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SEC PROPOSES TO OVERHAUL REGULATION OF ASSET-BACKED SECURITIES

CAROL MCGEE, GARY D. ROTH, AND TARA CASTILLO

This article describes the Securities and Exchange Commission's proposed rule that seeks to substantially modify the regulatory framework in place for asset-backed securities.

In an open meeting on April 7, 2010, the Securities and Exchange Commission ("SEC") unanimously approved for public comment proposed rules¹ that seek to substantially modify the regulatory framework in place for asset-backed securities ("ABS"). The proposals would make dramatic changes to the current offering, disclosure and reporting requirements for registered offerings of ABS and also would impose significant disclosure requirements on private offerings of structured finance products. Chairman Mary L. Shapiro, in her opening remarks, stated that the "release represents a fundamental revision to the way in which the ABS market would be regulated," and that the changes were "both necessary and critical components of restoring investor confidence."²

The proposed rules are published in the *Federal Register* and are subject to a 90-day comment period that ends August 2, 2010.

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CHANGES TO THE SECURITIES ACT REGISTRATION FORM AND PROCEDURES RELATING TO PUBLIC OFFERINGS OF ABS

Eligibility

Transaction Requirements

The SEC proposes to create two new registration statement forms (Forms SF-1 and SF-3) for ABS issuers and impose significant new conditions on offerings of ABS on a delayed or “shelf” basis on new Form SF-3. Currently, among other things, shelf eligibility for ABS issuers is available only if the issued securities are rated investment grade by at least one nationally recognized statistical rating organization. In order to reduce the SEC’s reliance on ratings provided by credit rating agencies and “eliminate the appearance of an imprimatur” that a mandatory credit rating might create, this rating condition would be replaced with the following four eligibility requirements:

- ***Risk retention:*** The sponsor or an affiliate of the sponsor must retain a “net economic interest” to be measured at the time of the issuance or at origination (in the case of the originator) and maintained on an ongoing basis in one of the two following manners: (1) a vertical slice of five percent of the nominal amount of each of the tranches sold or transferred to investors, net of the sponsor or affiliate’s hedging positions directly related to the securities or exposures, or (2) for revolving asset master trusts, retention of five percent of the originator’s interests of the nominal amount of the securitized exposures, net of hedge positions directly related to the securities or exposures taken by such sponsor or affiliate, provided that the originator’s interest and securities held by the investors are backed by the same pool and the payments of the originator’s interest are not less than five percent of payments on the securities held by investors collectively.³
- ***Third party review of repurchase obligations:*** The proposed rules would require the party obligated to repurchase the assets for breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back to the obligated party.

- ***Certification of the depositor's Chief Executive Officer:*** The depositor's Chief Executive Officer would be required to certify that to his/her knowledge the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce cash flows at times and in the amounts necessary to service payments as described in the prospectus, and that he or she has reviewed the prospectus and the necessary underlying documents in order to make such a certification.⁴
- ***Ongoing Exchange Act reporting requirements:*** While most public ABS issuers are currently exempted from ongoing Exchange Act reporting requirements on their securities following the first year after issuance (since the securities are typically held by fewer than 300 non-affiliated investors), the proposed rules would require the issuer to file Exchange Act reports on an ongoing basis for as long as non-affiliates of the depositor hold any of the issuer's securities that were sold in registered transactions.⁵

Sponsors would also be required to evaluate and report on compliance with these four new eligibility conditions on a quarterly basis. The SEC would amend Rule 401 for ABS issuers to include a quarterly determination as to whether the issuer had satisfied the Exchange Act reporting requirements as a precondition to conducting an offering of an effective shelf registration statement.

Mortgage Related Securities

The SEC is proposing to amend Rule 415 to eliminate the current separate accommodation for shelf eligibility for mortgage related securities. As proposed, delayed shelf offerings of mortgage related securities would be registered on proposed new Form SF-3, and would have to meet the same eligibility requirements as other ABS.

Substantive Revisions to Definition of Asset-backed Securities

The SEC expressed concerns that some pools may not be sufficiently developed at the time of an offering to fall within the disclosure framework of Regulation AB and be eligible for shelf registration on proposed new Form

SF-3. The proposal seeks to revise the definition of asset-backed securities as follows:

- To prohibit use of Regulation AB by master trust issuers backed by non-revolving assets;
- To reduce the number of years for revolving periods of non-revolving assets from three years from the date of issuance of the securities to one year; and
- To decrease the amount of pre-funding permitted from 50 percent to 10 percent of the offering proceeds, or for master trusts, 10 percent of the aggregate principal balance of the total asset pool whose cash flows support the asset-backed securities.

Shelf Procedures

Contents of Preliminary Prospectus and Waiting Period

Although ABS issuers would still be permitted to utilize shelf registration, ABS issuers would no longer be permitted to offer securities by using a base prospectus covered by a supplement that describes the specific terms of the offering. Each offering of ABS would require a preliminary prospectus filed under proposed Rule 424(h) that would include all the required disclosure in a single document. Under proposed new Rule 430D, which would replace Rule 430B for asset-backed issuers, the Rule 424(h) prospectus would include substantially all the information for the specific ABS takedown previously omitted from the prospectus filed as part of an effective registration statement, except for the information with respect to the offering price, underwriting discounts or commissions to dealers, amount of proceeds or other matters dependent upon the offering price. The preliminary prospectus would have to be on file with the SEC for five business days before any sales could be made. Material changes to the information provided in the 424(h) prospectus would require a new 424(h) filing and a new five business day waiting period. The final prospectus, including pricing-related information, would be filed under Rule 424 in accordance with current practice.

Continuous Offerings

Although the SEC noted it had not encountered particular problems with respect to continuous ABS offerings to date, and that ABS offerings are not typically made on a continuous basis, the SEC also proposes to amend Rule 415 to limit the registration of continuous offerings for ABS offerings to “all or none” offerings. Under the proposal, the continuous offering must be commenced promptly and made on the condition that all of the consideration paid for such security will be promptly refunded to the purchaser unless (A) all of the securities being offered are sold at a specified price within a specified time and (B) the total amount due to the seller is received by the seller by a specified date.

Exhibit Filing Requirements

The proposed rules would make clear that exhibits, including documents filed in connection with an ABS offering registered on Form SF-3, would have to be on file and made part of the registration statement no later than the date the final prospectus is required to be filed pursuant to Rule 424. This is an area where practice has not been consistent and will require many issuers to finalize their transaction documents sooner than is typical.

Exchange Act Rule 15c2-8(b)

In conjunction with the proposed new Rule 430D, which would require that a preliminary prospectus is on file with the SEC for five business days before any sales could be made, the proposed rules will eliminate the exception to the 48-hour preliminary prospectus delivery requirement for offerings of asset-backed securities under Rule 15c2-8(b), which had exempted a broker or a dealer of an ABS offering from having to deliver a preliminary prospectus at least 48 hours before sending a confirmation of sale for all offerings of asset-backed securities, including those relating to master trusts.

NEW DISCLOSURE REQUIREMENTS

The proposed rules would amend Regulation AB to require the following new disclosures:

- Disclosure of pool level or asset-level data for each loan;
- Disclosure of flow of funds, or “waterfall” in the form of a waterfall computer program; and
- Elimination of the temporary static pool accommodation under Rule 312 of Regulation S-T.

Loan Level Information

The proposed rule would require issuers to provide and file, as an asset data file on EDGAR in a tagged data format using extensible mark-up language (“XML”),⁶ standardized asset-level data for each loan in the pool at the time of the securitization, when new assets are added to the pool and on an ongoing basis. Further, issuers will be required to provide this information in the prospectus and as exhibits to periodic reports required under Section 13 and 15(d) of the Exchange Act.⁷ The proposal identifies and proposes definitions for each individual data point so that investors can receive standardized and comparable disclosure for the following asset classes:

- Residential mortgages;
- Commercial mortgages;
- Auto loans;
- Auto leases;
- Equipment loans;
- Equipment leases;
- Student loans;
- Floorplan financings;
- Corporate debt; and
- Resecuritizations.

Each item that would have to be disclosed for each asset in the pool will be outlined in a proposed new Item 1111(h) and Schedule L of Regulation AB that would enumerate all of the data points that must be provided for each

asset in the asset pool at the time of the offering. Issuers would be required to report any changes to the pool on a Form 8-K. The rule proposes that issuers provide responses to the asset level disclosure requirements as a date, number, text or coded response. Required coded responses will be included in the EDGAR Technical Specifications. Acknowledging privacy concerns triggered by the disclosure of certain asset-level related information, the SEC proposes to require issuers only disclose proximate ranges or categories of coded responses.

With respect to registered and unregistered commercial and residential mortgage-backed securities, several industry groups have already developed asset-level data standards to collect information about loans. The SEC has based the 137 data points in the proposed rule for residential mortgage-backed securities, and the 61 data points for commercial mortgage-backed securities asset classes primarily on definitions that already exist within this framework. For the other asset classes, the SEC has derived the proposed data points from the data in the aggregate pool level disclosure that are commonly provided in prospectuses relating to such offerings.

Although the proposed rule would exempt issuers of ABS backed by credit cards, charge cards and stranded costs from providing asset-level disclosure, it proposes that issuers of credit card and charge card asset classes would provide grouped account data pursuant to a new Item 1111(i) and Schedule CC of Regulation AB. This is intended to offer more granular disclosure about an underlying pool. Issuers also would be required to provide Schedule CC data as of a recent practicable date at the time of Rule 424(h) prospectus and at the time of the final prospectus under Rule 424(b). Further, if issuers were required to report changes to the pool, they would do so on a Form 8-K and an updated Schedule CC would be required to be filed with each periodic report on Form 10-D.

Pool Level Information

In response to a “loosening” of underwriting standards in the years leading up to the recent financial crisis, the SEC proposes to amend the pool level disclosure requirements in Item 1111 to require:

- That disclosure relating to the underwriting of assets that deviate from the disclosed origination standards be accompanied by specific data

about the amount and characteristic of those assets that did not meet the disclosed standards;

- Disclosure of the steps undertaken by the originator to verify the information used in the solicitation, credit granting or underwriting of the pool assets; and
- More robust disclosure of how modifications may affect cash flow from the assets or to the securities, whether or not a fraud representation is included among the representations and warranties, and descriptions of the provisions in the transaction agreements governing modification of the assets.

“Waterfall” Computer Program

Under the proposed rule, issuers would be required to file with the SEC a computer program that discloses the flow of funds for a particular ABS transaction (often referred to as the waterfall).⁸ The waterfall computer program will be required to be written in the Python downloadable source code programming language and produce a “programmable output” in machine readable form of all the resulting cash flows related to the ABS, including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities, and each other person or account entitled to payments or distributions in connection with the securities until the final legal maturity date. Issuers of ABS backed by stranded costs would be exempted from the requirement to provide the waterfall computer program. The waterfall computer program would be a part of the prospectus and an issuer would be required to provide it at the time of filing the Rule 424(h) prospectus and the Rule 424(b) final prospectus.

Static Pool Information

Currently, due to the voluminous nature of static pool data, issuers are permitted to post the static pool information on a Web site pursuant to Temporary Rule 312, set to expire at the end of 2010. Under the proposed rules, static pool data required by Item 1105 of Regulation AB would have to be filed on EDGAR as part of the registration statement, although it could be incorporated by

reference through a filing on Form 8-K. Under the proposed rules, the static pool information would be filed on Form 8-K on the same date that the form of prospectus is required to be filed under the proposed new Rule 424(h) and incorporated by reference, and the prospectus would have to state where the information can be found. In addition, the rule proposes additional changes to the static pool disclosure requirements for amortizing asset pools.

OTHER DISCLOSURE OBLIGATIONS

- **Identification of the originator:** Currently, Item 1110(a) of Regulation AB requires identification of originators (apart from the sponsor or its affiliates) only if the originator originated, or expects to originate, 10 percent or more of the pool assets. The proposed rules would require an originator to be identified even if such originator has originated less than 10 percent of the pool assets.
- **Obligation to repurchase assets:** Many transaction agreements underlying a securitization provide for the repurchase of pool assets by an obligated party upon breach of a representation and warranty related to the pool assets. Expanded disclosure would be required regarding the obligations to repurchase assets.
- **Economic interest in a transaction:** Disclosure identifying a sponsor, servicer or 20 percent of the originator's continuing interest in the pool assets retained in a transaction and the amount and nature of the interest would be required.
- **Prospectus summary:** A new instruction to Item 1103(a)(2) of Regulation AB would clarify the summary disclosure requirements in the prospectus and instruct issuers to provide statistical information regarding the types of underwriting or origination programs, exceptions related criteria, and if applicable, modifications made to the pool after origination.

New Regulatory Requirements Relating to Private Offerings of ABS

The rule proposes significant changes to the safe harbor framework for exempt offerings and resales of structured finance products. The proposal

represents a significant departure from the general theoretical basis of private placements pursuant to which sophisticated institutional investors are presumed to be able to “fend for themselves.”

DISCLOSURE REQUIREMENTS

As a condition to relying on the safe harbors of Rule 144A or Rule 506 of Regulation D, a structured finance issuer would have to agree to provide to prospective investors and/or security holders, upon request, the same information that would be required if the offering had been registered pursuant to the Securities Act and such ongoing information were required by Section 15(d) of the Exchange Act. In addition, the SEC is proposing to amend Rule 144 for non-reporting issuers of structured finance products. Under the proposals, affiliates of non-reporting structured finance issuers could not satisfy the current public information requirement of Rule 144 unless, first, the underlying transaction agreement grants any purchaser, security holder and prospective purchaser of the securities designated by the holder the right to obtain, upon request of the purchaser or security holder, information that would be required if the offering were registered on Form S-1 or Form SF-1 under the Securities Act, as well as any ongoing information regarding the securities that would be required by Section 15(d) of the Exchange Act if the issuer were required to file reports under that section. Second, the issuer must have represented that it would provide such information to the purchaser, security holder or prospective purchaser.

One thing that the SEC notes in the release is that these requirements are phrased in terms of the representations. Failure to comply for representations means that the safe harbors are unavailable and may mean that investors would have a cause of action to sue under a breach of contract theory.

Proposed new Rule 192 would provide a basis for the SEC to bring an enforcement action against an issuer that fails to provide information to an investor in accordance with the transaction documents. Thus, if the underlying transaction documents include the required representation and covenants, but the issuer subsequently fails to provide information to an investor or security holder, that failure would not mean the conditions of the safe

harbors were not met but would subject the issuer to potential SEC enforcement action and/or private claims from investors.

NOTICE REQUIREMENTS

The rule also proposes to require an ABS issuer to file with the SEC a notice of the initial placement of structured finance products to be sold in reliance on Rule 144A. Additionally the notice for Regulation D offerings would also be amended to require the same information that the SEC proposes to require in the Rule 144A notice, together with a checkbox that would indicate if the issuer is offering or selling structured finance products. Each of the new proposed requirements for privately offered ABS would apply to “structured finance products.” This term as used in the rule proposal is defined more broadly than “asset-backed security” in Regulation AB, in order to capture other kinds of asset-backed securities that are sold in the private markets. As proposed, the definition of structured finance product would include synthetic asset-backed securities, CDOs, and any security that at the time of the offering is commonly known as an asset-backed security or structured finance product.

NOTES

¹ See Proposed Rule Securities and Exchange Commission Release Nos. 33-9117; 34-61858; File No. S7-08-10, 75 Fed. Reg. 23328 (May 3, 2010), *available at* <http://edocket.access.gpo.gov/2010/pdf/2010-8282.pdf>.

² Opening Statement at SEC Open Meeting by Chairman Mary L. Schapiro, *available at* <http://www.sec.gov/news/speech/2010/spch040710mls.htm> (April 7, 2010).

³ See Proposed Rule at 53 (recognizing that currently some issuers (*i.e.*, credit cards) typically retain an originator’s interest in the pool, and in this instance, the “proposed risk retention shelf eligibility condition should not impact those issuers”). In addition, a sponsor may still elect to issue ABS publicly without retaining any of the risk, but such an offering would be registered on proposed Form SF-1 rather than Form SF-3.

⁴ An officer providing a false certification could be subject to the action by the SEC for violating Securities Act Section 17. The certification would be included as an

additional exhibit to the shelf registration statement, would be required to be filed by the time the final prospectus is required to be filed pursuant to Rule 424 and would not be applicable to the non-shelf registration statement Form SF-1.

⁵ In connection with this additional reporting requirement, the rule proposes to require disclosure in the prospectus for the offering that the issuer has undertaken and will file with the SEC the reports as would be required pursuant to Exchange Act Section 15(d) and the rules thereunder if the issuer were required to report under that section. Further, the rule seeks to revise Item 1106 of Regulation AB to require disclosure in the prospectus of any failure in the last year of an issuing entity sponsored by the depositor or any affiliate of the depositor to file, or file in a timely manner, an Exchange Act report that is required either by rule or by virtue of an undertaking.

⁶ *See* Proposed Rule at 192 (noting that the SEC proposed “XML, rather than XBRL, because there are many commercial products that can be used with XML, including parsers that would allow investors to insert data into a relational database for analysis, data extensions available in XBRL are not applicable to this data set, the nature of the repetitive data lends itself to an XML format and the schema could be easily updated”).

⁷ The proposed asset-level performance data in the periodic reports will differ from the information that would be required at the time of the offering.

⁸ A waterfall essentially outlines the rules that dictate how the borrowers’ loan payments are distributed to investors in the ABS, how losses or lack of payment on those loans is divided among the investors and when administrative expenses (such as servicing fees) are paid to service providers.