THE BIG PICTURE: 10 KEY CONCEPTS IN THE SEC's ABS RELEASE

The Securities and Exchange Commission has finally released its rulemaking proposal for asset-backed securities. Here are 10 "big picture" concepts about the Release we think you should understand:

1. A nearly comprehensive release. The Release is a nearly comprehensive set of rules for ABS. It would replace a grab bag of no-action letters, interpretive positions, and - most of all - inconsistently administered practices that have developed over 20 years.

K&E Comment: The benefit of this approach is that there will be more transparency and level treatment. The risk is that written rules could take on a life of their own and move in unexpected directions. On balance, we think written rules will be better. But cases will arise where issuers will lose some of the flexibility inherent in a system of unwritten rules.

2. SEC run amok or industry crying wolf? The SEC's staff advertised the Release in advance as containing just "incremental change" to current practice, though the staff did forewarn that static pool data would be sought. Perhaps the staff's pre-marketing lulled market participants into a false sense of security. However, the Release's arrival caused a major outcry over the perceived burden of portions of the Release, particularly in the static pool and compliance assertion/attestation areas.

K&E Comment: The SEC didn't seem to appreciate how much incremental data it proposed. But a major attraction of ABS to sponsors is that they can issue highly rated securities without recourse. The basis for that bargain is the reliability of the data on which the rating is based - so it's hard to take the position that data shouldn't be made available to investors.

3. More disclosure is on the way. The SEC wants a fundamental re-evaluation of disclosure standards in ABS. The principal areas in which commenters have focused are static pool data for sponsors and servicer disclosures for deals with multiple servicers. But the SEC is also seeking more actual pool data, more financial data on significant credit enhancers (and swap providers), and more data on non-sponsor originators and others.

K&E Comment: The SEC is walking a tightrope here. It is trying to revisit entrenched practices that it blessed for 15-20 years. Some suggested disclosures overreach; some (ironically) may be too limited . We expect some paring back in the final rules, but most of it will survive.

4. Have recent scandals caused the SEC to pick on ABS? In the Release, the SEC alludes several times to "recent market events," which seems to be code for "fraud." Those references, including cites to articles about various frauds, and the enhanced disclosures sought in the Release may have some feeling like the SEC has decided to crack down on securitization.

K&E Comment: Perhaps lost in the hue and cry are many significant securities law advantages that ABS still enjoys over other corporate finance tools. E.g., ABS final prospectus filings under Rule 424(b) get a timing break not available to others; neither audited financial statements nor audited servicer reports are required; and non-reporting companies can register ABS on the shelf. The SEC is getting a bit stricter, but securitization still has favored child status.

5. The SEC wants someone in charge. Specialization of functions is a strength of securitization, as it facilitates efficiency. But functional specialization can also reduce accountability.

The SEC has taken note. It wants to designate the depositor or the servicer as the "responsible party" that would report on compliance for the entire servicing function. The Release proposes that one auditor would attest to the responsible party's assessment. Parties who effect multi-servicer securitizations have objected, arguing it will greatly increase costs to monitor and attest to multiple servicers.

K&E Comment: It's hard to argue with the SEC view that someone should take responsibility. Multi-national corporates, by way of comparison, can't avoid audited financials just because it's expensive to audit overseas operations. For the typical "single company" securitizer, like a captive finance subsidiary, these *proposals should not cause enormous burdens. For aggregators with multiple servicers, it will be more work, but practical solutions will be found.*

6. What, me? Material? The SEC has liberally sprinkled its proposed disclosure standards with a topping of "materiality." Static pool data, credit enhancement, legal proceedings and other disclosures are to be made "to the extent material." The SEC has adopted a principles-based approach to disclosure, rather than a detailed set of rules, and is expecting parties to assess materiality in formulating disclosure.

K&E Comment: Having to make judgments of materiality may be a frightening prospect to many. However, we think the SEC did the right thing here. Just compare the hopeless morass of rules in FIN 46 for a view of the alternative. We also think that "materiality" can be used affirmatively by issuers to impose a rational limit on the amount of data supplied in a prospectus.

7. Even with all the rules, many issues will remain. Although the SEC release runs nearly 400 pages, many questions remain about what is intended. Even where there may be no real disagreement with the SEC, issues exist. E.g., shelf registration of auto leases is allowed, so long as the residual value is less than 60% of the original asset pool. But how do you measure residual value?

K&E Comment: Even if the SEC addresses all of the questions of this ilk raised in comment letters, many interpretive issues will remain. At best, it will take a few years of practice under the new rules with the SEC to really get a handle on how things will work.

8. Will the SEC drive issuers to the Rule 144A market? The SEC's standards will apply to registered public offerings. Some have suggested that the result of creating overly burdensome disclosure and reporting obligations will be to cause issuers to migrate to the Rule 144A market, where the disclosure can be more relaxed. Others think the strict liability standard imposed on issuers in public offerings, even when it is disclosure about a third party, could have the same impact.

K&E Comment: We don't think desertion of the public markets is likely on a large scale. One big reason is that the Rule 144A market has always taken its disclosure cues from the public market. Lawyers will be uncomfortable issuing, and bankers will be uncomfortable accepting, 10b-5 "negative assurance" statements on disclosure that shortcuts public offering standards. Strict liability already exists, and registrants seem to be willing to take that risk at present.

9. This system will take a lot of work to implement. In the Paperwork Reduction Act section of the Release, the SEC estimates that the new disclosure requirements would add only 250 hours of additional work to each S-3. The SEC estimates that the **total** annual incremental cost of S-3s from the new proposals, for all issuers collectively, will be just $9,450,000.

K&E Comment: The SEC has considered only the initial S-3 filings; it seems to have missed the point that there are multiple takedowns from a shelf, each of which can be as expensive as the initial filing. Whenever rules change, the cost of compliance goes up. The SEC has badly underestimated the cost. Especially in the beginning of the process, issuers, counsel and auditors will be spending a lot of time working through new rules, new information from their issuers, and new presentation formats. It won't be cheap.

10. The SEC will read comment letters. The SEC really does want to get comments. It's quite clear from the Release that the SEC paid a lot of attention to what they heard in the years leading up to this Release, not only from investors but also from other parties. The Release is full of footnotes referencing letters submitted to the SEC and meetings of the SEC and the industry.

K&E Comment: In the past, the SEC has definitely considered comments it has received. We expect the same here. We think they will take all reasonable comments seriously. We suggest that you participate.

Should you have questions about this Alert, please contact these Asset Finance & Securitization partners, or any other K&E attorney:

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