demand to repurchase or replace assets for breach of the representation and warranties concerning the assets in the last three years pursuant to the transaction agreements. The percentage of the amount that was not then repurchased or replaced by the obligated party would also be disclosed, as well as whether

[12] Rule 430B would no longer apply to ABS transactions under the ABS Proposals.

[13] See footnote 183 of the Release.

[14] Id. at page 476.

an opinion of a third party has been furnished to the trustee that confirms that the assets not repurchased or replaced (if any) did not violate a representation or warranty.

II. Proposed Revisions to Safe Harbors for Privately Placed Structured Finance Products

A. Definition of "Structured Finance Products"

The ABS Proposals create indirect requirements for Regulation AB disclosure and reporting in the case of unregistered transactions. As described below, amendments to Rule 144A, Regulation D and Rule 144 will require that contractual provisions give investors and prospective transferees the right to request initial disclosure, and in some cases ongoing reporting, that would be the same as for a registered transaction. These conditions will apply not only to ABS transactions as such, but to all "structured finance products". The proposed definition of "structured finance product" is significantly broader than the definition of "asset-backed security" under Regulation AB Item 1101(c).[15] The proposed definition of "structured finance product" would include:

- a synthetic asset-backed security; or
- a fixed-income or other security collateralized by any pool of self-liquidating financial assets, such as loans, leases, mortgages and secured or unsecured receivables, that entitles its holder to receive payments that depend on the cash flow from the assets -- including:
  - a Regulation AB Item 1101(c) asset-backed security,
  - a collateralized mortgage obligation,
  - a collateralized debt obligation ("CDO"),
  - a collateralized bond obligation,
  - a CDO of asset-backed securities,
  - a CDO of CDOs, or

[15] Regulation AB Item 1101(c) 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 distributions of proceeds to the security holders; 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 proposed rules carve back some prior exceptions to the discrete pool requirement and further limit the amount of time assets in the pool may be revolving.

- a security that at the time of the offering is commonly known as an asset-backed security or a structured finance product.

The status of many different types of securities that have structured finance features but might not ordinarily be thought to represent "structured finance" transactions is unclear under the ABS Proposals. Questions may arise regarding the status of hybrid corporate securities which use special purpose entity structures (such as financial institution trust preferred capital securities); securities issued in project finance transactions; equity, commodity or credit-linked notes issued "on the balance sheet" of a corporate entity rather than through a special purpose entity; covered bonds or other debt securities secured by loans or similar collateral; certain types of REITs or hedge funds; or other structures which may use characteristic elements of structured finance or invest in similar asset classes. Asset-backed commercial paper is specifically contemplated to be included as a "structured finance product."

The additional requirements proposed to be applicable to "structured finance products" are summarized below.

B. Notification Provisions

1. *Rule 144A Transactions*. Under the proposed rules, issuers would be required to file a public notice with the SEC on a new Form 144A-SF regarding the initial placement of securities eligible for resale under Rule 144A. This form would provide information regarding major participants in the securitization, the type of securities being offered, the basic structure of the securitization and the assets in the underlying pool. It must be filed no later than 15 calendar days after the first sale of securities in the Rule 144A offering. Form 144A-SF must disclose the principal amount of the securities offered or sold in the initial placement and the date of the initial placement and the date of the initial resale of securities to be made in reliance on Securities Act Rule 144A. Such information would be filed and tagged in XML to facilitate investors' use of data files. Form 144A-SF would also include an undertaking by the issuer to furnish the offering materials related to the securities to the SEC upon written request.

Filing of Form 144A-SF would not be a condition of availability of the Rule 144A safe harbor. However, if the issuer fails to file Form 144A-SF, then the Rule 144A safe harbor will be unavailable for subsequent resales of newly issued structured finance products of the issuer or its affiliates.

2. *Regulation D*. Existing Form D is the official notice of private placement of securities in reliance on the exemption from registration provided by Regulation D.

Filing of Form D is not a condition to the availability of the exemption.[16] The proposed rules would revise Form D to require the same information provided in the proposed notice for Rule 144A.

C. Ability of Security Holders to Request Disclosure and Ongoing Reporting

1. *Rule 144A*. Under the ABS Proposals, in order for a reseller of a structured finance product to sell a security to qualified institutional buyers in reliance on Rule 144A, the underlying transaction agreement (such as the indenture or pooling and servicing agreement) must contain a provision requiring the issuer, promptly upon request, to provide to purchasers or holders of the securities (and to prospective purchasers designated by a holder) any information that would be required to be filed with the SEC if the transaction were registered on Form S-1 or Form SF-1 under the Securities Act. The issuer must further undertake to provide any ongoing information regarding the securities that would be required by Section 15(d) of the Exchange Act if the issuer were required to report under that section. The issuer must also represent that it will comply with the foregoing information requirements.

2. *Regulation D Transactions*. The same standard of Regulation AB-type disclosure upon request of investors will apply to Regulation D transactions. However, Regulation D is not a resale rule but a rule addressed to initial placements, and therefore the required disclosure requirements will only apply in connection with the initial distribution as opposed to subsequent sales. Thus, in contrast to the amendments to Rule 144A, the amendments to Regulation D require that Regulation AB information be provided only to "any purchaser in the offering" – as opposed to actual or proposed subsequent transferees.[17] In addition, the proposed Rule 144A requirement that the issuer make available "ongoing information regarding the securities that would be required by Section 15(d) of the Exchange Act if the issuer were required to report under that section"[18] does not apply.

3. *Rule 144*. The same requirements applicable to Rule 144A – both as to initial disclosure and as to ongoing reporting – also apply in the case of Rule 144. However, in the case of Rule 144 the application of these requirements would be more limited. The additional reporting requirements would only be a condition to a resale within the first year after the initial sale, or a sale by an affiliate as contemplated by Rule 144(b)(2). The information requirements of the ABS Proposals would not be a condition to a resale occurring more than one year after purchase of the securities by a non-affiliate of the issuer.

[16] Rule 507 of Regulation D disqualifies an issuer from using a Regulation D exemption in the future if it has been enjoined by the court for violating the Regulation D provision that requires the filing of Form D. 17 CFR 230.507.

[17] See page 484 of the Release.

[18] Id. at 466.

4. *Contents of Disclosure and Reporting*. The information required to be provided in order to rely on the safe harbors would be the same information as required if the offering were registered on Form S-1 or Form SF-1 under the Securities Act and the issuer were required to provide information on an ongoing basis as required by Section 15(d) of the Exchange Act.

The specific disclosure that would need to be provided to satisfy the information condition of the safe harbors would vary depending on the type of security offered. For an offering of a structured finance product where the securities meet the Regulation AB definition of an "asset-backed security," the disclosure requirements of Form SF-1 would apply. For offerings of structured finance products where the securities fall outside the Regulation AB definition of "asset-backed security," the requirements of Form S-1 would apply, and the issuer would be required to provide not only information required under Regulation AB but also additional information required under Regulation S-K.[19]

5. *Remedies for Violation of Disclosure and Reporting Rules*. Consequences of the failure to provide the new Rule 144A, Regulation D or Rule 144 information to investors upon request will not be limited to remedies for breach of the underlying agreements. A proposed new Rule 192 will specify that where information is required to be provided in accordance with a Rule 144A, Regulation D or Rule 144 undertaking, a failure to provide such information "would constitute an engagement in a transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser of the securities."[20] Violation of Rule 192 would thus mean that "the Commission could bring an enforcement action under this rule against an issuer that failed to provide the required information."[21] However, compliance with the obligation to provide information under proposed new Rule 192 would not be a condition to the availability or effect of the Rule 144A, Regulation D or Rule 144 safe harbors for purposes of Section 5 of the Securities Act.

D. Application of the Regulation AB Framework to Certain Structured Finance Products

Many of the structured finance products to which Regulation AB disclosure and reporting requirements may indirectly apply under the ABS Proposals are securities, such as CLOs and CDOs, which have generally not been registered under the Securities Act in the past. Little or no experience applying Regulation AB's requirements therefore exists in relation to these securities, and the requirements of Regulation AB do not take into account

[19] Material information that is required by Regulation S-K would be required but not all of the item requirements in Regulation S-K may be applicable to the issuer.

[20] See page 470 of the Release.

[21] Id. at 281.

many transactional features of the market for these securities. Highlights of the Regulation AB reporting framework and some issues raised by application of these standards to Rule 144A structured finance products are described below.

1. *Principal Requirements of Regulation AB.* Regulation AB as originally adopted in 2005 codified a set of interpretive practices and guidance under the Securities Act and the Exchange Act that emerged generally in the context of mortgage, credit card, auto loan and other types of securitizations closely connected to credit origination activity. The registrants under Regulation AB generally have been either affiliates of originators of loans and other receivables, or underwriters sponsoring securitizations as part of a "pipeline" relationship with third party financial institutions. Regulation AB therefore contemplates in most cases direct availability to the registrant of information from originators or sponsors that is relevant to the credit characteristics of the securitized assets, including performance information as to similar asset pools.

Some of the more important disclosure items required under Regulation AB include information regarding:

- underwriting criteria and practices of each originator of 20% or more of the assets in the pool (Item 1110);

- experience, policies and procedures of the servicer, and any changes in its policies in the past three years (Item 1108);

- static pool information "for prior securitized pools of the sponsor for that asset type," to the extent material, for the lesser of five years or for so long as the sponsor has been securitizing assets of the same type (Item 1105);

- financial information for "significant obligors"– i.e., selected GAAP financial information for obligors at concentrations of 10% of more of the pool and full GAAP financial statements for obligors at concentrations of 20% or more (Item 1112);

- financial information for any credit enhancement provider, based on similar thresholds (Item 1114);

- similar information in relation to any derivative counterparty to which the issuer has sufficient estimated exposure based on the concept of a "significance percentage" (Item 1115);[22]

[22] The significance percentage is a measure of the maximum probable exposure (made in substantially the same manner as that used in the sponsor's internal risk management process) of the issuer to the relevant swap counterparty.

- if pool assets include securities, "the market price of the securities and the basis on which the market price was determined" (Item 1107);

- any non-arm's length transactions between the depositor, sponsor or any issuing entity and any servicer, trustee, originator, significant obligor, credit enhancement provider, derivative counterparty or other transaction participants (Item 1119); and

- all fees paid from cash flows on the pool assets (Item 1113).

2. *Difficulties for Secondary Market Transactions*. Many structured finance products involve securitization or synthetic securitization of seasoned assets that have been purchased in the secondary market, and not pursuant to any agreement with an initial lender or other originator. Indeed, for tax reasons CLOs often severely limit the issuer's involvement in the origination process. There are substantial uncertainties regarding the impact of the ABS Proposals on these products, which include for example, CLOs, CDOs, synthetic transactions and repackagings of existing ABS assets. The assets purchased for inclusion in a CLO or other repackaging may have been purchased from parties who do not have even an indirect right to obtain access to an "originator" as defined in Regulation AB for the type of information that a 144A issuer may be requested to provide. Even the simple identification of an originator contemplated by Item 1110 may be unclear: for example, who should be considered the "originator" for a syndicated loan agreement? A description of the originator's underwriting criteria, and its origination portfolio in the case of a 20% originator, may present quite difficult obstacles in this context.[23]

In addition, many structured finance products such as CLOs involve some ability to manage the pool assets. The existing Item 1105 requirements, however, simply do not contemplate managed transactions – a transaction is specified to be either an amortizing pool or a revolving master trust, rather than a transaction in which principal proceeds or sale proceeds can be applied to purchase new assets in the discretion of a manager. A managed transaction generally does have a "sponsor" such as an underwriter or arranger, and a sponsor of managed transactions often can obtain information regarding "delinquencies, cumulative losses and prepayments for prior securitized pools of the sponsor" of the same asset type. But it is unclear how relevant such information would be to understanding, for example, a structure employing a different asset manager. The appropriate "static pool" information may well be some kind of historical performance information for other transactions managed by the same asset manager, but neither Regulation AB nor the ABS

[23] The new Item 1111(a)(3) requirements refer to credit-granting or underwriting criteria used to "originate or purchase" the assets – seeming to contemplate that a sponsor can make disclosure of its own criteria, rather than those of an originator. See page 382 of the Release. The new Item 1111(a)(5) requirement to disclose "steps undertaken by the originator to verify the information used in the solicitation, credit-granting or underwriting of the pool assets" would have a much more uncertain application. See id. at page 383.

Proposals allows for this.[24] Similar uncertainties would exist for Exchange Act-style reporting undertaken by Rule 144A qualifying transactions.[25]

There is also substantial doubt as to exactly what sort of disclosure will ultimately be required in the case of CLO assets. The Item 1 (General) requirements in Schedule L are expressed to be applicable to all assets. However, the extent of the additional data points specified for similar assets is very different. For commercial mortgage loans, the ABS Proposals have an extensive set of data points for both initial disclosures and subsequent reporting. For corporate debt securities, a quite limited set of information is required. For unsecured corporate loans or corporate loans not secured by real estate, no data points or specific disclosure items have yet been specified. This likely reflects the dearth of experience with registered corporate loan securitizations, but leaves a sponsor of a CLO uncertain as to what detail might actually be required.

Where the details of the required reporting are known, obstacles will be faced regarding the ability of secondary market sponsors to obtain the necessary data. Existing assets have not been originated with Regulation AB reporting requirements in mind, and may not entitle lenders to necessary information. Also, loan and other private placement documents often have confidentiality requirements. The Regulation AB standards are particularly difficult to meet for any ABS which are themselves repackaged or securitized. The ABS Proposals would require a complete "drill down" in relation to such ABS, such that a securitization including ABS must provide all the information that would be required if the ABS itself were being registered. Especially with respect to existing ABS which may have no provisions for holders to obtain the relevant reporting information, this may render the public or 144A securitization of existing ABS essentially unfeasible.

A similar problem would exist with respect to "significant obligor" disclosure. In a registered repackaging transaction, "significant obligor" disclosure has effectively only been possible where the relevant corporate credit is an Exchange Act reporting company. This is because in the context of secondary market transactions, a sponsor of a securitization has no right of access to the relevant obligor to obtain or diligence its financial statements. Recognizing this fact, the SEC, through Rule 190 and Item 1100 of Regulation AB, has allowed registrants to meet the requirements of Item 1112 by referring to publicly available reports of the relevant obligor, so long as the obligor continues to be an Exchange Act

[24] There have been instances in the context of registered repackagings where the SEC staff has accepted arguments from a registrant to the effect that "static pool information" would not be material. For example, sponsors of corporate bond repackagings have not been required to provide delinquency, loss or prepayment data in relation to other corporate bonds repackaged by the same sponsor. Notably, also, Item 1105 does include language to the effect that static pool information may be omitted if it is unknown and not available "without unreasonable effort or expense."

[25] It is not clear, for example, how a 144A CLO would meet a demand for an accounting firm's attestation under Item 1122 of Regulation AB.

reporting company (and is eligible to use Form S-3 for a primary offering of non-investment grade securities). Under existing Regulation AB practice, if a "significant obligor" ceases to file Exchange Act reports (for example due to a merger or acquisition), a transaction including that significant obligor must either sell its exposures to the significant obligor or terminate. The literal effect of Rule 192 would mean that if Exchange Act reporting ceased to be available in relation to a significant securitization obligor, the issuer could either be required to liquidate its assets or face liability for a "fraud or deceit" under Rule 192.

3. *Synthetic and Derivative Transactions*. The uncertainties as to the manner in which the Regulation AB items would be applied to securitizations of assets acquired in the secondary market become even more substantial in the area of derivative products. Synthetic ABS and synthetic CDO transactions were proscribed from being registered under Regulation AB, and there has been no experience applying its terms to such transactions. A credit derivative by its nature generally involves the potential deliverability of loans or bonds "originated" and/or "serviced" by no single entity or institution, or indeed not yet originated or serviced at all at the time the credit derivative is entered into. It is similarly unclear what relevance "static pool" information would have for derivative exposures.

The SEC did give some indications of the types of disclosure it would seek for the structured finance products described above. For a managed CDO offering, the SEC stated that it would expect disclosure regarding the underlying assets and the asset or collateral manager, including fees and related party transaction information, the objectives and strategies of the manager, any interest that the manager has retained in the transaction or underlying assets, and substitution, reinvestment and management parameters. For a synthetic CDO offering, the SEC stated that it would expect, among other things, disclosure of the differences between the spreads on synthetic assets and the market prices for the assets,[26] the process for obtaining the credit default swap or other synthetic assets, and the internal rate of return to equity if that was a consideration in the structuring of the transaction. But there are no provisions in the ABS Proposals to square the language of either the existing Regulation AB items, or any of the new required disclosures, with these transactional contexts.

III. Implications for Privately Placed Transactions

The ABS Proposals will substantially limit the benefits afforded by Rule 144A and Regulation D to non-registered transactions. Whereas Rule 144A eligibility will continue to afford increased liquidity and ease of secondary transfers of assets, it will now come at a very high cost as compared to other options. In the case of Regulation D offerings, since the right to request Regulation AB style disclosures is required only in the initial distribution, the degree to which investors will take advantage of this right to demand such disclosure

[26] In the context of a synthetic CDO linked to standard credit derivative exposures, it is unclear what the reference to "market prices for the assets" is intended to capture. See page 278 of the Release.

may be ascertainable in advance, and thus the effect of the ABS Proposals may be limited. For 144A offerings however, the application of the undertakings to any subsequent transfer may make it incumbent on the issuer to provide for the full potential costs of Regulation AB reporting from the outset.

The ABS Proposals make clear that the disclosure requirements under Regulation AB do not apply to private placements that rely on the basic "non-public offering" exemption available under Section 4(2) of the Securities Act. The SEC recognized that "structured finance products issuers may conduct offerings in reliance on a statutory exemption under the Securities Act without seeking the safe harbor provided by Rule 506 of Regulation D or without representing that the securities are eligible for sale under Rule 144A,"[27] and that as a result, the ABS Proposals "would not apply to these offerings, or so called 4(1½) under the Securities Act."[28] Accordingly, it may be expected that the ABS Proposals will encourage a return to pre-Rule 144A practices regarding limited offerings and subsequent "4(1½)" private transfers.

Another safe harbor to which the ABS Proposals have not been applied is the safe harbor under Regulation S. Again, the possibly prohibitive costs associated with use of Rule 144A for structured finance products may give rise to renewed interest in offshore placements, and in secondary transactions in the U.S. with respect to ABS which have previously come to rest offshore. Notably, the SEC has sought comment on whether this safe harbor should be addressed as well.

IV. Effective Date; Transition Period

The SEC has invited comments on when the proposed rules should become effective and whether a transition period should apply, and appears open to the concept of a transition period of less than one year. As currently proposed, however, the new requirements would become effective immediately upon the proposed rules becoming effective. The SEC expressly noted its intent to require application of the ABS Proposals to securitizations or resecuritizations occurring after adoption of the rules, even if they involve assets originated or securitizations arranged prior to the rules' effectiveness.

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[27] See page 271 of the Release.

[28] "4(1½)" under the Securities Act refers to the doctrine that after an initial placement of a privately offered security, if an investor to whom a private sale could originally have been made purchases that privately offered security from another investor, and the new investor will be subject to the same restrictions imposed on the original purchaser in the private placement, the resale should be considered exempt from the restrictions of Section 5. While it is not expressly provided for in the Securities Act, the reasoning for the 4 (1½) exemption is that the transaction logically falls in between a transaction "by any person other than an issuer, underwriter, or dealer" under Section 4(1) and a "transaction by an issuer not involving any public offering" under Section 4(2).

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Structured Finance or Capital Markets in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax