

KIRKLAND ALERT

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Taking the Plunge — Can ABS Survive the Waterfall Computer Program Proposal?

The SEC's proposed "waterfall computer program" requirement could mean substantial difficulty, significant cost and unsettling potential liability for the asset-backed securities market.

In 1901, 63-year-old schoolteacher Annie Edson Taylor became the first person to go over Niagara Falls in a barrel. It was a risky stunt that, she hoped, would gain her fame and fortune. But it was not to be. Her manager for her subsequent lecture tour was a con man who took everything, and she lived in poverty the rest of her life.

Hers may be a cautionary tale for the asset-backed securities (ABS) market, as it contemplates the hazards of the "waterfall computer program" that the Securities and Exchange Commission (SEC) proposes to require. The "waterfall" in an ABS deal is the set of priorities for distributions that are made each month to securityholders and others, and the SEC wants issuers to provide a computer program that investors can use to model distributions on offered securities.

We worry that, in the manner of Annie Taylor's manager, the SEC's requirement could leave the market foundering. The SEC seems to have little appreciation for the substantial difficulty, significant cost and unsettling potential liability this waterfall requirement would impose.

Annie Taylor's advice to others when she emerged from her barrel was, "Don't try it." We wish the SEC would follow that guidance. If the SEC puts issuers in a barrel and pushes them downstream, we think the ABS market could be left gasping for air.

What Does the SEC Want?

The waterfall program the SEC wants ABS issuers to create would need to:

- be composed in downloadable source code in Python, an "open source" programming language
- be usable with the asset level data files required from issuers to be provided during the offering and at the time of each distribution report thereafter
- be filed with the SEC, enabling an investor to download the code and run it through a Python "interpreter" that the investor obtains elsewhere
- give effect to *all* rules (including any contingencies) by which available funds are distributed to each class of ABS *and* to "each other person entitled to payments or distributions"
- permit a user to input his own assumptions about the performance of, and cash flows from, the pool assets
- produce an output of all cash flows to each ABS class and each other person listed in the waterfall for the life of the security.

The SEC also proposes that each ABS issuer would prepare and file a sample output for each ABS tranche based on sample inputs selected by the issuer.

The waterfall program would need to be filed contemporaneously with the preliminary prospectus for the ABS being sold. Additionally, credit card master trusts would be required to file updated waterfall programs when "changes occur to the waterfall" (presumably as a result of a new series being issued or an existing series maturing, though the SEC does not say that).

Although these requirements are framed entirely in the context of publicly-offered ABS, the SEC's proposed disclosure rule for Rule 144A offerings — that the issuer in Rule 144A offerings of ABS must agree to provide dis-

closure comparable to that of a public offering — would seem to mean that ABS issuers would need to make waterfall programs available in 144A offerings as well.

What Do Investors Want?

It is difficult to speak with conviction about what investors want, as there is no authoritative source of investor perspective. However, we have been participating in a couple of groups organized by the American Securitization Forum (ASF) that include investors and that have been discussing this proposal. We have also heard reports of the discussions of this proposal by the ASF's Investor Committee. Our discussion below is based on these sources.

The results, to say the least, are disheartening. The overall ASF comment letter process has abandoned the effort to reach a consensus industry position on the waterfall program, and the ASF seems likely to submit both an “issuer position” and an “investor position” on this requirement. And the investor position seems likely to take an even harder line in several respects than the SEC itself proposed.

Investors are palpably upset about shortcomings in pre-crisis residential mortgage-backed securities (RMBS) offerings, and they have latched onto the waterfall program proposal as a seeming cure-all. For example, investors have expressed consternation that waterfall descriptions in prospectuses at times varied in substantive respects from the language that eventually turned up in the pooling and servicing agreement (PSA). Inasmuch as it is the PSA and not the prospectus that is the controlling document, the investors ended up with a security that differed from what they thought they were buying.

Frankly, we agree with investors that such an outcome is deplorable. It was due to an apparently common pre-crisis RMBS practice (not tolerated in other ABS sectors) of finalizing operative documents weeks after the offering had closed. Some investors reason from this experience that the “solution” is to specify that the waterfall program — rather than the PSA or even the prospectus — should be the governing set of rules for cash flow allocations. That idea strikes us as truly hazardous, given the imprecision we discuss below.

Investors also insist that issuers have strict liability for waterfall programs, that issuers be required to update waterfall programs whenever a change occurs in the deal structure and that the waterfall program should tie directly into the trustee's monthly settlement statements.

For amortizing trust structures, investors seem to believe that the waterfall should exactly mirror the PSA provisions, with no simplifying assumptions permitted. For revolving master trusts, investors apparently are willing to consider allowing the use of some simplifying assumptions — but it does not appear that agreement has been reached on just what those assumptions might be.

Modeling an ABS Transaction

The waterfall computer program is just one step in the process of modeling an ABS transaction. In simplistic terms, the process of modeling an ABS transaction involves the following steps, which we have depicted in the chart on the following page:

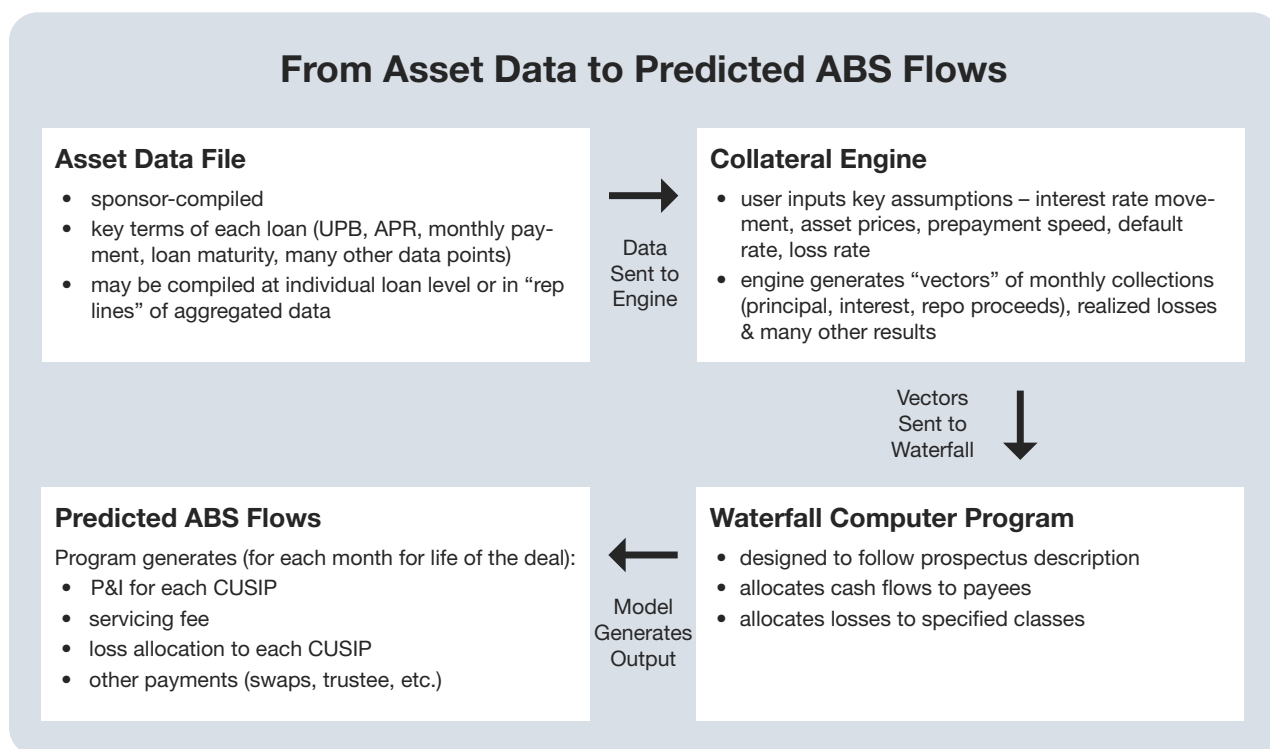
First, the ABS sponsor compiles an **asset data file**, which has relevant data regarding the securitized assets. The data typically is at the individual loan level for RMBS and commercial mortgage-backed securities (CMBS), but it is usually grouped into so-called “rep lines” for retail auto and equipment transactions.

Second, the asset data file is run through a **collateral engine**, which is a highly developed computer program that enables the user to input assumptions about market conditions (interest rates, prices of repossessed collateral) and about the way in which the user expects the securitized assets to perform (delinquency or default rates). The collateral engine will produce rows of pool performance data — so-called “vectors” — for each month of the transaction's life.

It is at this stage that a user — such as an investor or rating agency — can run multiple scenarios to test various combinations of stress case assumptions. Although the SEC says that it is requiring only a waterfall computer program, the SEC specification that the user must be able to input assumptions in areas such as expected interest rates, loss rates and the like would require at least a rudimentary collateral engine.

Third, the vectors from the collateral engine are run through the **waterfall computer program**, which gives effect to the rules for allocations and distributions specified in the transaction's governing documents.

This process produces the **predicted ABS flows** — principal and interest payments, allocated losses and so on — for each security, or CUSIP, for that transaction for each remaining month of the transaction's life. These outputs will tell the user whether the particular bond should be able to withstand the stresses that the user was testing, what timing an investor might expect for payments on a security or how to value a security.



What Really Exists Right Now?

In both the ASF groups and in separate discussions, we have been talking with a number of industry participants that are considering the SEC’s waterfall program requirement. What we gather from these sources is that practice varies widely across the ABS industry, ranging from extremely robust data and modeling availability for some transactions and in some asset classes to far less-developed approaches in other sectors.

Here is our admittedly impressionistic take on the state of ABS modeling programs today:

- Almost no sponsors or issuers prepare their own collateral engines or waterfall programs to test cash flows when structuring a transaction.
- A sponsor generally relies on the lead investment bank to develop a model that will be used by the bank and the rating agencies for the purpose of sizing and stressing the different classes of securities to be offered. These models are not distributed to investors, although banks will run different scenarios and provide the results, known as computational materials, to rating agencies and (sometimes) to investors.
- Investment banks use a variety of software for this modeling: Excel, bank proprietary code and Intex programs, among others.
- In the secondary market, most investors utilize sys-

tems consisting of collateral engines and waterfall programs supplied by third-party vendors, such as Intex, Bloomberg and Interactive Data, who have each invested years of time and tens of millions of dollars in the development of their proprietary code. These systems utilize files supplied by investment banks, servicers or trustees that contain individual or aggregated collateral data for the pool in question.

- The posted files also contain computer code that will interact with the vendor’s proprietary system to produce bond cash flows after an investor inputs its assumptions into the vendor’s collateral engine. Over the last few years, data has increasingly been made available during the marketing period so that investors can run the models on a pre-sale basis.
- These waterfall programs are models, and they have inherent limitations in trying to anticipate each possible event in a waterfall. We think virtually all of them make simplifying assumptions of one sort or another. For example, the program for a retail auto ABS with floating rate tranches would not have programmed into it the ability to model the effect of a swap counterparty termination. Another example is the master trust. Models of master trusts do not come close to running simultaneous simulations of all existing series with effect given to the many “sharing” provisions across series.

- Essentially no one uses Python as the language for developing a waterfall program (although one trustee is currently hawking its ability to create these models in Python).
- The asset classes with the most developed analytical capabilities are RMBS and CMBS.
- Modeling in the credit card sector is not as robust as in other sectors, and in floorplan it seems to be even further behind. The complexity of the master trust structures used in these transactions requires simplifying assumptions to be made. Further, the underlying collateral pool is constantly changing, due both to the revolving nature of the accounts and the ability of the sponsor to change the terms of the accounts and — particularly for cards — its underwriting standards.

What would be the Liability Standard for the Waterfall Program?

In registered offerings under the SEC proposal, the waterfall program would be part of the registration statement and prospectus, and therefore subject to the same liability regime as other information in the registration statement and prospectus. The Securities Act of 1933 (the 1933 Act) has several liability provisions. Here is a brief general summary:

- Under §11, each of the issuer, the directors of the issuer, the signatories to the registration statement, each named expert and the underwriters is liable for material misstatements and half-truths¹ in the registration statement (but each of the foregoing parties, other than the issuer, can be exonerated by establishing a due diligence defense).
- Under §12(a)(2), each seller (and seller includes both the issuer and the underwriter) of a security that was sold by means of a prospectus or oral communication related to a prospectus which included material misstatements and half-truths is liable to the purchaser for rescission of the sale (but each such seller can avoid liability by establishing a due diligence defense).

In addition, Rule 10b-5 under the Securities Exchange Act of 1934 could be used by an aggrieved investor to make a claim based on material misstatements or half-truths in the offering materials. In a Rule 10b-5 action, plaintiffs can receive actual damages, but rescission is not available. Liability under Rule 10b-5 is premised on fraud, which imposes a higher burden of proof on a

plaintiff than would a strict liability action under §11 of the 1933 Act.

The bottom line here is that, under the SEC's proposal, ABS issuers in public offerings will have strict §11 liability for losses resulting from material misstatements and half-truths in the waterfall program. Underwriters will have potential liability, too, although they will have the opportunity to establish a due diligence defense. Although ABS sponsors do not directly have liability under any of these sections, they often have agreed in underwriting agreements to backstop the indemnities granted by ABS issuers to underwriters.

In a Rule 144A transaction, §11 of the 1933 Act would not apply and §12(a)(2) would also likely not apply. However, Rule 10b-5 would certainly apply.

It is worth noting that the SEC could specify a different liability standard for waterfall programs. For example, Regulation AB, as originally adopted, provided that static pool data for securitized pools originated prior to the effectiveness of Regulation AB, while required to be disclosed, would be subject only to antifraud, or Rule 10b-5, liability, and not to strict liability. In a similar vein, free writing prospectuses authorized by the SEC's "Securities Offering Reform" initiative in 2005 were made subject to § 12(a)(2) and Rule 10b-5 liability, but not to § 11 liability.

So What's Wrong With the SEC's Proposal?

The SEC's proposal would add a significant new dimension to required disclosures in ABS offerings. If adopted in its current form, this provision would give sponsors and issuers plenty to worry about. On the surface, the proposal would seem to be a plus for investors. But we think even investors should recognize that this proposal might be so burdensome as to be counterproductive. Here are our thoughts on the problems the SEC proposal creates:

Complexity. The SEC proposal glosses over the enormous complexity of the regime it seeks to impose on issuers, particularly in the area of ABS master trusts. Although industry vendors have been developing their own modeling programs for more than 25 years, they still have only rudimentary master trust models. Yet the SEC expects issuers to produce precise replicas of their PSA waterfalls, including everything in series supplements, in a programming language not previously used for such models, from a virtual standing start.

The SEC also seems to think that access to the underlying code will provide investors with greater transparency, but that logic will only apply to investors who have the sophistication and resources to de-code the workings of the program. To those investors without that capacity, the program will simply produce another “black box” that they do not understand.

Cost. Implementing the waterfall program requirement would be expensive for sponsors and issuers. Virtually none of them do ABS modeling themselves at present, so they will need to pay to acquire the programming. Moreover, the requirements that take this modeling above and beyond current practice, and that impose a high liability standard, will raise the costs substantially, as sponsors seek to attain the necessary level of accuracy and reliability.

Based in part on the major misconception that sponsors already have waterfall programs, the SEC estimates that it will take just 672 hours of programming time for a sponsor to reprogram the code into Python — a one-time exercise — and just two hours of time to verify the code for each individual offering. The SEC scheme puts this cost at something like \$126,000 of out-of-pocket expenses per sponsor for the one-time conversion, and at a de minimis level for each new offering.

We suspect the SEC’s estimate is not even within an order of magnitude of the correct level. Even if an issuer can acquire some kind of existing technology, which will be far from costless, it will then need to add in the incremental precision demanded by the SEC and convert the program to Python. On an ongoing basis, the need for significant due diligence efforts by underwriters, lawyers, auditors and programmers to verify the accuracy of the programs will add significant additional costs. And it doesn’t look like the SEC even appreciates that many sponsors have more than one ABS platform.

Novelty. The SEC seems to have little appreciation for the novelty of this proposal and the difficulties that will accompany implementation. Start with the idea of using Python, which is a programming language used by no one in the ABS industry. Not only do knowledgeable resources likely not exist to generate waterfall programs on the requisite scale if all issuers were to attempt to build the programs, but the SEC would be casting aside the significant development work that has occurred among third-party providers in favor of a completely untried and unproven approach. We understand, for example, that the same Python program can actually gen-

erate different results, depending on the hardware on which it is run.

Precision. The idea that the waterfall program must exactly mirror the operative documents raises the stakes substantially for sponsors. Indeed, this feature of the rule would impose a higher standard on the waterfall program than exists for the prospectus disclosure of these provisions, which is permitted to omit immaterial features. As we note above, even state-of-the-art models today inevitably make some simplifying assumptions. This requirement, if absolutely maintained, will either drive master trust issuers from the market altogether, or it will force them to simplify their structures dramatically to eliminate the “sharing” features across series. The irony of that simplification is that these sharing features are largely there for the benefit of investors in underperforming series; they permit series that have shortfalls in cash flows to use the excess cash flows from other series. Eliminating the sharing would have the principal effect of increasing the risks to investors, as the extra funds would, by and large, just revert to the issuer.

Strict Liability. The imposition of a strict liability standard on issuers for a novel and complex disclosure requirement in public offerings is going to create an additional reason for issuers to avoid public offerings. The SEC seeks to mandate a practice for all issuers that essentially no issuers have previously undertaken, in a field that is likely to require virtually all issuers to hire or outsource the expertise.

Collateral Engine. The SEC proposes that the waterfall computer program permit a user to make its own assumptions about extrinsic factors, such as interest rates, and pool performance measures, such as loss rates. This feature of the proposal goes well beyond the “disclosure” paradigm that has always been the SEC’s focus in securities offerings, and thrusts the issuer into a position of providing the investor with tools to speculate on outcomes. Which variables, exactly, should issuers allow investors to manipulate? Will an issuer be at risk if it does not design a sufficiently robust collateral engine? There are hundreds of ways to manipulate data to speculate on outcomes, as shown by the vibrant existing market for collateral engines. We think this aspect of the SEC proposal is particularly dangerous.

Comparability. We think that one of the unintended casualties of the SEC proposal would be a significant decline in investors’ ability to compare different ABS. At present, the vendors like Intex, Bloomberg and Interac-

tive Data offer platforms with standardized controls and formatting. Learning to use any one of their systems is time-consuming, but an educated user can quickly compare different ABS using common assumptions.

In a world in which each issuer is responsible for creating its own waterfall program, it is inevitable that there will be great variations in the “look and feel” of various issuer programs. Form and functionality will vary greatly across issuers. Outputs will no doubt have widely differing formats. For an investor in a given asset class, the aggregate time needed to learn how to operate the waterfall computer program produced by each individual issuer will likely dwarf the time commitment required to operate a third party vendor’s platform. Far from benefitting investors, we think the SEC’s proposal will increase their workload.

What’s the Bottom Line?

We think the SEC’s waterfall computer program pro-

posal is the wrong tool to solve the problems that led ABS investors to lose a lot of money (mostly on RMBS and CDOs of RMBS). These liabilities were not the result of an inability to model exactly when each dollar of principal and interest would be received.

The waterfall program, as currently proposed, would be costly, risky and time-consuming for ABS sponsors. We suspect it would provide few benefits to investors; its greater impact is more likely to be a reduction in the number of sponsors willing to incur the cost and risk of developing the program.

We encourage sponsors and others who are concerned about the negative implications of this proposal to take action. Talk to investors; point out to them the risks of this proposal. Submit a comment letter to the SEC; let your views be known. Don’t let the SEC push the ABS industry over Niagara Falls in a barrel.

¹ More precisely, § 11 liability attaches “[i]n case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland author or your regular Kirkland contact.

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