KIRKLAND & ELLIS LLP Alert

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DISCLOSURE: 10 KEY REQUIREMENTS IN THE SEC'S ABS RELEASE

The Securities and Exchange Commission's rulemaking proposal for asset-backed securities has many new disclosure specifications, in Items 1102 to 1118 of proposed Regulation AB. Here are 10 that we think you will want to know about:

1. Static pool data will stick (Item 1104(e)). The SEC wants static pool data for delinquencies and losses, "to the extent material." They want it in the prospectus, which means issuers and underwriters will have Section 11 liability. The cost and the potential liability have generated lots of complaints, but it's pretty clear the SEC considers static pool data important for investors. At a recent forum, the SEC answered complaints curtly: "Get over it. That's life in the capital markets."

K&E Comment: The challenge will be to determine what static pool data is material -- where to draw the line. For a sponsor that consistently securitizes the same "mix" of assets -- based on seasoning, credit scores, geography, asset type or other relevant measures -- it should be sufficient to just provide pool data for earlier securitized pools. For a sponsor whose pool composition varies more from deal to deal, the amount of "material" static pool data needed for investors to analyze expected pool performance may be greater.

Ironically, the SEC could be said to have asked for too little, in some respects. Three years' worth of data isn't much, if the receivables are 5-year auto loans or 30-year mortgages. Also, there's no requirement for prepayment data. However, in other respects the proposal seeks an astonishing amount of data,such as slicing up monthly static pools in four or five different ways. We expect some relief on the breadth of the data required.

2. Spotlight on servicers (Item 1107(a), (b)). The SEC wants a lot more information on servicers, like experience in servicing assets of the type being securitized; the size, composition and growth of the serviced portfolio; collection and billing processes, computer systems and backup systems; material changes to servicing procedures and policies in the last 3 years; and "the servicer's financial condition where it could have a material impact on one or more aspects of servicing of the pool assets and where those aspects could materially impact pool performance on the asset-backed securities." Statistical data on historical servicer advances is sought, to the extent material.

K&E Comment: The SEC plainly believes that existing servicer disclosure is inadequate. These rules would beef up servicer disclosure a lot. Generally, it should be fairly easy to gather the information for a sponsor/servicer. It's not clear to us, though, how to interpret the "financial condition" provision: is it the servicer's current financial condition that is relevant, or should one assume a deterioration? Does the ease of replacing the servicer matter?

3. Multiple servicers = multiplicity of disclosures (Item 1107). If there is more than one servicer, the SEC wants disclosure about the master servicer, each affiliated servicer, each other servicer with responsibility for 10% or more of the pool assets, and each special servicer "upon which the performance of the pool assets or the asset-backed securities is materially dependent."

K&E Comment: These rules largely affect aggregators who buy servicing-retained pools from multiple sources and to CMBS deals with special servicers. They'd like to see the SEC raise the 10% threshold to 20% or more, but we think that is unlikely. It's more likely, we think, that aggregators will change their pool composition to limit the number of significant servicers in a deal.

4. Successor Servicing (Item 1107(c)). The SEC wants disclosure of backup/successor matters, such as the process for transferring servicing to a successor, provisions for the payment of expenses of a servicing transfer, and the amount of funds set aside for servicing transfers.

K&E Comment: It will be challenging to describe the expected process of a servicing transfer when no actual arrangements are in place with a successor.

5. Depositors remain in the shadows (Item 1105). The SEC has sought fairly little information about depositors, which are the intermediate special purpose entities. The SEC does ask for activities of the depositor other than securitizing assets and for its continuing duties after issuance of the securities.

K&E Comment: Notably, the SEC didn't ask for executive compensation info on directors and executive officers (it did so for issuing entities that are corporations), nor did it ask for any disclosure about the depositor's role in other securitizations.

6. Pool asset disclosures (Item 1110). The SEC would like to see pool asset distributional data in multiple dimensions - not just by interest rate and geographic location, but also by other material variables, *e.g.*, average balance, average age, remaining term, loan-to-value, and weighted average credit score. Underwriting criteria, changes in the criteria and ability to override the criteria are solicited. For deals with revolving periods, the SEC seeks data like the maximum amount of assets to be added in the revolving period, the percentage of the asset pool represented by the "revolving account," the party that has the authority to add assets and whether anyone independently verifies the exercise of that authority.

K&E Comment: The original pool disclosures will add a page or two to most prospectuses, but should not prove too difficult to generate ordinarily. Sponsors may be sensitive about new disclosures, like FICO scores or other credit measures. The revolving period rules suggest that the SEC doesn't understand the revolving period mechanics in credit card or floorplan deals.

7. Enhancer/counterparty disclosures (Item 1113). The proposal calls for selected financial data about credit enhancers (including derivative counterparties) who are liable or contingently liable for payments of 10% to 19.99% of the cash flow supporting any class of securities, and for full financial statements if at or over 20%. The proposal states, "Even if a swap…was currently 'out of the money'…, if the swap provider was contingently liable for more than 10% of the cash flow supporting a class (for example, if interest rates changed), [financial] disclosure would be required…" The SEC rejects valuation as a relevant test.

K&E Comment: Liability under caps and swaps is, at the outset, both contingent and unknown in its magnitude. The SEC seem to take the simplistic view that one should assume the worst in computing the aggregate liability. The SEC must accept that some set of assumptions and a valuation methodology are needed to estimate potential liability. Banks and rating agencies routinely use models to assess derivative counterparty exposure and make assumptions to arrive at the inputs for those models. The Basel committee also wrestles with this issue for capital allocation. We think the SEC should be guided by those other well established efforts, and should adopt -- or allow market participants to utilize -- a meaningful and practical methodology for estimating exposure for disclosure purposes.

8. Tax opinions (Item 1114). In addition to disclosure of material tax consequences to investors, the proposal asks for a couple of new tax disclosures: the federal tax treatment of the *transaction*, and "identification of the material tax consequences upon which counsel has not been asked, or is unable, to opine."

K&E Comment: Disclosure of the tax treatment of the "transaction" would seem to mean how the sponsor is treating it; the relevance there seems questionable. The disclosure of "un-opined" tax consequences seems to involve proving a negative: how do you decide what you have not been asked to cover?

9. Interested party transactions (Item 1117). The proposal would expand disclosure of affiliations, and transactions, among the key participants in an offering. Any business relationship or arrangement on non-arms' length terms or outside the ordinary course of business -- and the SEC says a warehouse line would not be ordinary course -- should be disclosed, if material.

K&E Comment: The SEC has always had a special interest in interested party transactions, and recent scandals have further piqued it. We think this requirement will remain as proposed.

10. Fees and expenses (Item 1112(c)). The SEC seeks itemized disclosure of all fees and expenses to be paid from pool cash flows, and whether they can be changed without investor consent. Notably, the proposal does not cover fees and expenses paid by other means.

K&E Comment: This disclosure will be a hot topic for credit enhancer fees, for both monolines and CIA investors, where prevailing practice is not to disclose the amounts. We think that perhaps disclosure of a maximum amount will suffice.

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

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