



SEC Rules on Asset-Backed Securities

New SEC rules will standardize filing practices for issuers of asset-backed securities, add tailored disclosure requirements, and expand the types of asset-backed securities that qualify for shelf registration.¹ The added disclosure obligations include more static-pool data at the time of each offering, new events to be reported on Form 8-K, new Form 10-D for periodic reporting, and annual reports by all significant servicers on their compliance with SEC-mandated servicing criteria together with an independent auditor's attestation report on each servicer's report.

The new rules will establish uniform requirements for registration, ongoing reporting, and disclosure by issuers of asset-backed securities. The regulatory structure will affect financial-services firms and the many companies in diverse industries that securitize financial assets. This edition of *Defining Issues* highlights features of the new requirements.

The new rules—collectively referred to as Regulation AB—are effective for covered asset-backed-securities offerings initiated after December 31, 2005, and apply equally to foreign and domestic issuers. More detailed transition requirements apply to previously registered asset-backed securities.

Applicability

The applicability of the new rules depends on the definition of "asset-backed security." The rules define the term and then qualify it in some ways that broaden and other ways that narrow its range.

An asset-backed security is defined 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."

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¹ SEC Release No. 33-8518, *Asset-Backed Securities*, December 22, 2004, available at <http://www.sec.gov/rules/final/33-8518.htm>.

A security issued in a synthetic securitization is not within the scope of Regulation AB, because the synthetic security does not represent ownership in the underlying asset pool. Instead a synthetic securitization typically creates cash flows from an asset pool through a credit default swap or a total return swap.

The definition is qualified by conditions that also put some other securities beyond the scope of the new rules. In order for the definition to be satisfied, the security must meet all of the following conditions:

- Neither the depositor nor the issuing entity is an investment company under the Investment Company Act, and neither will become one as a result of the transaction.
- The issuing entity's activities are limited and passive (it owns the pool or assets, issues the securities, and performs only reasonably incidental related activities). However, the definition does not specify the issuing entity's legal characteristics.
- No non-performing assets are part of the asset pool at the time of issuance.
- Delinquent assets are less than 50 percent of the asset pool if registering on Form S-1 and less than 20 percent if registering on Form S-3. An asset is delinquent if it is 30 or more days past due on a required contractual payment. Partial payments on past-due amounts do not eliminate the delinquency unless they are made in accordance with a contract to restructure the obligation.

Securities Backed by Leases

The definition of an asset-backed security was expanded to include securities backed by leases, depending on the percentage of the cash flows that come from the disposal of the asset underlying the lease and provided specified disclosures are made. Cash flows

from the sale of a physical asset to recover residual value are different from cash flows from financial assets that "by their terms convert into cash," but these types of securitizations have become common in recent years with the popularity of consumer auto leases and other equipment-type leases.

For purposes of meeting the definition of an asset-backed security, the limits on the amount of the cash flows that are anticipated to be derived from the disposal of the leased physical assets are as follows: (1) for automobile leases, 65 percent of the original asset pool at the time of issuance; (2) for all other leases, 50 percent. For all other leases to be eligible for shelf registration on Form S-3 the limit of cash flows from anticipated disposals of the leased assets is 20 percent of total cash flows. The issuer must also disclose how the residual values are estimated and derived, statistical information on historical realization rates, and the manner and process in which residual values will be realized, including which entity will convert the residual values into cash.

Broadened Treatment of "Discrete Pool of Assets"

The new rules state that several asset pools meet the discrete-pool-of-assets criterion for purposes of being considered asset-backed securities—in effect, broadening the definition. The first designated asset pool meeting the criterion is master trusts. The definition's language allows that the offering related to the securities may "contemplate" adding assets to the pool for future issuances of asset-backed securities, master trusts with revolving periods or receivables or other financial assets that arise under revolving accounts, and additions to the asset pool in connection with maintaining minimum pool balances in accordance with the transaction agreements.

In addition, the definition's language on pre-funding periods allows the period to extend up to one year from the date of issuance of the asset-backed security if the prefunded amount is not in excess of 50 percent of offering proceeds or, in the case of master trusts, not in excess of 50 percent of the aggregate principal balance of the total asset pool whose cash flows support the asset-backed security.

The language saying that revolving periods meet the discrete-pool-of-assets criterion substantially increases flexibility in structuring asset-backed securities and is a direct result of comments received on the proposed rules. Under the rules there are no restrictions on the revolving periods for securities backed by receivables or other financial assets that arise under revolving accounts, which is consistent with current practice. Securities backed by receivables or other financial assets that do not arise under revolving accounts are permitted an unlimited revolving period for up to three years, so long as the new pool assets that are added are of the same general character as the original pool assets.

Registration Requirements

The new rules restrict the forms that can be used to register offerings of asset-backed securities to Forms S-1 and S-3, which is consistent with current practice.

In the most common type of asset-backed-securities offering today, a sponsor registers the securities for one or more subsequent offerings or "takedowns" of securities off of the shelf-registration statement, typically on Form S-3. Offerings registered on Form S-3 typically have a "core" prospectus that outlines the types of offerings that may be conducted in the future and a prospectus supplement that specifies how the transaction will be conducted when the offering goes effective.

Disclosure

The rules and commentary make it clear that only those items that are material need to be disclosed. However, the SEC expressed concern that some issuers have treated as immaterial for public reporting information that was considered material for disclosure to rating agencies, rather than making consistent materiality evaluations.

The information that must be disclosed about the parties to the transaction includes these items.

- The sponsor's role in structuring the transaction, material roles and responsibilities in its securitization program, experience in asset securitizations, including the size, composition, and growth of the type of assets to be securitized.
- If the depositor as defined is different from the sponsor, information similar to that disclosed about the sponsor.
- Information regarding the issuing trust or other entity created at the direction of the sponsor or depositor that holds the pool assets, including a description of the entity's permissible activities, restrictions on activities, and capitalization. Also information about how the assets in the trust would be treated in the event of a bankruptcy or similar proceeding against the issuing entity, sponsor, depositor, or other related entity. Legal counsel's expert opinion in the offering is an optional disclosure.
- Information about each servicer's role and responsibility in the servicing function to the extent those roles are material and would be useful for the reader to gain an understanding of how servicing can affect expected performance. Additional information is required if servicers' asset levels exceed certain percentage thresholds. For

purposes of this disclosure, any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the securities is considered a "servicer."

- Information about issuing entity's trustees, originators, and other transaction parties.

Static-Pool Disclosures

The asset-backed-securities rules require new disclosures about pools of securities that do not change over time (so-called "static pools"). If material, delinquencies, cumulative losses, and prepayments for the respective asset type must be disclosed. Different types of information may be considered material for different asset classes, such as commercial mortgages. Issuers are also encouraged to disclose other static-pool information that may be considered material or unique to asset classes.

Under the new rules, the issuer can choose the method of presenting the information related to static pools. It can be included in the prospectus or, in the case of offerings on a Form S-3, can be included by reference to a filed Exchange Act report. According to a temporary accommodation available until December 31, 2009 (at which time the SEC expects to have EDGAR modified to accommodate this information), the issuer may present the information on a Web site if certain conditions are met. All information related to the filing on the Web site will be subject to liability provisions applicable to prospectuses and registration statements.

These are the conditions for including static-pool information on a Web site:

- The prospectus at effectiveness must disclose the intention to provide the information through a Web site, and the final

prospectus must provide the specific Internet address where the information is posted;

- The information is to be unrestricted and free of charge;
- The information will be available on the Web site for a minimum of five years; and
- The registration statement must affirm that the information provided through the specified Internet address is part of the prospectus included in the registration statement.²

The new rules set out disclosure objectives for pool assets through examples and identify some items that are required. These disclosures are required:

- **Pool Composition**—Brief description of the asset type to be securitized and a general description of the material terms of the pool assets, description of the underwriting or related criteria used to originate or purchase pool assets, description of the selection criteria for the asset pool and the cut-off date for establishing pool composition, geographical distribution (including specific material economic risk factors for geographical concentrations of 10 percent or more of pool assets), and delinquency and loss information in minimum 30-day aging buckets. (More detailed disclosures are required for commercial-mortgage-backed securities.)
- **Sources of Pool Cash Flow**—If there are multiple sources of cash flows (such as lease-back transactions), information on specific sources and uses of those funds, including any assumptions and models used to derive the amounts (such as valuation models on the residual value of leased assets). Specific disclosures related to residual values, including how residual

² See SEC Release No. 33-7856 regarding the treatment of other Web site information during a registered offering and issuer responsibility for hyperlinked information.

values are estimated, statistical information regarding historic turn-in rates and residual-value realization rates, the manner in which residual values are to be realized (including the name and experience of the entity that will convert the assets to cash), and the effect on the securities given cash flows greater or less than those estimated for residual-value disposals.

- Changes in the asset pool, such as through pre-funding or revolving periods and for certain rights and claims on pool assets.

Item 202 of Regulation S-K will continue to provide the core disclosure requirements for the transaction structure of securities issued, and Item 1113 of Regulation AB will clarify and require additional disclosures that are unique to asset-backed securities.

Significant Obligors

Significant obligors are obligors that represent ten percent or more of pool assets. A significant obligor may be an individual or a group of affiliated obligors, a single property or group of related properties, or a lessee or group of affiliated lessees that is responsible for the cash flows supporting the pool assets.

The issuer is required to disclose both descriptive and financial information about each significant obligor. Selected financial data consistent with Item 301 of Regulation S-K is required if the obligor is 10 percent or more but less than 20 percent of pool assets. If the obligor is 20 percent or more, audited financial statements meeting the requirements of Regulation S-X are required. There may be some flexibility in disclosing financial information as it relates to third parties noted above if defined criteria are met.

Credit Enhancement and Other Disclosures

The requirements for disclosing material financial information related to providers of

credit enhancement and other support are the same as those for significant obligors. Credit enhancement usually takes the form of a derivative instrument or other guarantee that backs up the asset-backed security's cash flows. Disclosures related to other derivative instruments not meant for credit enhancement are also required, for example, a derivative instrument used to alter the payment characteristics of asset classes.

The new rules also contain disclosure requirements for taxes, legal proceedings, related parties, and ratings.

Ongoing Reporting

The new rules substantially change ongoing reporting for registered issuers of asset-backed securities. The changes include eliminating the use of Form 8-K for periodic reporting, instituting new Form 10-D for that purpose, and adding disclosure requirements for timely reporting of specified events on Form 8-K. Annual reports on Form 10-K require assessment reports by servicers based on SEC-mandated minimum servicing criteria and an auditor's attestation report on each servicer's assessment.

New Form 10-D

Issuers of asset-backed securities will not have to file quarterly reports on Form 10-Q, but will have to file new Form 10-D to disclose both distribution and pool performance information for the distribution period and other matters. The nonfinancial items required on Form 10-Q are required on Form 10-D. The instructions to Form 10-D specify which recently adopted Form 8-K events are applicable to asset-backed securities and add to those events.

The information to be included on Form 10-D includes these items:

- Applicable dates for calculating distributions
- Cashflows received and their sources

- Fees paid and accrued, including credit and other enhancement fees and identifying both the purpose of the fees and the party receiving them
- Beginning and ending principal balances, reserve balances, and other material account activity during the period
- Interest rates applicable to pool assets and the related securities
- Any amounts drawn on credit or other enhancement facilities and any remaining amounts available in those facilities
- Delinquency and loss information for the period
- Material modifications to pool assets, including fees and penalties
- Material breaches of pool asset representations or warranties
- Information related to ration, coverage, or other tests used to determine performance triggers and whether those triggers were met
- Information related to any new issuance of securities backed by the same asset pool

The rules express a preference for the tabular or graphical presentation of statistical information.

Filings on Form 10-D are required within 15 days after each required distribution date on the asset-backed securities. A five-calendar-day extension will be available under Exchange Act Rule 12b-25. The registrant availing itself of the extension will have to make specified representations, including why unreasonable effort or expense would have otherwise been necessary.

Form 8-K

Under the new rules, issuers of asset-backed securities will file Form 8-K to report extraordinary events or transaction agreements, not for routine periodic reporting. Some reportable events are carried forward

from previous requirements, including bankruptcy, material impairments, changes in control of the registrant, and entry and termination of a material definitive agreement.

Those newly required include:

- Change of servicer or trustee,
- Change in credit enhancement or other external support, and
- Failure to make a required distribution.

Asset-backed issuers must file Form 8-K within four business days of a specified reportable event.

Form 10-K

The requirements for reports on Form 10-K include a certification in accordance with section 302 of the Sarbanes-Oxley Act, reports by all significant servicers on their compliance with SEC-mandated service criteria, and an independent auditor's attestation report on each servicer report. Issuers must also include information on the following subjects:

- Significant obligors,
- Significant enhancement providers,
- Legal proceedings, and
- Affiliations and related-party transactions, plus
- A servicer-compliance statement.

The servicer-compliance statement is different from the servicer's assessment of compliance with servicing criteria. The servicer-compliance statement, signed by an authorized officer of the servicer, communicates that the servicer has reviewed its activities and its performance under the servicing agreement and that, except as disclosed, has fulfilled its obligations under the agreement for the reporting period. These statements are required for all master servicers, affiliated servicers, and unaffiliated servicers that service ten percent or more of pool assets.

The signature requirements for the 302 certification differ from those for other issuers, because asset-backed-securities issuers do not typically have a principal executive officer or principal financial officer. Either the senior officer in charge of securitization of the depositor if the depositor is signing the Form 10-K or the senior officer in charge of the servicing function must sign the certification if the servicer is signing the Form 10-K report on behalf of the issuing entity.

Issuers of asset-backed securities are not required to include in their Form 10-K filing their annual financial statements with an accompanying independent auditor's report or a report on internal control over financial reporting in accordance with section 404 of the Sarbanes-Oxley Act.

Compliance With Servicing Criteria. The new rules require as exhibits to Form 10-K, a report from each covered party participating in the servicing function that assesses compliance with specified servicing criteria and an attestation report from a registered public accounting firm on each assessment report as of and for the period ending the end of the fiscal year covered by the report on Form 10-K.

The attestation report must comply with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board and must be available for general use, without restricted-use language.

According to the SEC release, an instance of material noncompliance identified in the reports will not by itself lead to regulatory restrictions on market access. The assessment and reporting is designed to provide a proper disclosure of such instances. The issuer will have to provide a servicer's

assessment report and an attestation report on each servicer's report unless the entity's activities relate only to five percent or less of pool assets. In other words, even if a servicer's function is immaterial to the issuer, a report is required if that function covers more than five percent of pool assets.

Item 1122 of Regulation AB contains the mandated servicing criteria. They include the criteria below from the four categories in the SEC release:

- **General servicing considerations—** Policies and procedures to monitor the asset-backed securities, procedures to monitor third-party performance in relation to servicing, maintenance of proper levels of insurance.
- **Cash collection and administration—** Payments are deposited timely (as defined in transaction agreements) in custodial bank accounts; proper authorization of wire transfers; movement of funds is reviewed and approved as specified in the transaction agreements; maintenance of separate cash accounts as outlined in the transaction agreements; appropriate reconciliation controls are in place and working as designed for cash and related accounts.
- **Investor remittances and reporting—** Timely preparation of reports; information presented is calculated as defined in transaction agreements; reports are filed with the SEC as required; reconciliation of investors' or trustee's records to the servicer's.
- **Pool asset administration—** Collateral on pool assets is maintained as required by transaction agreements; pool assets and documentation are safeguarded; changes to pool assets are reviewed, approved, and made in accordance with the transaction agreements; payments on pool assets (including proper allocation to principal,



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(212) 909-5600

Contributing authors:

Michael D. Foley
Jeffrey M. Rojek

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interest, and escrow) are made as defined in the transaction agreements; loss mitigation or recovery actions are in accordance with the agreements; proper documentation of collection efforts is retained; interest-rate adjustments are in accordance with the agreements; delinquencies are recognized in accordance with the agreements; external enhancements are maintained in accordance with the agreements; and with regard to funds held in trust (e.g., escrow), interest is paid in accordance with agreements and funds held are returned to the obligor within 30 calendar days of the full repayment of the related pool asset or other time period specified in the agreements.

The assessment of compliance with the criteria is to be performed at the “platform,” not the “transaction” level. That is, even though it will necessarily involve some assessment of compliance with individual procedures, the assessment is performed with respect to compliance with the criteria for the collective set of servicing obligations. The attestation report would also be governed by the “platform” level concept.

Transition

Asset-backed-securities transactions with an initial offering date on or before December 31, 2005 are not required to comply with the new rules. They are fully grandfathered. However, any transactions with an offering date after December 31, 2005 must comply with all aspects of the new rules.

With respect to an asset-backed-securities shelf-registration statement filed *on or before* August 31, 2005, for a takedown with an initial offering date after December 31, 2005, but not after March 31, 2006: the base prospectus and the prospectus supplement taken together must comply with the new rules. In addition, Part II of the registration statement must be amended post-effectively to add any required undertakings. If the takedown has an initial offering date after March 31, 2006, the registration statement must be amended post-effectively to bring the base prospectus into compliance with the new requirements and to add any required undertakings to Part II of the registration statement.

With respect to an asset-backed-securities shelf-registration statement filed *after* August 31, 2005, for a takedown with an initial offering date after December 31, 2005: the registration statement must be pre- or post-effectively amended to bring the base prospectus into compliance with the new rules and to add any required undertakings to Part II of the registration statement.

The descriptive and summary statements above are not intended to substitute for the text of SEC Release 33-8518 and are not necessarily applicable to any entity's specific circumstances. Issuers of asset-backed securities should rely on the text of the applicable documents that set out requirements and consult their accounting and legal advisors.