Linklaters

A Dialogue About the ABS Definition in Regulation AB

by Gary Barnett, Partner

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John Smith, a partner with a major New York law firm representing clients in exotic asset securitizations, and David Jones, a partner with another major New York law firm representing clients in more mainline securitizations[1], were standing at the back of the conference room waiting for their panel discussion about the recently adopted SEC ABS Rules to begin.

"Hi David, how are you doing?" asked John.

"Pretty well John," responded David. "Are you ready for the presentation?"

"Yeah, I think so," said John.

"Good," said David, looking at the clock and seeing it was nearly time for their presentation. "Do you have any questions you want to discuss before we get up there?"

"Not really -- I think I have it down," John replied. Suddenly, contradicting himself, he said to David, "Actually, you know, there is a fundamental issue I would like to discuss."

"What's that?" asked David.

"It's about the ABS definition," said John.

"What do you mean?" asked David.

"Well, I am a bit frustrated by it," said John. "You know my clients do funkier deals that don't meet the definition, and studying it with their perspectives in mind the definition doesn't always seem to work," John replied.

"Why get frustrated?" asked David, "The ABS definition has been around for over 10 years."

"Well, you know David, it wasn't really an issue when it was just used to define who could do ABS shelf deals. But when the definition gets used to determine who gets the benefit of the alternate registration and disclosure regime and who doesn't there's a lot more at stake."

David was nonplussed, "I think you should be happy that the SEC so clearly acknowledged that the kind of information solicited by the traditional regime about operating businesses is largely not relevant to ABS -- and was willing to codify a regime that solicits information material to securitizations -- like the assets, structures and service providers."

1 John Smith and David Jones are fictional characters and no similarity to any other person is intended.

John nodded. “Oh, I agree with all that! My point is that the definition is under-inclusive – it fails to pick up many deals which should be included in the new regime.”

David seemed unaffected. “Well it doesn’t affect me. As far as I can see there is nothing wrong with the definition of ‘asset-backed security’. As far as I can tell it’s been perfectly fine for 10 years and, in fact, it now has a greater scope than it did previously.”

John tried to explain, perhaps a bit clumsily, “Not really man. From my perspective the definition was already outdated when it was adopted for the S-3 shelf more than 12 years ago. And frankly the exceptions that have now been attached to it create internal contradictions and …”

David cut him off. “What do you mean by ‘internal contradictions’?”

John tried to explain, “Look, the basic rule says that a deal is only a securitization if you issue securities that are supported by a discrete pool of financial assets that by their terms are to convert into cash, right?”

“Yeah, so?”

“So that means no hard assets and by extension no nonperforming assets, right?”

“Right, they won’t self-liquidate through obligor payoffs so you have to sell them off to realize their value.”

“Ok, but then we have this exception for lease securitizations in which up to 65% of the pool can come from the residual value of autos after the leases mature.”

“Yeah, so what? Are you saying the SEC shouldn’t have done that? I think it’s great,” said David.

“No – I am certainly not saying they shouldn’t have done that. I am glad they did it too. But my point is if we can see our way to accepting 65% hard assets as long as they come from lease terminations, why not allow hard assets from the beginning?” asked John.

“Look, auto lease securitizations are an accepted and recognized asset class in the public securitization markets, the SEC understands it, it’s tested and so on,” said David emphatically.

“Ok, but we can take up to 50% of the pool from the residual value of any other type of hard asset – airplanes, computers, widgets – so long as the asset was first subject to a lease. Why not just allow the hard assets in even if they were never subject to leases?”

“First of all, don’t forget that the 50% limit for non-auto leases is for non-shelf deals. You are limited to up to 20% for non-auto lease shelf deals,” said David, correcting John. “But the point is the same: the SEC is comfortable with lease securitizations.”

“But David, that an asset is subject to a lease until the lease terminates doesn’t change the fact that you still have to have someone manage and realize the value of the hard assets after the lease terminates. If you are willing to accept that risk for any asset as long as it was once tied a lease, why not go farther?”

“They will only take that kind of disposition risk with leases. That’s it” said David.

“I don’t think that is really true,” offered John.

"Really? How so?" asked David.

"Well, what about all those balloon mortgages in CMBS deals?"

"What about them? They totally fit the definition of an asset backed security! The notes require payoff at balloon maturity by their terms!"

"Yes, literally they do. But the practical reality is that the notes are nonrecourse and won't be paid off unless the hard asset – the real estate – can be refinanced or sold off. So shouldn't we just acknowledge that the note is, at least for this purpose, sort of meaningless and that its payment is dependent on realizing the value of the underlying asset? To say that only cash flow structures based on financial assets are ABS is proved wrong by the SEC's exceptions – leases and CMBS balloons. By the way, I feel the same way about the discrete pool requirement."

"What's wrong with the discrete pool requirement?" asked David with frustration in his voice.

"Well, the first part of the definition says a deal has to have a discrete pool to be an asset-backed security, but now we have these exceptions for master trusts, prefunding accounts and revolving and reinvestment structures. Aren't these exceptions so large as to disprove the general premise, i.e., that securitizations should be viewed in the first instance as only transactions with a discrete pool?"

"Not really, John," said David. "The point is to draw a circle around what should get the ABS regime instead of the traditional registration and disclosure regime. I don't think the SEC wants to widen the circle out of a concern that some deals that are pretty structured but still highly dependent on management to replace assets or realize asset value might inappropriately get the benefit of the regime."

"But David, how do you distinguish these "grey area" deals from the lease-backed residual assets or the master trust and so on? How can you find a way to make your premise about cash-flow structured deals backed by discrete pools of financial assets consistent with the permitted exceptions?"

"Look John, this isn't a logic game. It's about regulation. These rules are basically saying that if you fit in the definition you will be treated as a securitization and if you fit in a slightly tighter definition you will get the benefit of the S-3 shelf rule. Otherwise you have to go to the SEC and discuss it with them to see the extent to which a third approach might be appropriate for your deal," replied David. "They said in the release that if you call for a prefiling conference they will discuss it with you."

John shook his head. "David, I appreciate what you say and we'll try it out. But reading between the lines in the release it seems a little more problematic than that."

"How so?"

"The release says the definition is principle based. The stated principle is not about whether the securities will depend on underlying assets or the operating results of a business. No, instead it's talking about a pay-through or pass-through deal backed by financial assets, subject to exceptions that contradict the first principle. I am worried that someone at the SEC might lose track of the real issue here when we get to the 'grey area' deals."

"Oh come on. How so?" asked David.

"Well, what about nonperforming asset deals or synthetic deals?" asked John.

“What about them? They aren’t permitted,” replied David emphatically.

“Exactly my point. Let’s say I had a client with a pool that was 80% comprised of performing auto loans and 20% nonperforming auto leases at or near their maturity. My client wants to structure the deal to have 80% of the deal supported by the self-liquidation of the performing auto loans and 20% supported from selling off the leases or foreclosing them and selling off the cars. Are the nonperforming auto loans so different from the residual asset exception for auto leases?”

“I don’t know, but I am pretty sure they will struggle with nonperforming assets,” said David.

“Why?” asked John, continuing to press the point.

“Because they want self-liquidating assets.”

“But non-self-liquidating assets are already allowed – so why not these? Besides, are you saying that the traditional disclosure regime is more appropriate for this hypothetical deal as compared to the ABS regime for a deal that must liquidate up to 65% of a pool of real autos that come off terminated leases?”

“No, but I think they would struggle with it but of course you have to ask them. But what was your point about synthetics?”

“Well, let’s say I set up an SPV filled with Treasuries that enters into a credit default swap referencing a pool of mortgage loans. Under the terms of the transaction, the SPV will use the Treasuries to make credit protection payments for credit losses suffered by the reference mortage loans. At maturity, any remaining Treasuries will be used to pay off the SPV’s notes. Thus the SPV’s noteholders get the same economics as if the SPV had owned and pledged the actual mortage loans.”

“Sorry but it’s pretty clear they don’t want to allow synthetic securitizations. They feel that the performance of the offered securities should NOT come from the performance of assets outside the deal.”

“But why is my hypothetical deal more appropriate for the traditional regime? There is no operating business to disclose. Just a pool of Treasuries and a reference pool of mortgage loans!”

“Sorry, it doesn’t meet the definition,” said David.

“I know it doesn’t meet the definition – the question is, shouldn’t it get the same treatment as if it did? Where is the risk? Couldn’t that risk be dealt with by disclosure about the reference assets?”

“It could be abused.”

“Ok, what if my client disclosed as much as if it were actually putting the reference assets into the deal on a cash basis?”

Just then the panel moderator waved at John and David, pointing at the clock. It was time for the presentation.

John knew his present discussion with David was not a topic for today’s panel. “Well, thanks David. You know, I take your point that there is a regulatory reason for setting defaults defining which deals will automatically get the ABS regime and/or access to the S-3 shelf. I also take your point that other sorts of deals ought to be discussed to see if they should go in one regime or the other, or even somewhere in between in a ‘third approach.’ But I hope you can see my point that the SEC definition loses the main distinction between operating company deals and true securitizations. Frankly, I worry that the definition may have a life of its own outside of just defining which deals are automatically subject to the ABS regime. I worry that the discussion of an appropriate third approach for any deal will be stifled by the ‘principle’ behind the definition.”

“Ok John. Let’s talk about it some more at another time. For now, let’s go do this,” said David as he walked toward the podium at the front of the room.

To be continued …

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Thoughts about the ABS Definition in Regulation AB

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I. Introduction: A new regime for "asset-backed securities" and a possible "Third Approach" for other structured securities

In a new release[2] (the "ABS Release") the Securities and Exchange Commission (the "SEC") adopted new rules and forms to comprehensively address the registration, disclosure and reporting requirements for asset-backed securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. The ABS Release describes the final rules (the "ABS Rules") adopted by the SEC following publication in May 2004 of proposed rules[3] and the receipt of more than 50 comment letters from all parts of the securitization market in response.

As part of the ABS Rules, the SEC adopted a new subpart to Regulation S-K, called "Regulation AB", which contains required disclosure items for qualifying securitization transactions and adopts a definition of "asset-backed security." Only securities meeting the definition of "asset-backed security" are subject to the ABS Rules rather than the traditional registration, disclosure and reporting requirements. As the definition of "asset-backed security" demarcates the securities and offerings to which the ABS Rules apply (and, with certain additional limitations, which securities meet the Form S-3 shelf eligibility requirements), the definition plays a pivotal role in the regulation of securitizations in the United States. Notwithstanding the important function of the definition, the SEC acknowledges that it only captures "an appropriately definable group of asset-backed securities[4]" and that automatic default to the traditional regime may not make sense for certain structured securities. Indeed, the SEC suggests that in some cases a "third approach might be more appropriate" (without further elaboration).

In particular, the SEC noted:

> "Structured securities outside the definition have been registered before the adoption of Regulation AB, and the staff has worked with issuers to develop appropriate disclosures for such securities under our existing disclosure regime. As is the case today, we encourage issuers that are contemplating structured securities outside of the Regulation AB definition to have pre-filing

2 Release Nos. 33-8518; 34-50905; File No. S7-21-04. Available for review at http://www.sec.gov/rules/final/33-8518.htm

3 Release Nos. 33-8419; 34-4964; File No. S7-21-04. Available for review at http://www.sec.gov/rules/proposed/33-8419.htm

4 The ABS Release at Part III.A.2.a, page 37.

> conferences with the staff to discuss the proposed transaction and the appropriate approach."

The SEC also sought additional comment on whether they should consider an alternative scheme for these kinds of securities.

Despite these encouraging indications about the future flexibility of the SEC and the potential to design a third approach for those structured securities that do not meet the definition of "asset-backed security" in Regulation AB (referred to hereafter as "Excluded Structured Securities"), many other references in the release suggest that the principle imbedded in the definition may affect the SEC's view of when an alternative to the traditional regime might be considered appropriate. Therefore this article reviews the definition of "asset-backed security" and proposes some ways to think about a "third approach" for Excluded Structured Securities in the hope of suggesting a sensible methodology for determining an appropriate regime for any of them.

To begin the discussion, let us first examine the definition to determine which structured securities are "asset-backed securities" (and therefore are subject to the ABS Rules) and those which are Excluded Structured Securities and for which a third approach may be appropriate.

II. The Definition of "asset-backed security": which structured securities fall within and which are excluded from the regime?

The starting place: the 1992 S-3 Shelf Rule: The "major premise" of the definition of "asset-backed security" included in Regulation AB is taken from the definition of asset-backed security set forth in the SEC release published in 1992 (the "1992 Release") which provided for the shelf registration of investment grade asset-backed securities. In particular the definition provided that an asset-backed security is:

> "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 to cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the securityholders."

This definition essentially contemplated only cash-flow, pass-through or pay-through securities backed by a discrete pool of financial assets. Conversely, the definition effectively barred from S-3 shelf access securitizations backed by assets that were not "receivables or other financial assets" (e.g., hard assets, like autos, or executory contracts) or non-performing receivables or, even if performing, any receivables not considered part of a "discrete pool" backing the transaction. Similarly, the definition barred from S-3 shelf registration securitizations dependent upon disposal or other realization of the assets' market value (as compared to a cash-flow, pay-through structure depending on the self-liquidation of the financial assets) or where performance of the related securities turned on the performance of reference assets not included in the discrete pool (e.g., synthetic securitizations).

SEC additions to the 1992 definition: With the ABS Release, the SEC recognized that the definition from the 1992 Release effectively excluded a number of asset classes and structures that were recognized and accepted in the public securitization markets and that a broader definition was justified to pick up these other classes of assets and structures. Accordingly, the SEC modified the definition to also permit:

1. lease securitizations which contemplate

    a. in the case of auto lease securitizations, up to 65% of the value of the pool backing the securities to consist of residual assets (e.g., autos), and

    b. in the case of all other assets, up to 50% of the value of the pool backing the securities to consist of other types of residual assets (but limited to 20% for purposes of obtaining access to S-3 shelf registration); and

2. the following exceptions to the discrete pool requirement:

    a. use of the master trust structure;

    b. prefunding periods with a prefunded amount of up to 50% of the offering proceeds; and

    c. no restrictions on revolving periods for securities backed by receivables or other financial assets that arise under revolving accounts and a revolving period for up to three years provided that the new pool assets are of the same general character.

Given the needs of the current public ABS market, these exceptions are sensible, practical compromises to the 1992 Release definition. However, even after these modifications, the final definition continues to exclude a significant number of types of securitization transactions and, given the dynamic nature of the market, is likely to become outdated quickly.

III. Is the scope of the asset-backed security definition appropriate and sufficient?

Should the final definition of "asset-backed security" included in Reg AB have included additional assets or structures? To answer this question, it is essential to examine the principles underlying the final definition and the regulatory objectives that are involved.

The principles behind the definition of "asset-backed security": The SEC describes the ABS definition in Regulation AB as "principle-based and flexible". A principle-based approach to defining structured securities subject to the ABS regime would be beneficial to legal practitioners, bankers and sponsors of securitizations because it would provide these market participants with a coherent internal logic by which to make judgments in situations not previously encountered or specifically addressed by the SEC. The guidance provided by such an approach would regulate market activities by requiring relevant concerns to be taken into account yet permit (and perhaps even encourage) flexibility and creativity.

However, analysis of the definition of "asset-backed security" raises questions as to whether it is truly "principle-based," particularly upon comparison of the major premise of the ABS definition (i.e., the portion first taken from the 1992 Release as described above) with its proviso and conditions (i.e., the exceptions for residual assets from leases and the "discrete pool" requirement).

The major premise of the ABS definition seemingly stands for the proposition that a securitization cannot obtain the benefit of the new regime if it is supported by hard assets or non-performing financial assets. In fact, the SEC states its preference that qualifying securitizations rely primarily upon self-liquidating financial assets. Yet by the proviso, the SEC permits up to 65% of the pool to come from the *disposition* of hard assets (i.e., autos in the case of auto lease securitizations). What principle is the SEC trying to express? Is there more risk in relying upon the realizable value of autos that are put directly into a pool at inception than the same risk with respect to autos that come into the pool as residual assets of leases that first comprised the pool? Perhaps so in particular situations, but certainly not in all instances – in which case it seems inappropriate to exclude any such case without reference to relevant distinctions. Even without comparing the major premise to its proviso, the same issue can be identified in deals currently accepted as "asset-backed securities" (and thus subject to the ABS Rules). For example, consider the case of a nonrecourse, balloon commercial mortgage loan. From the SEC's perspective, the loan is a receivable that is supposed to convert to cash by its terms and is therefore an "asset-backed security". Practically, however, there is a significant likelihood that the receivable won't be paid unless the loan borrower is able to realize the value of the underlying real estate by selling the property or refinancing it with another loan. Obviously the SEC understands that these dynamics exist given the extra focus it requires for property disclosure (see, for example, Section III.B.5 of the ABS Release). But if this type of disclosure is sufficient to cover this sort of "operational risk" for CMBS, then shouldn't similar disclosure requirements (tailored for the particular assets) also be appropriate for an Excluded Structured Security with comparable "operational risk"?

Similar concerns grow out of an analysis of the discrete pool requirement and its exceptions. According to the major premise of the discrete pool requirement, a mortgage-backed bond that requires maintenance of a certain amount of collateral can not be an asset-backed security. However, a master trust that cycles through many generations of assets is permitted.

In short, the exceptions to the major premise create inherent contradictions within the ABS definition that are difficult, if not impossible, to reconcile. These contradictions make the definition look like a patchwork intended only to capture much of the current public ABS marketplace rather than to provide a "principle-based and flexible" regime that can adapt with the market.

Regulatory Objectives: Perhaps the SEC's regulatory objectives are not dependent upon logical consistency in the definition of asset-backed security. The SEC has made it clear that the traditional registration and disclosure regime applicable to operating businesses does not elicit appropriate information for asset-backed securities, and has provided an alternate regime for asset-backed securities. On the other hand, the SEC also expressed its concern about operating risk in Excluded Structured Securities. This element of operating risk causes the SEC concern about the appropriateness of the alternate regime for these Excluded Structured Securities. Perhaps the definition should be looked at as merely a determiner of which transactions may go forward under the alternate ABS regime without further approval from the SEC, with all other structured transactions being subject to SEC consideration of a possible "third approach".

To this extent, the definition of "asset-backed security" may serve its purpose. However, once a discussion of a possible "third approach" is commenced, any lingering resistance to open-minded analysis caused by the definition is problematic.

IV. How should we treat Excluded Structured Securities?

Without a firm commitment to a “third approach,” the definition of asset-backed securities in Regulation AB does not leave much room for either existing or subsequently emerging Excluded Structured Securities which arguably would be better suited for at least a portion of the new disclosure regime (but without more would be subject to the traditional regime for operating companies). However, as the SEC has acknowledged, automatic application of the traditional regime may not make sense for certain structured securities. How should we analyze an Excluded Structured Security to determine whether a “third approach” is appropriate for it and how the particular third approach should be structured?

It is clear from the discussion above, that the analysis of whether a third approach is appropriate in any given situation can NOT be driven by such things as whether or not there is a “discrete pool” or whether the underlying assets are “receivables” per se. To do so, would abdicate substantive analysis of relevant distinctions for “short-hand” reasoning that rests on unsatisfactory provisions of the definition. Instead, each transaction that fails to satisfy the definition should be subject to review for such characteristics as those that justify the creation of a separate ABS regime: are the risks and rewards of an investment in the particular structured security best disclosed (initially and on an ongoing basis) by application of the traditional disclosure regime or is the ABS regime more appropriate –- albeit with any modifications as necessary to deal with risks that are not usually found in “asset-backed securities”? This analysis should be informed by the way that various operating and other risks are dealt with for “asset-backed securities” (as in the case of balloon risk in CMBS transactions or the reliance on the recoverable value in residual assets in lease securitizations).