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Shearman & Sterling LLP has been a central participant in some of the largest, most complex structured finance transactions. With lawyers in New York, Washington, DC, London and Frankfurt, its structured finance group assists clients in developing, structuring and executing a broad range of complex financings involving securitisation and other sophisticated financing techniques. Lawers have in-depth experience in all aspects of the public and private distribution of structured finance securities. Highly regarded by major corporations and financial institutions, the firm represents the entire range of global market participants, including issuers, underwriters, investors, trustees, servicers, credit-enhancement providers, lenders, rating agencies and conduits.

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1. Structurally Embedded Laws of General Application

1.1 Insolvency Laws

Upon the commencement of bankruptcy proceedings, creditors will, with some exceptions, be subject to the automatic stay on their ability to collect on, or otherwise enforce against, the property of the bankruptcy estate, even if they have been granted a security interest in such property. Lifting the automatic stay can be time-consuming and costly, and the impact on the creditors in the meantime could be material. In addition, the bankruptcy court has broad statutory and equitable powers that could affect the creditors' rights depending on the specific facts and circumstances of the bankruptcy, including the power to:

- release excess collateral, thereby reducing the amount of collateral available to the secured creditor;
- add additional super-priority debt, pari passu debt or junior debt secured by the collateral;
- substitute different collateral for the original collateral; and
- reject executory contracts.

A bankruptcy also renders unenforceable provisions that trigger off a debtor's bankruptcy or financial condition (so-called ipso facto clauses) except for certain enumerated rights and contract types.

Consequently, a key focus of securitisation transactions is to insulate the securitisation issuer (the issuer) from such bankruptcy risks. If a seller's sale of assets to the issuer is deemed to be a loan from the issuer to the seller despite being in the form of a sale then the issuer will be subject to the automatic stay on its ability to collect on, or otherwise enforce against, the transferred assets upon the seller becoming subject to bankruptcy proceedings. Consequently, one important aspect of insulating the issuer and its assets against the risks of the transferor's bankruptcy is to ensure that the assets are transferred in a 'true sale', which is discussed in more detail immediately below. Alternatively, it is also possible to structure a securitisation transaction using certain types of contracts that are afforded protections against the automatic stay and some of the other more troublesome bankruptcy powers, which is discussed in more detail under the heading "Protected Contracts" below.

As part of insulating a securitisation transaction from potential bankruptcy risks, it is also important to protect against voluntary and involuntary bankruptcy filings of the issuer as well as the issuer's dissolution. These considerations are discussed in **1.2 Special-Purpose Entities**. Furthermore, even where the securitisation entity is otherwise solvent and is not subject to any involuntary or voluntary bankruptcy petition, there is a risk that a bankruptcy court applying the equitable doctrine of substantive consolidation could pull a securitisation issuer into the bankruptcy of its sponsor, seller or their affiliates in the absence of sufficient separateness between such entities and the issuer, which is discussed below under the heading "Substantive Consolidation."

True Sale v Secured Loan

If an asset has been transferred to an issuer in a true sale, the asset will cease to belong to the seller and will not be part of the seller's estate in the event of any subsequent bankruptcy proceedings involving the seller. Documenting the transfer as a sale is important, but not dispositive. The Uniform Commercial Code (UCC) expressly provides in Section 9-202 that title to collateral is immaterial. It is possible to have a true sale where the seller retains title, just as it is possible to have a loan even though the seller transfers title. When distinguishing between transfers constituting true sales and transfers only conferring a security interest, courts have focused upon whether the transaction predominantly has the characteristics of a sale or those of a secured loan. Not surprisingly, the more numerous the secured loan characteristics of a transaction, the greater the likelihood that a court will view it as a loan and, conversely, the more numerous the sale characteristics, the greater the likelihood of sales treatment by the court. However, not all factors are given equal weight in this analysis.

Generally, the most important factors that a court will consider in resolving the characterisation of a transaction are (i) recourse and collection risk, and (ii) the transferor's retained rights in the transferred assets. The level and nature of recourse against the transferor appears to be the most significant factor in determining whether a transaction constitutes a granting of a security interest or a true sale. The greater the degree of recourse to the transferor and the more collection risk retained by the transferor, the smaller the likelihood that a court would view the transaction as a true sale. That is not to say that all recourse precludes a transaction being characterised as a true sale. Recourse for breach of representations and warranties limited to the characteristics and condition of the purchased assets at the time of sale are generally viewed as consistent with a sale treatment. Similarly, the courts have consistently held in the context of receivables that where a seller of receivables bears all the risk of non-collection from account debtors, the transaction is a secured loan. As such, securitisation transactions generally will seek to limit the recourse to time of sale representations that go to the characteristics and conditions of the sold assets and will ensure that the delinquency risk is borne by the securitisation entity.

Another important factor in distinguishing a true sale from a secured loan is the absence of a right of the transferor to redeem the transferred property. Similarly, a right of the transferor to receive (or for the transferee to account for) any surplus is also an important factor for concluding that the transaction is a secured loan rather than a true sale. Securitisation transactions often do permit some degree of repurchases for purposes of maintaining compliance with the appropriate diversification requirements of the securitisation. However, in order to ensure compliance with the true sale criteria, such repurchases tend to be limited both to a maximum percentage of the transferred assets as well as a prohibition against reacquiring delinquent or defaulted assets.

Administration of, and control over, the underlying assets is another factor frequently cited by courts in resolving the loan versus sale characterisation. For example, the fact that a transferee has the authority to control the collection on the relevant assets and that the obligors have been notified of the transfer would support a true sale treatment. However, in many instances it is current market practice for a seller of loans or receivables to remain as servicer thereof and as such it is not dispositive if a loan obligor is not notified of such sale.

Intent of the parties is also a factor that, although not dispositive of the issue, is often cited by courts. While it is typical for securitisation documents to include a provision stating the intent of the parties to be that of effectuating a true sale, most courts de-emphasise the language used in a document and consider intent and actual conduct more relevant.

The courts have identified a variety of other factors that do not fall within the categories above but may be indicative of a secured loan. Among the more significant of these factors are the following:

- the transferor of the financial assets is a debtor of the transferee on or before the purchase date;
- the transferee's rights in the transferred assets can be extinguished by payments or repurchased by the transferor or by payment from sources other than collections on the financial asset; and
- the transferor is obliged to pay the transferee's costs incurred in collecting delinquent or uncollectible receivables.

Protection for Transferred Assets

An asset that is transferred in a true sale will, by definition, not be part of the transferor's estate and the issuer's rights in such assets will consequently not be affected by the transferor's bankruptcy. In contrast, a transfer that is characterised as security for a loan means that the seller continues to have ownership rights in such assets. The issuer's rights in the assets will therefore be subject to the automatic stay and all the other powers of the bankruptcy courts in the event of any bankruptcy proceedings relating to the seller.

Bankruptcy Court's Powers

The bankruptcy court has broad statutory and equitable powers, some of which are outlined above. Of all the bankruptcy court's powers, the automatic stay will likely have the most significant impact. The duration of the stay will be fact-specific and difficult to assess in advance. Bankruptcy proceedings in the USA encompass a workout regime (Chapter 11 proceedings) as well as a liquidation regime (Chapter 7 proceedings). In particular, Chapter 11 proceedings have a high degree of variability in terms of the workout plan and surrounding facts that makes it difficult to predict how the exercise of the various rights and powers of the bankruptcy court may affect the issuer, if the transfer of assets to the issuer were to be characterised as simply providing the issuer with a security interest instead of outright ownership.

Opinion of Counsel

It is common to obtain a true sale opinion in conjunction with a securitisation and such opinion is typically required by rating agencies and accountants. Generally the opinion will describe the salient facts considered relevant by the courts faced with the question of distinguishing a sale from a loan and analyse these facts in light of the factors that speak for or against sale treatment. Typically some factors will support the true sale conclusion while other factors, in isolation, may have more in common with a secured loan. The opinion will usually identify these key factors and draw a conclusion based on the overall analysis and reasoning in the opinion letter. The conclusion delivered in a true sale opinion would typically be that a court properly presented with the facts would determine that the transfer of the relevant financial assets prior to the seller's bankruptcy will not constitute 'property of the estate' of the seller.

Other Aspects of Bankruptcy Remote Transfers

As noted above, a transfer of financial assets can constitute a true sale even if the seller retains title to the transferred assets. It is therefore possible to effectuate a true sale for accounting and bankruptcy purposes through a participation agreement. This is often an attractive means of transferring the financial asset when it is important for the seller to remain the holder of record; for example, where the financial asset consists of revolving loans or delayed draw commitments.

Also, it is worth noting that the consideration for a true sale is not limited to cash. As such, the true sale analysis also applies where the relevant asset is contributed to the issuer in exchange for equity in the issuer. However, it is important that the consideration for the transferred assets has a reasonably equivalent value to such asset. A transfer for less than equivalent value is a factor that argues for treating the transaction as a loan instead of a true sale. Furthermore, transfers at less than equivalent value can also give rise to claw-back rights as a fraudulent conveyance under Section 548 of the Bankruptcy Code or similar provisions under applicable state law.

Where the transferor is an institution insured by the Federal Deposit Insurance Corporation (FDIC), the true-sale analysis will be similar, although the FDIC's receivership powers may be broader or different in many important respects to that of the bankruptcy court. However, the FDIC has promulgated non-exclusive safe harbour regulations that, if complied with, will provide additional comfort that a compliant transfer will be recognised as a true sale by the FDIC (see 12 CFR Section 360.6). The safer harbour rule includes a number of provisions that would apply in a typical non-safe harbour sale as well as additional provisions that establish various disclosure and documentary requirements that must be satisfied for the safe harbour to apply.

1.2 Special-Purpose Entities

Creating a properly structured special-purpose entity (SPE) is a core tool in insulating the risks of a securitisation from that of other related parties. An SPE that is narrowly circumscribed in its permitted activities protects against the SPE incurring liabilities or becoming subject to credit risk from unrelated activities. Typical SPE separateness provisions also protect the SPE against the risk of substantive consolidation with the sponsor, seller and their affiliates. As such, the SPE construct provides important insulation for the securitisation structure and is, in many respects, a hallmark distinction between securitisations and other secured financing structures.

The primary goal of an SPE in a securitisation structure is to insulate the SPE against risks external to the securitised assets. The various rating agencies have promulgated requirements with different levels of detail that provide a useful checklist of required and desired features. These features can be categorised based on the type of risk they are intended to address, such as the risk of:

- incurring unrelated liabilities and otherwise becoming subject to involuntary bankruptcy filings;
- automatic dissolution of the SPE;
- voluntary bankruptcy filing by the SPE; and
- substantive consolidation of the SPE.

Insulating the SPE against liability from unrelated activities and protecting the SPE against an involuntary bankruptcy filing by one or more transaction parties is relatively straightforward by means of including appropriate provisions in the SPE's constitutive documents and in the related transaction documents. Rating agencies also look for provisions that restrict the SPE from:

- incurring additional debt;
- owning property;
- establishing subsidiaries; and

• having employees.

The organic documents and the transaction documents will also usually be structured to protect against entity-level tax liability on the SPE. It is also typical to ensure that the SPE is newly formed in the sense of not having engaged in prior unrelated activities and that the SPE has all necessary licences and authorisations for its activities.

Protection against and involuntary filing by transaction parties is generally effected through a non-petition clause in the relevant transaction documents pursuant to which each of the transaction parties agrees not to file, or participates in the filing of, an involuntary bankruptcy petition against the issuer. Such waiver does not raise enforcement concerns and it is commonly viewed as one of the 'boiler-plate' provisions in the transaction documents. However, it is important to ensure that the language of the non-petition clause is drafted so as to capture all the relevant transaction parties required to achieve its intended purpose. For example, senior noteholders of the CLO named Zais Investment Grade Limited VII, a Cayman Islands SPE, took advantage of the fact that they were not subject to the non-petition clause. By filing the CLO for bankruptcy in New Jersey, the senior noteholders managed to circumvent restrictions in the indenture on sale of the underlying assets that otherwise required consent from noteholders of each class of notes.

Delaware limited partnerships and limited liability companies also contain certain default automatic dissolution provisions that need to be addressed. Dissolutions that occur at such times or upon the occurrence of such events as specified in the relevant constitutive documents are easily addressed by avoiding such provisions. Similarly, default dissolution events that can be turned off in the constitutive documents are readily addressed by including relevant language to such effect. The requirement that there is at least one general partner or one member, respectively, is mandatory but can also be addressed in the constitutive documents by providing that there will be a designated 'springing member' if there would otherwise be none. Often, the independent director will be designated as that springing member. Finally, any judicial dissolution upon member or manager application to the relevant court whenever it is not reasonably practicable to carry on the business of the relevant entity can be addressed by requiring the vote of the independent director for any such dissolution.

Protecting the SPE against voluntary bankruptcy filings is more challenging. An outright prohibition against filing a voluntary bankruptcy petition would be unenforceable as against public policy. Therefore the risk of a voluntary bankruptcy filing is commonly addressed by including provisions in the SPE's organic documents requiring an independent director to participate in any vote to file for bankruptcy or amend the separateness provisions. However, it is also important to address the director's fiduciary obligations. For example, an SPE organised as a Delaware corporation means that its directors will have a fiduciary obligation to its shareholders that introduces voluntary bankruptcy risk where such shareholders are in bankruptcy, as was demonstrated by the General Growth companies' bankruptcy proceedings in 2011. Delaware limited liability companies are generally a more flexible organisation form than corporations in terms of turning off or redirecting fiduciary duties and are therefore preferable from a bankruptcy remoteness point of view.

Provisions that limit the ability to effectuate a voluntary bankruptcy filing are prone to be challenged on the basis that they amount to an unenforceable prohibition against the company filing for bankruptcy protection. There are a number of cases where such provisions have been found to be unenforceable (see, for example, in re Intervention Energy Holdings, LLC, et al, Case 16-11247-KJC (Bankr D Del 2016) (voiding on policy grounds an arrangement whereby a vote by an independent holder of a special share was required for a voluntary bankruptcy filing) and in re Lake Michigan Beach Pottawattamie Resort LLC, 2016 BL 109205 (Bankr ND Ill Apr 5, 2016) (voiding on policy grounds the requirement that an independent director had to vote for a voluntary bankruptcy proceeding)). These cases involved changes in the relevant entity's organisational documents that were made at the bequest of creditors at a time of distress and are therefore readily distinguishable from securitisation SPEs established in the ordinary course of business. However, it is important to ensure that the voting provisions in the SPE are drafted so as not to require reliance on provisions of a type that the courts have expressly disallowed. It is also important to take into consideration the incentives that a sponsor, equity-holder or their creditors may have in pulling the SPE into a bankruptcy, whether through a voluntary bankruptcy filing or otherwise. For example, where the assets held by the SPE consist of financial assets rather than equity interests of an operating company or assets required for the successful reorganisation of the sponsor or equity owner, the incentives for causing a bankruptcy of the SPE are significantly less than what was the case in the Intervention Energy Holdings and Pottawattamie Resort cases cited above. One of the most important such incentive-reducing measures, regardless of the asset class being securitised, is the grant by the SPE of a security interest in all its assets to the indenture trustee (or similar trustee) for the benefit of the noteholders.

Finally, to address the substantive consolidation risk outlined below, it is typical to include detailed separateness covenants in the SPE organic documents and the transaction documents. These provisions are outlined in greater detail below.

Substantive Consolidation

Substantive consolidation is a doctrine that comes into play as a potential basis for disregarding the separateness of an entity from that of its affiliates and, effectively, creates a risk that an SPE can become subject to its affiliates' bankruptcy proceedings. The substantive consolidation doctrine has its roots in cases relating to piercing of the corporate veil and alter ego theories but has developed well beyond those cases as part of the bankruptcy court's equitable powers. The analysis is fact-specific and depends on the relevant circuit in which a bankruptcy filing occurs. There are effectively three lines of circuit-level cases that provide the modern statement of the doctrine.

The Second Circuit and the Ninth Circuit rely on the test formulated by the Second Circuit in Union Sav Bank v Augie/Restivo Baking Co Ltd, 860 F2d 515 (2d Cir 1988) (Augie Restivo), pursuant to which substantive consolidation hinges on (i) "whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit," or (ii) "whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

The Third Circuit relies on a test that is similar to Augie Restivo in re Owens Corning419 F3d 195 (3d Circ 2005) (Owens Corning), where the proponent seeking substantive consolidation must establish that (i) the entities pre-petition "disregarded [their] separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity," or (ii) post-petition the "assets and liabilities [of the entities] are so scrambled that separating them is prohibitive and hurts all creditors."

The DC Circuit, together with the Eighth and the Eleventh Circuit apply a more consolidation-friendly test formulated in Drabkin v Midland-Ross Corp (in re Auto-Train Corp, Inc) 810 F 2d 270 (DC Cir 1987) (Auto Train), pursuant to which the proponent of consolidation must make a prima facie case demonstrating (i) that there is "a substantial identity between the entities to be consolidated" and (ii) "that consolidation is necessary to avoid some harm or to realise some benefit." Once the proponent for consolidation has made this showing, "a creditor may object on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."

In courts with no controlling circuit-level Court of Appeals authority, the courts may rely on an analysis based upon a number of factors. One list of such factors taken from the older alter ego and veil-piercing cases is collected in the Tenth Circuit opinion of Fish v East, 114 F2d 117 (10th Cir 1940):

- the parent corporation owns all or a majority of the capital stock of the subsidiary;
- the parent and subsidiary corporations have common directors or officers;
- the parent corporation finances the subsidiary;
- the parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation;
- the subsidiary had grossly inadequate capital;
- the parent corporation pays the salaries or expenses or losses of the subsidiary;
- the subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation;
- in the papers of the parent corporation and in the statements of its officers, the subsidiary is referred to as such or as a department or division;
- the directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation; and
- the formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

The second commonly cited list of such factors appears in the case of in re Vecco Constr Indus 4 BR 407, 410 (Bankr ED Va 1980):

- the degree of difficulty in segregating and ascertaining individual assets and liabilities;
- the presence or absence of consolidated financial statements;
- profitability of consolidation at a single physical location;
- the commingling of assets and business functions;
- the unity of interests and ownership between the various corporate entities;
- the existence of parent or intercorporate guarantees or loans; and
- the transfer of assets without formal observance of corporate formalities.

An additional factor, articulated by the Fourth Circuit Court of Appeals in 1942 in Stone v Eacho, 127 F2d 284, 288 (4th Cir 1942) has also been cited by a number of cases, namely whether "by... ignoring the separate corporate entity of the [subsidiaries] and consolidating the proceeding... with those of the parent corporation... all the creditors receive that equality of treatment which is the purpose of the bankruptcy act to afford."

The presence or absence of some or all of these factors does not necessarily result in substantive consolidation. In fact, many of these elements are present in most bankruptcy cases involving holding company structures or affiliated companies without thereby leading to substantive consolidation. Various courts have noted that some factors may be more important than others, in particular the "consolidation of financial statements," "difficulty of separating assets," "commingling of assets" and "profitability to all creditors."

The manner in which the risk of substantive consolidation generally is addressed is to include, and require compliance with, separateness provisions in the SPE's organisational documents. The transaction documents also include requirements not to violate such separateness covenants and related covenants in the transaction documents. These covenants are derived from substantive consolidation case law, in particular the cases that specify lists of factors to be considered as outlined above. For a good list of separateness covenants it is useful to look at the SPE criteria published by the various rating agencies (see, for example, Standard & Poor's 'Legal Criteria For US Structured Finance Transactions: Special Purpose Entities' (2006, as revised through March 2017)).

Opinion of Counsel

Counsel usually provides an opinion relating to substantive consolidation. This opinion is generally a reasoned opinion that examines the various criteria under relevant lines of cases, in light of the specific facts of the relevant securitisation structure and relevant transaction documents. It is typical for such opinions to assume that each party will comply with their obligations under the documents and that the representations set forth in the documents are true. The conclusion generally will be to the effect that in the light of the discussed circumstances, in the opinion-giver's opinion, if one of the relevant subject entities were to become a debtor in a case under the Bankruptcy Code, a bankruptcy court would not substantively consolidate the assets and liabilities of the SPE with those of the subject entity. The opinion will normally emphasise that substantive consolidation is an equitable doctrine and note that courts afford different degrees of importance to the various factual elements before them in determining whether to exercise their equitable power to order substantive consolidation. The opinion will also generally assume that a party in interest would present an objection to substantive consolidation in a timely manner and brief and argue such objection and the opinion, and will exclude from the non-consolidation opinion situations where the required majority of creditors of the SPE consent to a bankruptcy plan that involves consolidation of the SPE with a subject entity.

1.3 Transfer of Financial Assets

In order for a security interest to be valid and enforceable against third parties, it has to 'attach' and be 'perfected'. These requirements apply to security interests granted in financial assets and other personal property and fixtures as well as to an outright sale of accounts, chattel paper, payment intangibles or promissory notes (see UCC Sections 1-201(b)(35) and 9-109). A security interest attaches if (i) 'value' has been given, (ii) the transferor has rights in the relevant asset, or the right to grant rights in the relevant asset and (iii) there is a signed agreement that reasonably identifies the rights and assets in which a security interest is granted. Although it is possible for a security interest to attach in some circumstances without a written agreement, it is not practicable to rely on those circumstances always being present in a securitisation transaction.

The relevant mode of perfection differs based on the type of asset and type of transfer. Broadly speaking, perfection can be (i) automatic, (ii) by control (or possession), or (iii) by filing of a UCC statement.

Means of Perfection

The general means of perfecting a security interest in financial assets other than a deposit account is by filing a UCC financing statement in the applicable filing office. A security interest in deposit accounts can only be perfected by control. Perfection by filing is also a permissible form of perfecting a sale of accounts, chattel paper, payment intangibles and promissory notes. However, perfection by control or possession, where permitted, will provide better protection of priority than perfection by filing. Possession is a permissible means of perfecting a security interest in tangible negotiable documents, goods, instruments, money, tangible chattel paper and certificated securities, and a security interest in investment property, deposit accounts, letter-of-credit rights, electronic chattel paper or electronic documents may be perfected by control (see UCC Sections 9-313 and 9-314). The perfection of a security interest in a financial asset automatically also perfects a security interest in supporting rights relating to such financial assets, such as collateral or letter of credit rights.

A transfer that is a true sale of a financial asset will in most instances (i) fall outside the framework for secured transactions established under the UCC, (ii) benefit from automatic perfection upon attachment or (iii) be perfected by the transfer of possession or control over the relevant purchased financial asset. As noted above, sales of accounts, chattel paper, payment intangibles or promissory notes are expressly made subject to the perfection requirements of UCC Article 9. The sale of such financial assets can all be perfected against third-party rights by filing a UCC financing statement, although a sale of payment intangibles and promissory notes is automatically perfected upon attachment and therefore does not require additional perfection steps. Chattel paper on the other hand requires perfection by filing, possession (in the case of tangible chattel paper) or control (in the case of electronic chattel paper). Accounts are only automatically perfected if the transfer of such accounts "does not by itself or in conjunction with other assignments to the assignee transfer a significant part of the assignor's outstanding accounts" (UCC Section 9-309(2)) and will otherwise have to be perfected by filing.

However, as outlined above, distinguishing a true sale from the grant of a security interest is fact-specific and can be difficult. The overlapping nature of various UCC categories such as accounts and general intangibles also adds to the difficulty of assessing whether a filing strictly speaking is required for perfection. However, since the filing of a UCC financing statement is cheap and easy, and since the securitisation transaction in any event will further grant a security interest to the noteholders that is perfected by filing, as a practical matter it is common to file a UCC financing statement also against the seller relating to the assets sold to a securitisation entity.

Differences in Rights for a Transferee

In a true sale, the beneficial ownership of the sold financial asset is transferred to the SPE. As such, the SPE is free to hold and dispose of the transferred assets without regard to the transferor. On the other hand, a transfer of assets in which the transferee only holds a security interest would not give the transferee beneficial ownership rights beyond the security interest and would subject the SPE to an obligation to hold such assets in a manner required of collateral. Any enforcement against collateral would have to be made in accordance with the requirements of the UCC, one of which is that “every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable” (UCC 9-610(b)). Additionally, as mentioned above, upon an insolvency of the transferor, the SPE’s ability to sell and dispose over assets transferred to it in a true sale will be free of any restrictions relating to the transferor, whereas the ability to dispose of financial assets transferred as collateral would be subject to the automatic stay and otherwise part of the bankruptcy estate.

1.4 Construction of Bankruptcy-Remote Transactions

Protected Contracts

There are certain types of contracts that are protected against the most troublesome aspects of the automatic stay and certain other bankruptcy powers, and which therefore are suitable alternatives to a true sale for transferring the exposure of a financial asset to a securitisation SPE.

These protected types of contracts include securities contracts, commodity contracts, swap agreements, repurchase agreements and forward contracts, as each such term is defined in the Bankruptcy Code. Between them, these contracts cover most derivatives, certain mortgage repurchase agreements and a number of securities contracts, including securities repurchase, reverse repurchase and securities lending agreements. The protected rights may only be exercised by certain protected classes of counterparties, which vary depending on the relevant type of contract. As such, it is important to structure the transaction such that the parties are of a type that can exercise the relevant protected rights. However, for the most commonly used type of protected contract, namely derivatives (which are referred to as swaps in the Bankruptcy Code), any “swap participant” can exercise the relevant rights, where swap participant is defined in the Bankruptcy Code as any entity that, at any time before the filing of the petition, has an outstanding swap agreement with the relevant debtor (see 11 USC Section 101(53(C))).

Synthetic securitisations are discussed in more detail in **8 Synthetic Securitisations**. In such structures the SPE typically invests its net proceeds from issuing notes in a pool of assets (ie, a pool of permitted investments) and enters into a series of credit default swaps (CDSs) or other swaps with one or more counterparties. In the case of a CDS, the counterparty will typically pay a protection premium to the SPE, which then uses the combination of such premium payments and the return on the permitted investments to pay the noteholders. If there are losses on the CDS reference assets, the SPE will use the proceeds from its permitted investments to pay the losses to the CDS counterparty pursuant to the terms of the CDS. In the case of a total return swap, the SPE would effectively pay one measure of return (usually fixed or floating interest) and receive (or make) payments based on the returns and losses of the reference assets, and the net amount of these two payment streams will be payable under the total return swap to, or by, the SPE as applicable.

In the case of an insolvency of the counterparty, the SPE will have the right to terminate and close out each swap, and realise against any collateral or other credit support relating to such swap, without being subject to the stay or the prohibition against ipso facto clauses. The application of the preference rules and fraudulent conveyance rules under the Bankruptcy Code are also largely turned off with respect to such contracts (other than actual intent to hinder or delay), which protect against any claw-back claims that otherwise could be made where a party posts new collateral for antecedent obligations.

However, the protected rights are construed narrowly. As such, it is important to consider carefully the protected rights and their limitations when building a securitisation around a synthetic structure instead of an outright true sale. For example, many pre-crises synthetic securitisations included ‘flip-clauses’ that would cause a defaulting swap counterparty to drop from a senior to a junior position in the waterfall. Triggering such adverse treatment off a bankruptcy event or a ratings event would be an unenforceable ipso facto clause in bankruptcy, since the enumerated protected rights do not include such subordination.

Obtaining an Enforceability Opinion

It is common to obtain an enforceability opinion for the relevant protected contract, similar to the other transaction documents. In fact, obtaining such opinion is part of the operational criteria for synthetic securitisations under Basel III as implemented in the USA. The qualifications are the same as the typical qualifications for any enforceability opinion for contracts, which include bankruptcy, insolvency and other similar laws affecting creditors’ rights generally; general principles of equity; and qualifications relating to particular provisions as appropriate.

2. Tax Laws and Issues

2.1 Taxes and Tax Avoidance

When considering the tax implications of a securitisation transaction, the immediate goal is typically to achieve tax neutrality in the sense that the securitisation transaction to the extent possible should not lead to any tax liabilities, or acceleration of tax liabilities, that would not have occurred in a traditional financing. Second, to the extent that the securitisation has tax costs, it is important that any such tax costs are known and appropriately addressed in the structure consistent with applicable ratings requirements and debt modelling.

In the USA, taxes can theoretically be assessed at federal, state and local level. There is no federal value-added tax, sales tax or stamp tax on the transfer of financial assets to a securitisation SPE, but in some cases the transfer of loans or leases accompanied by transfers of the underlying assets securing such loans or leases could trigger certain state or local sales tax.

The sale of loans and other receivables can also trigger certain gains or losses, generally depending on whether the SPE is part of the same tax consolidated group as the transferor and may, depending on applicable law and the characterisation of the transfer, also have consequences for the transferor's continued ability to deduct losses from bad loans.

Many of these issues are addressed as part of the structuring of the SPE. For example, a single-member limited liability company (LLC) is, for federal tax purposes, disregarded (in the absence of the SPE electing any contrary tax treatment) and therefore any transfer of assets from a parent to its wholly owned LLC will not be a taxable event. An SPE that is organised as a partnership or an LLC that has elected to be treated as a partnership for tax purposes would not be subject to entity-level tax, but transfers to a securitisation SPE that is treated as a partnership for tax purposes may have different tax consequences than transfers to a disregarded entity and, as such, it is possible to structure the SPE (and use a multi-SPE structure) so as to optimise the securitisation for the desired tax neutrality.

From an investor's perspective, if an SPE is treated as a partnership for tax purposes, and the notes issued by the SPE to such investor were to be treated as equity for tax purposes, then the noteholder would be taxed individually on its share of the SPE's income, gain, loss, deductions and credits attributable to the SPE's ownership of the assets and liabilities of the SPE without regard to whether there were actual distributions of that income. This, in turn, could affect the amount, timing, character and source of items of income and deductions of the noteholder compared to what would be the case if the notes were respected as debt for tax purposes.

As such, among the types of tax issues often considered by parties to a securitisation transaction are the following.

From the standpoint of the originator, such issues include:

- whether the sale of a financial asset to a securitisation SPE would be a taxable event that gives rise to an obligation to pay taxes (or the ability to deduct losses) relating to such financial asset;
- whether there are stamp taxes or transfer taxes resulting from transfers of the financial assets or collateral securing such assets;
- whether the choice of securitisation entity and structure impacts the originator's ability to deduct losses for bad debt and other similar losses;
- whether the securitisation structure results in taxable income at the originator through servicing activities or through profits from the securitisation entity; and
- whether the originator will have any tax consequences from gains or losses resulting from credit enhancements.

From the standpoint of the issuer SPE, some of the concerns include (i) selecting a structure, jurisdiction of formation and limitations on activities, as required to avoid entity-level taxation; and (ii) establishing operational parameters that reduce the risk of the SPE being taxed as a resident in any other jurisdiction than the ones considered under the transaction documents.

From the standpoint of the investor, some of the issues include (i) obtaining comfort that any debt investment in a securitisation SPE will be recognised as such also for tax purposes and (ii) any potential reduction in cash flows resulting from any entity-level taxation of the SPE.

In some securitisation transactions, the parties may seek to achieve more specific tax goals, in which case the relevant transactions will often contain a number of additional features and restrictions or other obligations indented to address such tax issues.

2.2 Taxes on SPEs

An SPE that is subject to entity-level tax, such as a corporation or a partnership that is taxed as a corporation, will potentially incur tax liability for any gains resulting from the sale of financial assets and any income otherwise paid with respect to the financial assets in excess of deductible expenses.

To avoid such taxes, the SPE is usually structured to avoid entity-level taxation. For example, this can be done by using a tax-transparent organisational form or by incorporating the SPE in a jurisdiction that does not impose such taxes. SPEs established as single-member LLCs or Delaware statutory trusts can be readily structured to avoid entity-level tax. Partnerships and entities treated as partnerships also generally are treated as pass-through entities for tax purposes depending on the number of partners, the trading activities in such partnership levels and the availability of relevant safe harbours. A partnership that is deemed to be a publicly traded partnership for US tax purposes could be subject to entity-level tax as if it were a corporation. Applicable tax laws also may cause debt instruments to be characterised as equity interests for purposes of that determination. As such, it is typical to obtain an opinion of counsel relating to the treatment of the notes issued by the SPE as debt for tax purposes and, depending on the activities of the SPE and the level of comfort provided under such opinions, to include additional transfer restrictions on instruments that are, or could be, equity for tax purposes so as to avoid the SPE becoming taxed as a corporation.

2.3 Taxes on Transfers Crossing Borders

Payments based on US-source income to foreign individuals and corporations are potentially subject to withholding tax. Interest paid or accrued by a typical securitisation SPE to a foreign person will – subject to satisfaction of certain requirements relating to the investor's US activities and equity or control person relationship with the SPE and related persons – usually be exempt from withholding tax by virtue of falling within the 'portfolio interest' exemption from withholding. In circumstances where that exemption does not apply, the withholding tax could still be reduced or eliminated by virtue of applicable income tax treaties.

In addition, the Foreign Account Tax Compliance Act (FATCA) imposes a withholding tax on certain payments (including interest in respect of debt instruments issued by a securitisation SPE and gross proceeds from the sale, exchange or other disposition of such debt instruments) made to a foreign entity if the entity fails to satisfy certain disclosure and reporting rules. FATCA generally requires that (i) in the case of a foreign financial institution (defined broadly to include a hedge fund, a private equity fund, a mutual fund, a securitisation vehicle or other investment vehicle), the entity must identify and provide information in respect of financial accounts with such entity held directly or indirectly by US persons and US-owned foreign entities, and (ii) in the case of a non-financial foreign entity, the entity must identify and provide information in respect of substantial US owners of such entity. Foreign entities located in jurisdictions that have entered into intergovernmental agreements with the USA in connection with FATCA may be subject to special rules or requirements.

2.4 Other Taxes

Another tax issue that arises in connection with the use of foreign SPE issuers that are treated as corporations for US federal tax purposes is whether the SPE is engaged in a US trade or business for US federal income tax purposes. If a foreign securitisation issuer were to be engaged in US trade or business for US federal income tax purposes, it would become subject to US federal income tax and potentially also subject to state and local income tax. To avoid this outcome, foreign securitisation issuers tend to conduct their activities in accordance with detailed guidelines that are aimed at ensuring that they are not engaged in loan origination or otherwise treated as conducting a lending or other financial business in the USA.

2.5 Obtaining Legal Opinions

In a securitisation transaction it is common for tax counsel to provide an opinion addressing the tax treatment of the issued securities; in particular, whether the offered notes would be treated as debt securities for US federal income tax purposes. The level of comfort is reflected in terms such as 'will', 'should' and 'more likely than not', where will is the highest level of comfort and should still provide a high level of confidence but with a more than insignificant risk of a different conclusion. It is also common as part of the closing opinions for a securitisation to include an opinion that the securitisation entity would not be taxed as a corporation for federal tax purposes. The latter opinion is frequently also required in the case of certain amendments to the corporate documents.

In the case of foreign SPEs that are treated as corporations for US income tax purposes and that rely on not being taxed in the USA, there are various sensitive activities that could give rise to adverse tax treatment. Because of the significant consequences to the securitisation transaction, the rating agencies tend to require an opinion to the effect that the SPE's activities would not amount to it engaging in a US trade or business.

3. Accounting Rules and Issues

3.1 Legal Issues with Securitisation Accounting Rules

The intersection of legal and accounting requirements often plays a significant role in structuring a securitisation transaction. For example, one of the operational requirements for a US banking entity to receive favourable capital treatment for a traditional securitisation (as opposed to a synthetic securitisation) under the Basel III capital rules as implemented in the USA is that the securitisation entity is not consolidated with the banking institution for accounting purposes. Whether, and with whom, to consolidate a securitisation SPE is addressed in Accounting Standards Codification (ASC) topic 810 and is a complex analysis that hinges on identifying who controls the aspects of the SPE that most significantly impact the SPE's performance. This analysis will typically focus on the entities that have the ability to direct the SPE's activities (and may also look at activities that took place prior to the relevant transaction). While that analysis is not a legal analysis per se, it will involve a review of the various contractual rights existing in the transaction documents.

As such, an awareness of the types of features that drive the consolidation analysis is often important in structuring the SPE and drafting the relevant transaction documents.

Legal and accounting criteria also come together as part of the true sale analysis for accounting purposes. One of the requirements for achieving sale accounting for financial assets under US Generally Accepted Accounting Principles (GAAP) is that "the transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. The transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, a bankruptcy remote entity is not considered a consolidated affiliate for purposes of performing the isolation analysis" (ASC 860-10-40-5(a)).

3.2 Dealing with Legal Issues

As part of the GAAP codification, ASC 860-10-55 states in pertinent part that "in the context of US bankruptcy laws, a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor, any of its consolidated affiliates included in the financial statements being presented, and its creditors. In addition, a non-consolidation opinion is often required if the transfer is to an affiliated entity" (id at 55-18A). "A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested" (id at 55-18B).

The material conclusions in a true sale and non-consolidation analysis required by the accountants are typically the same as the true sale and non-consolidation opinions outlined above. The accounting literature includes commentaries on the legal opinions, including requirements that the opinion address certain items such as expressly mentioning each area of continued involvement between an originator and its affiliates and the securitisation SPE. The accounting standards also include a discussion of various types of qualifiers and assumptions that are deemed not to be appropriate for accounting purposes, such as the assumption that the transfer will be deemed a true sale for accounting purposes without carving out the legal isolation analysis for which the accountants look to the opinion. As such, a true sale and non-consolidation opinion that is delivered as part of a securitisation transaction may receive additional comments from accountants relating to assumptions and qualifications that are viewed as potentially problematic under applicable accounting literature.

4. Laws and Regulations Specifically Relating to Securitisation

4.1 Specific Disclosure Laws or Regulations

Securitisation-specific Disclosure Laws/Regulations

The principal laws that govern securities-related disclosures are the Securities Act of 1933, as amended (the Securities Act), which is the principal law governing the offer and sale of securities, and the Securities Exchange Act of 1934, as amended (the Exchange Act), which provides for broad regulatory powers to the SEC to regulate various market participants, prohibits certain types of conduct in the market and empowers the SEC to require certain periodic reporting.

Following the 2007-08 financial crisis (the Global Financial Crisis), the Exchange Act has been amended to require certain additional disclosure requirements that apply to all ABS, including:

- specific disclosure relating to the form and determination of securitisation exposures retained to comply with the risk retention rules as described in more detail below;
- reporting of repurchases and replacements of securitised assets in connection with breaches of representations and warranties, and of the conclusions and findings of third-party due diligence reports, which must be reported and filed with the SEC on Form ABS-15G; and
- certain disclosure requirements applicable to communications by and with rating agencies, which, amongst others, require the arranger to maintain, or contract with a third party to maintain, a password-protected website and post to that site all information provided to hired Nationally Recognized Statistical Ratings Organizations (NRSROs) in relation to the initial credit rating and information provided in connection with credit surveillance. The posting shall take place at the same time as the information is sent to the hired NRSROs and access to the website must be provided to all non-hired NRSROs. Among the information required to be posted on the 17g-5 website is a certification on Form 15E of the findings and conclusions of the third-party due diligence services provider.

The SEC introduced registration, disclosure and reporting requirements for registered offerings of ABS in the form of Regulation AB in 2004, which largely codified existing practices accepted by the SEC. Regulation AB was significantly revised and updated in 2014 (Reg AB II) to address a number of perceived shortcomings in prior practices and to enhance investor protection in the ABS market. In particular, Reg AB II expands the disclosure deemed necessary for the investors more fully to understand and gauge the risks of investing in ABS. The enhanced asset-level disclosure requirement for the specified asset classes is also viewed as a counter-measure against the perceived excessive reliance on credit ratings by enabling investors to conduct independent due diligence.

The asset-level disclosure requirement reflects a significant departure from the pool-level information that historically has been given and that is still the dominant form of disclosure in private placements. The asset-level disclosure requirements in Regulation AB II apply to registered offerings of securities backed by residential mortgages, commercial mortgages, auto loans or leases, re-securitisations of such assets and registered offerings of securities backed by corporate debt. Such asset-level information must be published at least three days prior to bringing a covered securitisation to market so as to provide investors with sufficient time to conduct their diligence independently. Reg AB II includes the ability for the SEC to expand the asset-level disclosure requirements to 144A private placements and permits the SEC to expand the asset-level disclosure requirements to additional asset classes, including equipment floorplan leases, revolving consumer credit and student loans. However, the SEC has not to date taken further action on expanding the Reg AB II requirements to additional asset classes or offering types and in a Treasury report from October 2017, the Treasury recommended against such expansion.

Reg AB II further seeks to address investor concerns around effective oversight by the principal officers of the ABS issuer, in particular around lack of sufficient due diligence when designing the securitisation structure and reviewing the pool assets, and around enforcement of representations and warranties. Reg AB II also strengthens investors' ability to enforce their rights under the transaction documents, including rights to require an originator or sponsor to repurchase an asset that does not comply with the applicable representations and warranties, by enhancing investors' ability to locate sufficient other ABS investors to exercise such rights.

Material Forms of Disclosure

Regulation AB II introduced new ABS-specific registration statement forms, Forms SF-1 and SF-3, to reflect the additional disclosure requirements and shelf-eligibility requirements under Reg AB II. ABS offerings that qualify for shelf registration must be filed on Form SF-3 and other registered ABS offerings must be filed on Form SF-1.

In order to be eligible to use the SF-3 shelf registration form, the depositor and each issuing entity must meet certain issuer requirements and the transaction must meet the transaction requirements. As such, the depositor and each affiliated issuer must have been current over the past 12 months in its required filings under the Securities Act for prior registered securitisations relating to the same asset class. Similarly, to the extent that the depositor or issuer is a reporting entity under the Exchange Act with respect to previously issued securities of the same asset class, they must also have complied with such filing requirements in a timely manner with a few specified exceptions.

The transaction requirements include the following.

- The filing of a prescribed certification by the chief executive officer of the depositor, certifying as to (i) the disclosure in the prospectus being true and not omitting any facts that would render the disclosure misleading, (ii) the fair presentation in material respects of the characteristics, structure and risks of the securitisation, and (iii) that there is a reasonable basis, in light of the disclosed characteristics of the securitised assets and the structure of the securitisation, to conclude that the securitisation is structured to produce expected cash flows at times and in amounts required to service scheduled payment of interest and principal in accordance with their terms.
- Provisions for an independent asset representations reviewer who is responsible for reviewing the underlying assets for compliance with the representations and warranties on the pool assets upon (i) the delinquencies exceeding a specified threshold, or (ii) an investor vote to require such review. The asset representations reviewer must have access to the transaction documents. Upon the occurrence of a trigger event, the reviewer must, at a minimum, review all assets that are 60 days or more delinquent for compliance with the representations and warranties under the transaction documents. However, the transaction parties are free to determine the definition of delinquency, the threshold percentage of delinquent assets triggering review and the minimum percentage, not in excess of 5%, of investors required to initiate a review. The prospectus must also give additional information about the asset representations reviewer, including the name and type of organisation, prior experience with similar asset pools, the reviewer's responsibilities under the transaction documents, the manner and amount of compensation, a description of indemnification to be paid from the cash flows and limitations on liabilities under the transaction documents, and the removal and replacement provisions under the transaction documents and related costs.
- Required dispute resolution provisions in the pooling and servicing agreement or other transaction agreement to be filed, and such provisions shall include a right of the party submitting a repurchase demand that has not been resolved within 180 days following notice thereof to refer the matter, at the demanding party's discretion, to mediation or third-party arbitration.
- Requirements in the transaction documents that the periodic investor reports include any request received during the relevant reporting period from an investor to communicate with other investors related to investors exercising their rights under the terms of the transaction agreements.
- Delinquent assets cannot exceed 20% on a dollar volume basis.
- If the securitised asset is a lease, other than a motor vehicle lease, that portion of the securitised pool balance

attributable to the residual value of the physical property cannot exceed 20%.

Form SF-1 is similar to Form SF-3 except it does not, naturally, contain the disclosure elements around shelf eligibility and certain other shelf-specific provisions.

Forms SF-1 and SF-3 each specify the required provisions of the prospectus, which includes:

- certain information that must be included on the cover pages (table of contents, dealer prospectus delivery obligation, transaction summary, risk factors, ratio of earnings to fixed charges);
- principal use of the net proceeds;
- the principal underwriters, if applicable, their role and any material relationships with the issuers;
- the names, roles and other information about the principal transaction parties (sponsors, depositors, issuing entities, servicers, trustees and other transaction parties, originators, significant obligors of pool assets, legal proceedings and affiliations, and certain relationships and related transactions);
- various information, including statistical information, of the pool assets;
- various asset-level information required in Schedule AL;
- information about the issued securities;
- the structure of the transaction (including flow of funds);
- credit enhancements and other credit support;
- information about derivatives and the derivatives counterparty (if applicable);
- certain tax matters, including the tax treatment of the ABS under federal income tax and the material tax consequences of purchasing, owning and selling the ABS;
- description of reports to be delivered to the investors;
- any required ratings;
- static pool information (which may be filed on Form 8-k and incorporated by reference); and
- any interest or connections of named experts.

In addition, the prospectus shall include the following information by reference: (i) any preliminary prospectus filed as part of the shelf and (ii) the required asset-level disclosure. The required asset-level disclosure must be provided in a standardised format in a tagged XML format and filed on the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) on Schedule AL and additional supplemental information can be filed through Form ABS-EE, which may incorporate by reference information filed by third parties, if applicable.

Regulation AB II deviates from the prior practice of using a base prospectus and a supplemental prospectus in connection with shelf take-downs and requires the filing of one integrated prospectus. The depositor must file a separate registration statement for each form of prospectus and each registration statement may cover only one asset class.

Amongst the required information in the prospectus for a registered asset-backed security is:

- the name of each originator, unless at least 90% of the total pool assets are originated by the sponsor or its affiliates;
- the financial condition of any sponsor or originator that is contractually obligated to repurchase pool assets for breach of any representation or warranty;
- the economic interest of each of the sponsor, servicer and each originator of 20% or more of the pool assets;
- a description of the provisions in the transaction documents governing modification of pool assets and the effects such modifications have on the cash flows from the pool; and
- a narrative description of the static pool information, including any key differences between the static pool and the securitised pool.

As outlined below, about 90% of the US securitisation market consist of mortgage-backed securities issued or guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac, and are expressly exempt from registration pursuant to the relevant Congressional act by which such entities were formed. Currently, most of the remaining ABS are issued in a private placement, typically in compliance with Rule 144A. Agency securities and private placements are not subject to ABS-specific disclosure requirements other than the disclosure requirements relating to risk retention, repurchase requests, the third-party due diligence disclosure and rating agency communication requirements. However, such securities offerings generally will look to the disclosure requirements applicable to registered offerings and seek to comply with disclosure requirements applicable to such offerings where practicable. Asset-level disclosures of the level of detail required in Reg AB II offerings are, however, not commonly included in private placements (and, in addition to avoiding the static pool requirements of Regulation AB II, are a primary benefit of issuing ABS in a private placement).

Principal Regulators

The principal regulator for the offer and sale of any security is the SEC, which has broad jurisdiction throughout the USA and abroad. In addition, the Financial Industry Regulatory Authority (FINRA), a self-regulatory organisation with authority over broker-dealers, also plays an important regulatory role in the market. For example, Securities Act Rule 461 requires a statement of no objection from FINRA before a public offering becomes effective. Each state also has its own securities laws, referred to as 'blue sky laws', which may come into play as part of an offering or enforcement. States will be pre-empted from regulating securities transactions relating to "covered securities" within the meaning of Section 18 of the Securities Act, and the blue sky laws themselves usually include certain exemptions outside the covered securities context. As such, the state blue sky laws play less of a role in the registration or qualification requirements in securitisation offerings, but the pre-emptions do not extend to the anti-fraud provisions of states' securities laws and, as such, blue sky laws shall play a role in enforcement actions.

Laws/Regulations on Violations of Required Disclosure
The principal laws relating to violations of required disclosure are the Securities Act and the Exchange Act, and the rules promulgated thereunder. Sections 11 and 12 of the Securities Act and Rule 10b-5 of the Exchange Act provide for potential liability in the event of any offer or sale (and, in the case of 10b-5, purchase) of a security by means of any communication that includes an untrue statement of material fact or omits to state a material fact necessary to make the statements, in light of the circumstances under which they were made, not misleading. Section 11 of the Securities Act provides for damages and applies to any such omissions or misstatements in a registration statement at the time it became effective and provides for virtually no defences for the issuer, but affords various defences to the other involved parties. Section 12 of the Securities Act allows a purchaser to rescind the purchase or to receive damages from its seller. Plaintiffs under Sections 11 and 12 of the Securities Act do not need to establish scienter or negligence.

Rule 10b-5 of the Exchange Act contains the general anti-fraud provision under the Exchange Act and makes it unlawful to use any means or instrumentality of interstate commerce "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." The Securities Act also contains a general anti-fraud provision, set forth in Section 17 thereof. However, Rule 10b-5 protects sellers as well as purchasers of securities and is therefore broader than the general anti-fraud provision in Section 17 of the Securities Act, which only protects purchasers. However, Rule 10b-5 requires scienter, whereas some claims under Section 17 can be brought on the basis of negligence. Section 10b-5 provides for a private right of action for damages, whereas Section 17 of the Securities Act does not. As such, Section 17 is primarily used in actions brought by the SEC under Section 20(b) of the Securities Act (which permits injunctions against violations of the Act) and in criminal actions brought by the Justice Department under Section 24 of the Act (which provides for criminal liability for wilful violations).

In addition, Section 18 of the Exchange Act creates a private right of action for any person who purchases or sells a security at a price affected by any false or misleading statement or omission made in a document required to be filed with the SEC and although Section 18 does not require scienter, the defendant provides for a defence based on good faith and lack of knowledge.

Furthermore, as mentioned above, the federal securities laws do not preclude state law actions, such as actions for common law fraud, arising out of securities transactions and such actions can be joined with actions for violation of the securities laws.

Public Market v Private Market
According to published statistics from Asset-Backed Alert, the US ABS offerings during 2017 were about 60% private placements in dollar volume and around 2.4 times as many in number of deals compared to the public market. The first three quarters of 2018 evidenced a similar relationship, with private placements constituting approximately 65% in dollar volume and 2.8 times the deal volume compared to public market deals. According to statistics published by the Securities Industry and Financial Markets Association (SIFMA), the ABS market is dwarfed by the mortgage-backed securities (MBS) market, in particular agency MBS, which totalled about USD1.9 trillion in 2017 and 2018 issuances as of the end of November 2018, were only 1.9% behind the corresponding year-to-date issuances for 2017. Agency-backed securities are exempt from registration and, other than certain risk transfer transactions, are normally guaranteed by the issuing agency – ie, the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), or the Federal Home Loan Mortgage Corporation (Freddie Mac). Ginnie Mae is backed by the full faith and credit of the US government, while Fannie Mae and Freddie Mac have special authority to borrow from the US Treasury.

There are no particular investor qualifications for registered offerings or agency-backed securities. Rule 144A offerings limit resales to "qualified institutional buyers" and issuers typically rely on the Securities Act's Section 4(a)(2) or Regulation D for the sale to the initial purchasers (ie, non-public offering to "accredited investors"). In order to be a qualified institutional buyer, one must be a corporation or one of the other enumerated types of entities, in each case that owns and invests on a discretionary basis at least USD100 million in securities of unaffiliated entities or a dealer that invests on a discretionary basis at least USD10 million in securities of unaffiliated entities.

Disclosures in registered offerings of ABS are dictated by the applicable requirements under Form SF-1 or SF-3. The prospectuses in agency-backed securities typically follow industry practice and the same is true for Rule 144A offering documents. As a market practice it is common to include information in a Rule 144A offering document that is substantially similar to what would be required in a registered offering to the extent practicable. However, in a large pool of assets, information about individual assets will normally not reach the materiality threshold under Rule 10b-5. Consequently, a Rule 144A transaction will likely continue the practice of providing pool-level disclosure rather than asset-level disclosure with the granularity required in registered offerings. At the same time, a trend towards increasing asset-level disclosures also in private placements is expected.

The issuer of Rule 144A securities must, upon the request of the holder of securities, deliver a brief statement of the nature of the issuer's business and offered products (typically viewed as applying to the sponsor in ABS transactions), and the issuer's most recent financial statements for the current and prior two years but Rule 144A does not otherwise mandate specific disclosure.

Legal Opinions as to Compliance

Registered offerings require, and Rule 144A offerings typically call for, opinions that the debt securities will be binding obligations of the issuer and the opinion must also cover the law of the jurisdiction governing the relevant agreements. Usual qualifications and exceptions include the effect of any applicable bankruptcy, insolvency, reorganisation or similar laws affecting creditors' rights generally as well as the effect of general principles of equity. It is also common to include a tax opinion as to the treatment of the securities held by the investors and the treatment of the ABS issuer, either as part of the disclosure in the offering document or provided separately. It is also customary to include a 'negative assurances letter' to the effect that, on the basis of the information gained in the course of performing the legal services, nothing has come to the attention of the opinion giver causing it to believe that the offering document contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading in light of the circumstances when made. The negative assurances letter typically will not cover the financial statements or other financial data contained in, or omitted from, the offering document.

4.2 'Credit Risk Retention'

The SEC, the Department of the Treasury, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve) and the FDIC were directed in Section 941(b) of the Dodd-Frank Act, which has been codified as Section 15G of the Exchange Act, jointly to prescribe regulations that require "securitisers" to retain, generally, not less than 5% of the credit risk of any asset that the securitiser, through the issuance of ABS, transfers, sells, or conveys to a third party, subject to certain exceptions. The SEC, the banking agencies, the Federal Housing Finance Agency and the Department of Housing and Urban Development and the SEC (the Agencies) promulgated final risk retention rules in 2014, as set forth in Regulation RR under the Exchange Act (the Risk Retention Rules). These rules became effective for ABS backed by residential mortgage-backed loans beginning 24 December 2015 and for issuances of ABS backed by other assets beginning 24 December 2017. Under the Risk Retention Rules, a "sponsor" is generally responsible for satisfying the risk retention requirements, either by directly retaining the required interest or causing a "majority-owned affiliate" to retain that interest. For most securitisations, risk retention may take any of three forms provided by the so-called standard approach, subject to multiple rigorous and highly technical conditions:

- retention of an eligible vertical interest, by holding at least 5% of each class of "ABS interests" issued by the issuing entity;
- retention of an eligible horizontal interest, by holding a residual interest equal to at least 5% of the "fair value" of all ABS interests issued by the issuing entity; and
- retention of a combined (or "L shaped") interest, by holding a combination, in any proportion, of an eligible vertical interest and an eligible horizontal interest such that the sum of the fair value of the retained horizontal interest (as a percentage of all ABS interests) and the percentage retained of each class of "ABS interests" is at least 5%.

For the eligible horizontal interest option, the amount of the required risk retention must be calculated pursuant to a fair value approach under US GAAP.

Sponsors and other parties that retain ABS interests to satisfy the credit risk retention requirement generally are prohibited from transferring the retained interests (other than to such parties' majority-owned affiliates), hedging their risk associated with the retained interest, or pledging the retained interest other than on a full recourse basis. The Risk Retention Rules generally provide sunset timeframes for expiry of these restrictions. Disclosure to investors (and to regulators, upon request) is required regarding, among other things, the form and amount of retained risk.

Section 15G of the Exchange Act imposes risk retention requirements on any "securitiser" of ABS. As defined in the Risk Retention Rules, a securitiser includes the sponsor, defined as a "person who organises and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer", a phrase that is substantially identical to the definition of sponsor under Regulation AB. While the definition of securitiser as used in Section 15G of the Exchange Act also includes "the depositor of the asset-backed securities," the Risk Retention Rules are narrower and require a sponsor or a majority-owned affiliate of a sponsor to retain the required risk. According to the adopting release for the Risk Retention Rules, 79 Fed Reg 77602 (24 December 2014) (the Risk Retention Adopting Release), an entity that serves only as a pass-through conduit for assets that are transferred into a securitisation vehicle or that only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after that purchase has been made would not qualify as a sponsor. According to guidance in the Risk Retention Adopting Release, "in order to qualify as a party that organises and initiates a securitisation transaction and, thus, as a securitiser or sponsor, the party must have actively participated in the organisation and initiation activities that would be expected to impact the quality of the securitised assets underlying the asset-backed securitisation transaction, typically through underwriting and/or asset selection" (Risk Retention Adopting Release at 77609).

Where the Risk Retention Rules require or permit the sponsor or any other party to retain credit risk then, except as otherwise specifically provided, the risk may be retained by a majority-owned affiliate of that party, which is an entity other than the issuer that directly or indirectly majority controls, is majority controlled by, or is under common majority control with, that party. For these purposes, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

A sponsor-retaining risk in the form of an eligible horizontal residual interest must provide, a reasonable time before sale of the ABS, the fair value of all ABS interests and of the eligible horizontal residual interest, and the dollar amount of the eligible horizontal residual interest that the sponsor expects to retain at closing. If specific prices, sizes or interest rates of the ABS interests are not available, the sponsor must provide a range of fair values that it expects to retain, based on bona fide estimates or specified prices, sizes or interest rates of each tranche and the method by which the range of bona fide estimates or specified prices, sizes or interest rates was determined. The sponsor must describe the material terms of the retained interest, the methodology used to calculate fair value (or range of fair values) and the key inputs and assumptions used (or a comprehensive description thereof) in measuring fair value (or range of fair values). At a minimum, the disclosure must include all inputs and assumptions that could have a material impact on any fair value calculation or would be material to an investor's evaluation of fair value, with certain specific items required if the disclosure includes a description of a curve in connection with any fair value calculation. If information about the pool assets is used, it generally must be as of a date no more than 60 days before first use with investors. Finally, the sponsor must summarily describe the reference data set or other historical information used to develop its key inputs and assumptions. A sponsor-retaining risk in the form of an eligible horizontal residual interest also must provide, a reasonable time after closing, the fair value of the eligible horizontal residual interest retained at closing, based on finalised sale prices and tranche sizes, and the fair value thereof that it was required to retain. To the extent that the valuation methodology or any key input or assumption materially differs from what was previously disclosed, those differences must be described.

The disclosure requirements for a sponsor retaining risk in the form of an eligible vertical interest are significantly less burdensome. A sponsor retaining such a vertical interest must provide, at a reasonable time before sale of the ABS, the form of the eligible vertical interest, the percentage that the sponsor is required to retain as a vertical interest and the material terms of the retained interest and the amount that the sponsor expects to retain at the closing of the securitisation transaction. The sponsor also must provide, a reasonable time after closing, the amount of the eligible vertical interest retained at closing if that amount differs materially from what was previously disclosed.

Records of all these items must be retained, and disclosed upon request to the SEC and any appropriate Banking Agency, until three years after all ABS interests are no longer outstanding.

There are specialised forms of risk retention available for revolving pool securitisations, certain asset-backed commercial paper (ABCP) conduits, CMBS, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS, open-market CLOs and qualified tender bonds each with accompanying disclosure requirements. In addition, there are exemptions available to securitisations of qualified residential mortgage loans, qualifying commercial loans, qualifying commercial real estate loans and qualifying automobile loans that satisfy certain underwriting criteria, certain government-backed securitisations, certain agricultural loans, state and municipal securitisations, and certain securitisations of assets that comply with the risk retention rules.

On 9 February 2018, the DC Court of Appeals ruled that treating managers of open-market CLOs as securitisers subject to the Risk Retention Rules exceeded the statutory authority to promulgate rules to implement the risk retention requirements under Section 941 of the Dodd-Frank Act (see The Loan Syndications & Trading Ass'n v SEC 882 F3d (DC Cir 2018) (the DC Circuit Open Market CLO Decision). The court held that under the statute, "securitisers" applies only to those parties that initiate securitisations by selling or transferring assets to securitisation vehicles and not to CLO managers who purchase assets in the CLO entity on behalf of investors. This means that managers of CLOs that do not act on behalf of, and are not otherwise affiliated with, the originators or sellers of the underlying assets will not be subject to the risk-retention rules as they currently exist.

In general, a sponsor is prohibited from transferring or hedging an interest that it is required to retain under the Risk Retention Rules, other than to a majority-owned affiliate, or pledging the retained interest other than in connection with a full-recourse financing. When required risk is retained by or transferred to a majority-owned affiliate, the majority-owned affiliate is then subject to the same restrictions on hedging, transfer and financing as if the interest were held by the sponsor. The retaining sponsor may also be permitted, subject to satisfaction of the applicable requirements in the Risk Retention Rules, to offset some of the risk it would otherwise be obliged to retain as an eligible horizontal or vertical interest by any such eligible interests acquired by the originator of one or more of the securitised assets at closing of the securitisation.

The hedging prohibitions generally require that neither a sponsor nor any affiliate enter into any transaction, agreement or position for which payments are materially related to the credit risk of any ABS interests that the sponsor (or a majority-owned affiliate) is required to retain, if such transaction, agreement or position would in any way limit the financial exposure to the credit risk that the sponsor or its majority-owned affiliate is required to retain. However, certain types of hedging activity are specifically permitted, including hedges related to interest rates, currency exchange rates or home prices, or that are otherwise tied to other sponsors' securities. Credit hedges involving instruments tied to an index that includes the ABS are also permitted provided that any class of ABS interests as to which the sponsor is required to retain risk represents no more than 10% of the dollar-weighted average (or corresponding average for ABS interests issued in a foreign currency) of all instruments in the index; and all classes of ABS interests in all issuing entities as to which the sponsor (or a majority-owned affiliate) is required to retain risk represent no more than 20% of the dollar-weighted average (or corresponding average for ABS interests issued in a foreign currency) of all instruments in the index.

Issuing entities' hedging activities are similarly limited. Any credit protection or hedge obtained by an issuing entity may not limit the financial exposure of the sponsor or its majority-owned affiliates on any interest required to be retained pursuant to the risk retention rules. For example, a credit insurance policy to cover losses on ABS interests or on a pool of securitised assets may not benefit the retained interest.

Neither a sponsor nor any affiliate may pledge an interest it is required to retain as collateral for any financing (including a transaction structured as a repurchase agreement) unless the financing obligation is with full recourse to the sponsor or affiliate, respectively.

For ABS, the transfer, hedging and financing restrictions expire on the latest of:

- the date on which the total unpaid principal balance (if applicable) of the securitised assets has been reduced to 33% (25% for RMBS) of the unpaid principal balance as of the cut-off date or similar date for establishing the composition of the securitised asset pool,
- the date on which the total unpaid principal balance of the ABS interests issued has been reduced to 33% (25% for RMBS) of the closing date unpaid principal balance; and
- two years (five years for RMBS) after the closing date.

In the case of RMBS, the hedging and financing restrictions will expire seven years after the closing date if they have not expired earlier pursuant to the foregoing.

Regulation and Enforcement

Section 15G of the Exchange Act allocates enforcement authority to the appropriate federal banking agency with respect to any securitiser that is an insured depository institution and the SEC with respect to any other securitiser. The OCC will have enforcement authority over securitisers that are national banks, federal savings associations, federal branches or agencies of a foreign bank and their subsidiaries. The Federal Reserve has enforcement authority over state member banks and their subsidiaries, and the FDIC will have enforcement authority over securitisers that are state non-member banks, FDIC-insured federal or state branches of a foreign bank, state savings associations and their subsidiaries. The SEC will have enforcement authority over all other securitisers.

Penalties for Non-Compliance

The Federal Deposit Insurance Act (FDIA) provides the bank regulatory agencies with broad enforcement powers against individuals and entities for violation of the applicable banking laws and regulations, including the Risk Retention Rules. As such, the banking agencies may seek cease-and-desist orders requiring cessation and potential corrective actions. The agency may also impose civil monetary penalties that can range between USD5,000 and USD1 million per day, and they may seek to impose removal and prohibition orders against any "institution-affiliated party" (a potentially broad list of persons), which may remove and potentially bar the person from participating in the business of the relevant banking entity or other specified entities.

The SEC's enforcement authority and remedies for violations of the Risk Retention Requirement would be the same as its general authority for violation of securities laws and regulations. As such, the SEC may seek permanent or temporary cease-and-desist orders. The SEC may also seek civil monetary penalties up to USD500,000 per act for any entity and USD100,000 per act for any natural person, prohibit persons from acting as director or officer of an SEC-registered company and strip a person of its adviser act registration, and could also expand the reach to "control persons" (subject to such control person's defence of acting in good faith or not inducing the relevant act). If the sponsor is an SEC registrant, it could also lose its registration.

If the failure to comply with the Risk Retention Rules also results in disclosure violations, there could be grounds for civil action by the SEC on that basis under Section 17(a) of the Securities Act and by the SEC, and pursuant to a private cause of action under Section 10(b) of the Exchange Act (including Rule 10b-5 thereunder) as described above. In a registered offering, there may also be liability by the issuers and the underwriters under Section 11 of the Securities Act (subject to due diligence defences in the case of underwriters) and may give rise to rescission claims under Section 12(a)(2) of the Securities Act as described above. Securities laws violations may also give rise to liability under state blue sky laws.

Furthermore, the Department of Justice has the authority to bring criminal actions for wilful violations of the securities laws as described above.

Section 29(a) of the Securities Act also provides for equitable remedies, including the right to rescind and void a contract made in violation of any provision of the Exchange Act.

Safe Harbour Provision

The Risk Retention Rules do not provide for substitute compliance. However, the US Risk Retention Rules have a safe harbour provision for certain predominantly non-US focused securitisations, which are securitisations:

- that are not required to be, and are not, registered under the Securities Act;
- for which no more than 10% of the dollar value (or equivalent amount in the currency in which the ABS interests are issued) of all classes of ABS interests are sold or transferred to US persons (as defined in the Risk Retention Rules) or for the account or benefit of US persons;
- for which neither the sponsor nor issuing entity is (i) organised under the laws of the USA or any US state, (ii) an unincorporated branch or office of a US entity, or (iii) an unincorporated branch or office located in the USA; and
- that, if the sponsor or issuing entity is organised under the laws of a foreign jurisdiction, have no more than 25% of the assets acquired from majority-owned affiliates organised under the laws of the USA or from an unincorporated branch or office located in the USA.

Legal Opinions

It is not typical to obtain legal opinions as to compliance with the Risk Retention Rules, although the practice differs between institutions. Some will provide for detailed due diligence questions, others may require a memo laying out the relevant criteria for the applicable risk-retention rules together with an assessment of whether the applicable risk-retention rules and related disclosure requirements have been complied with.

4.3 Periodic Reporting

The sponsor must file Form 15-G on a quarterly basis if there have been any repurchase demands made under the transaction documents for breach of representations and warranties during the relevant quarter. Even if there have been no such events, the ABS issuer must make an annual Form 15-G filing certifying to that fact.

Issuers of securities offered and sold in a registered offering, and issuers with assets in excess of USD10 million at fiscal year end and a class of securities (other than exempted securities) held by more than 2,000 persons or more than 500 persons that are not accredited investors may be required to make periodic filings of an annual report on Form 10-K and any updates regarding current events on Form 10-K. In addition, ABS issuers must file Issuer Distribution Reports on Form 10-D. The large number of investors required to trigger such filing requirements in the case of privately placed securities means that such filing requirements will likely not apply to issuers of securities sold in a registered offering.

Form 10-K is an annual report requirement, which is generally required of all registered issuers. However, pursuant to Reg AB II, certain otherwise required information may be omitted for issuers of ABS and instead the report must contain certain information required under Reg AB II, including:

- financial information relating to significant obligors (representing 10% or more of the asset pool);
- financial information about any entity or group of affiliated entities providing enhancement of support;
- legal proceedings pending against the sponsor, depositor, trustee, issuing entity or servicer;
- information about certain affiliate relationships;
- compliance with servicing criteria; and
- related servicer compliance statement.

Section 8-K is a form for public companies to report certain major events. Form 10-D must be used to provide distribution and pool performance information, and to provide disclosure of legal proceedings, sales of securities, defaults, voting information for holders, updates to report on significant obligors on pool assets, information about significant enhancement providers and other information.

These rules are all part of the Exchange Act and are thus enforced by the SEC as described above.

4.4 Activities of Rating Agencies (RA)

Rating agencies' securitisation activities are regulated by the SEC. The Credit Rating Agency Reform Act of 2006 created a new Section 15E under the Exchange Act and amended Section 17 of the Exchange Act, and the SEC promulgated rules thereunder in 2007, which were further significantly revised and updated in 2014.

Sections 15E and 17 of the Exchange Act and the rules promulgated thereunder establish a detailed set of records relating to NRSROs that must be created and disclosed to the SEC, and mandate making certain aspects of the disclosure publicly available free of charge. The NRSRO is also required to implement procedures to manage the handling of material non-public information and conflicts of interest.

Upon becoming an NRSRO, the rating agency must post specific portions of its Form NRSRO on its website and the NRSRO must make and keep specific records, and maintain certain other records relating to its business as a rating agency. NRSROs must maintain certain records for three years and furnish certain financial reports, including audited financial statements and an annual certification to the SEC within 90 days of the end of the NRSRO's fiscal year.

Furthermore, an NRSRO is required to maintain and enforce written policies and procedures to prevent misuse of material non-public information as well as procedures designed to address conflicts of interest. SEC Rule 17g-5 divides conflicts of interests into two categories: (i) conflicts that must be disclosed and managed by the NRSRO, and (ii) conflicts that are prohibited by the NRSRO. The NRSRO is also required to create records regarding its internal control structure and file certain related reports that have been certified by the NRSRO's chief executive officer or other individual performing a similar function relating to the accuracy of the report, which must be signed and included with the report. The NRSRO is also required to file the report of its designated compliance officer as part of its annual filing. Finally, the rules prohibit NRSROs from engaging in certain abusive and anti-competitive practices.

As part of the 17g-5 conflict rules, an NRSRO is required to obtain a representation from the issuer, sponsor or underwriter of an asset-backed security that the issuer, sponsor or underwriter will post on a password-protected website (i) all information the issuer, sponsor or underwriter provides to the NRSRO for the purpose of determining the initial credit rating or to undertake credit rating surveillance for the relevant security or money market instrument, simultaneously with it providing such information to the NRSRO, and (ii) any executed due diligence Form ABS–15E delivered by a person employed to provide third-party due diligence services with respect to the security or money market instrument promptly after receipt of such executed due diligence form.

Rule 17g-7 requires an NRSRO to publish – free of charge on an easily accessible portion of its website – the credit rating assigned to each obligor, security and money market instrument, and any subsequent upgrade or downgrade.

The SEC regulates NRSROs and has the power to enforce any violation of its rules. Penalties for violating the rules can include suspension or revocation of an NRSRO's registration if the SEC makes a finding under certain specified sections of the Exchange Act that the NRSRO violated the conflicts of interest rule and the violation affected a credit rating.

4.5 Treatment of Securitisation in Financial Entities

Banks

The US bank regulators have generally implemented the Basel III capital and liquidity rules but with some important distinctions. Just like the Basel III capital rules, the US bank capital rules distinguish between "traditional" and "synthetic" securitisations, each with different operational requirements.

The Basel III definition of securitisation is tied to a tranched exposure to a "pool" of underlying exposures. The corresponding rules as implemented in the USA also refer to tranched credit risk, but instead of a pool of underlying assets, the rules in the USA provide that an exposure to one or more underlying assets can qualify for the securitisation framework as long as various additional features are present, which include:

- all or a portion of the credit risk of any underlying exposure being transferred to a third party other than through credit derivatives or guarantees;
- the performance of the securitisation depending on the performance of the underlying assets;
- all or substantially all of the underlying exposures being financial exposures;
- the underlying exposures being not owned by an operating company, small business investment company or a firm in which investment would qualify as a community investment; and
- the transaction not being an investment fund, collective investment fund, employee benefit plan, synthetic exposure to the extent deducted from capital under the applicable capital regime rule or a registered fund under the Investment Company Act of 1940, as amended (the Investment Company Act).

Similarly, in the case of synthetic securitisations, the Basel III definition requires the credit risk to tie to "at least two different stratified risk positions or tranches." Under the US implementation, the focus is on a synthetic transfer of exposure to one or more financial assets for which the related credit risk has been separated into at least two tranches with different levels of seniority.

The US bank capital rules do not permit the use of the external ratings-based approach to determine the applicable risk weight. As such, whereas the Basel III rules and the US bank capital rules provide for the use of an internal ratings-based approach to determine the capital requirement if the bank has the capacity and the requisite regulatory approval, the next permitted fall-back under the Basel III framework would be to a ratings-based approach. Such ratings-based approach is not permitted in the USA, which instead defaults directly to the standardised approach to determine the credit risk. Under the Basel III hierarchy, the standardised approach is otherwise the third-level fall-back. Similar to the Basel III rules, where none of these approaches can be used, the securitisation exposure will receive a 1,250% risk weight.

In the USA, the minimum risk weight that will be given to a securitisation exposure is 20%, whereas the Basel III rules allow for a risk weight of down to 15% for highly rated securitisation exposures with a duration not to exceed a year (or even 10% for a highly rated short-term paper).

The US capital rules also differ in their treatment of resecuritisations, which the Basel rules define as the securitisation of a securitisation exposure. Following the Global Financial Crisis, resecuritisations are subject to significantly higher capital requirements due to the increased complexity, opacity and correlation concerns. Where the Basel rules allow for "[a]n exposure resulting from retranching of a securitisation exposure [not being] a resecuritisation exposure if the bank is able to demonstrate that the cash flows to and from the bank could be replicated in all circumstances and conditions by an exposure to the securitisation of a pool of assets that contain no securitisation exposures," the US rules only exclude retranching of single exposures, which is potentially somewhat narrower.

The USA has similar liquidity coverage ratio (LCR) requirements and net stable funding ratio (NSFR) as Basel III, where a bank is required to hold high-quality liquid assets (HQLA) to cover for its projected net cash outflows over a 30-day period (in the case of the LCR). However, the LCR requirements are more stringent in the USA than what the Basel III rules otherwise permit, in areas such as qualifying HQLA assets, assumed outflow ratios for certain types of funding and the calculation of net cash outflows. The more stringent LCR rules apply to certain large banking organisations (USD250 billion or more in total consolidated assets or USD10 billion or more in total on-balance sheet foreign exposure) with a less stringent LCR applicable to bank holding companies and banking organisations between USD50 billion and USD250 billion.

The USA has not yet announced how it plans to implement the Basel rules around Fundamental Review of the Trading Book, a set of rules that implements a modified standardised approach for securities held in a bank's trading book, intended to require banks to withstand market shocks. The US Treasury expressed its concerns about the adverse impact on the secondary market and, consequently, liquidity of securitisations in its report of October 2017, A Financial System That Creates Economic Opportunities – Capital Markets (the 2017 Treasury Report). That report also noted the punitive treatment of securitisations under the banks' stress-testing requirements under the Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act Stress Test (DFAST), where banks are currently required to apply pricing shocks to securitisations of the same magnitude as the 2007-09 peak to trough value, without taking into consideration collateral quality and other safeguards put in place since the crises. The 2017 Treasury Report recommended US banking regulators to rationalise the capital requirements for securitisations so as neither to encourage nor discourage such products.

Insurance Companies

Insurance companies' capital requirements are subject to state regulation. The National Association of Insurance Commissioners (NAIC) has adopted a risk-based capital (RBC) methodology intended to be a minimum regulatory capital standard based on the insurance company's risk profile and is one of the tools that give regulators legal authority to take control of an insurance company.

The adoption of the RBC regime was driven by a string of large-company insolvencies that occurred in the late 1980s and early 1990s, and was created to provide a capital adequacy standard that is related to risk, raises a safety net for insurers, is uniform among the states and provides regulatory authority for timely action. The RBC formulae establish a hypothetical minimum capital level that is compared to a company's actual capital level. The formulae were also promulgated together with changes in the model law granting state insurance regulators authority to take specific actions based on the level of impairment. The specific RBC formula varies depending on the primary insurance type: life, property/casualty, health and fraternal to capture the different economic environments each of these types of companies are facing.

The RBC formulae focus on three major areas: (i) asset risk, (ii) underwriting risk and (iii) other risk, with each formula placing different emphasis on these areas. The formulae are less focused on capturing each single risk exposure of individual insurance companies and are more focused on capturing the material risks that are common for the particular insurance lines of business.

The NAIC has its own credit rating scale, running from NAIC-1 (lowest risk) to NAIC-6 (highest risk – for defaulted or near-defaulted securities). The NAIC rating scale largely ties to ratings from NRSROs in non-mortgage asset classes. In 2009, the NAIC developed an alternative methodology for non-agency RMBS that has since been expanded to CMBS. These risk criteria, coupled with related factors, are used to assess solvency capital requirements. As such, the mapping of ABS assets to a NAIC rating will often dictate the attractiveness of a particular asset-backed security for an insurance company.

The RBC calculations are maintained by the NAIC Capital Adequacy (E) Task Force and its working groups and subgroups, and are periodically updated to meet the changing regulatory environment. For example, one of the more recent areas of focus has been to add granularity to the reporting categories or expand the risks quantified in the RBC formulae, so as to eliminate the incentive to invest in lower-quality bonds within the same NAIC designation.

Regulation and Enforcement
Bank capital rules are enforced by the relevant bank regulatory agency, which, depending on the bank, will be the OCC or the Federal Reserve. In certain circumstances, the FDIC may also bring enforcement actions. The bank regulators have the power to subject regulated institutions to a broad range of administrative actions and sanctions. Informal actions can range from memoranda of understanding or submission of commitment letters to board resolutions or safety and soundness plans for regulatory approval. More serious infractions can lead to formal actions, including cease-and-desist orders, formal written agreements, corrective action orders, assessment of civil money penalties and/or the denial, conditioning, or revocation of applications. Failure to maintain minimum capital ratios may also be the basis for an action by the FDIC to terminate its deposit insurance and could lead to additional enforcement actions under the FDIC's broad authority to address unsafe banking practices. Failure to comply with existing laws or enforcement actions can, in turn, result in more severe enforcement actions, including changing management, removing or suspending personnel, limiting growth and ceasing dividend payments.

Failure by insurance companies to maintain adequate capital will give state regulators authority to step in with corrective measures that vary depending on the relevant capital deficiency. There are four levels of action that can be triggered under the formulae and they are designed to permit early intervention:

- company-action level, which requires the relevant insurance company to identify and report on certain information and to submit a remedial plan;
- regulatory-action level, which requires the insurer to submit a remedial plan or revised remedial plan and requires the commissioner to perform such examinations and issue such corrective action orders as the commissioner determines are required;
- authorised-control level, which requires the commissioner to take certain required actions and potentially may result in the relevant insurer being placed under regulatory control; and
- mandatory-control level, which requires the commissioner to take such actions as are necessary to place the insurer under regulatory control.

Capital or Liquidity Benefit
The assets constituting high-quality liquid assets for purposes of the liquidity coverage ratio and the net stable funding ratio are narrower in the USA than that which is otherwise permitted under Basel III and do not include transactions such as "single, transparent and comparable" securitisations. For example, the US LCR rules do not include any non-agency securitisations among HQLA, even though the Basel III capital standards otherwise allow for level 2B HQLA treatment for certain securitisations. The 2017 Treasury Report noted that certain securities, such as corporate bonds, that fared worse than many securitised asset classes during the crises in the previous decade are given level 2B HQLA treatment and recommended that "high-quality securitised obligations with a proven track record should receive consideration as level 2B HQLA for purposes of LCR and NSFR. Regulators should consider applying to these senior securitised bonds a prescribed framework, similar to that used to determine the eligibility of corporate debt, to establish criteria under which a securitisation may receive HQLA treatment." The 2017 Treasury Report recommendations do not have a direct impact on current regulation and do not otherwise bind the relevant agencies, but the report does give a good insight into the relevant regulatory goals of the current administration.

4.6 Use of Derivatives
The derivatives market in the USA has traditionally been divided between highly standardised and highly regulated exchange traded futures and options on the one hand, and the largely unregulated OTC derivatives market that existed between sophisticated counterparties on the other hand. The highly standardised provisions and the margin requirements for cleared derivatives typically made those instruments less attractive for use in securitisations. Instead, securitisation structures have typically relied on OTC derivatives, to hedge interest or FX exposures and to create synthetic exposures to loans and other financial assets. Title VII of the Dodd-Frank Act and rules promulgated thereunder have expanded the regulation of OTC derivatives to make it similar, in many respects, to the market for cleared derivatives. Many of these rules create significant compliance and cost burdens on securitisation SPEs and may, in many circumstances, not work within the relevant securitisation structure. Consequently, much of the securitisation SPE-specific practice centres around achieving exemptions from generally applicable derivatives rules.

Title VII of the Dodd-Frank Act establishes a comprehensive regulatory framework for OTC derivatives to address a number of aspects of OTC derivatives that were identified as causing vulnerabilities in the financial system; in particular, the complexity, lack of transparency and interconnectivity of the OTC market and the lack of consistent margin requirements. This framework is built around the principles of:

- requiring clearing of standardised OTC derivatives through regulated central counterparties;
- requiring trading of standardised transactions to occur on exchanges or electronic trading platforms when appropriate;
- increasing transparency through regular data reporting; and
- imposing higher capital requirements on non-exchange traded OTC derivatives.

In addition, Title VII imposes registration, oversight and business conduct standards for dealers and large participants in the derivatives market.

The regulatory authority is primarily divided between the CFTC and the SEC, with the US banking regulators setting capital and margin requirements for banks. The CFTC has authority over most OTC derivatives, referred to as "swaps" in the Commodity Exchange Act (CEA), whereas the SEC has authority over OTC derivatives that fall within the Exchange Act definition of "security-based swaps," which covers derivatives linked to single-name loans or securities, narrow-based indexes of loans or securities, or events relating to such loans or securities, or their issuers. The Dodd-Frank Act had the effect of causing swaps to be included in the definition of "commodity pool" under the CEA and under the definition of "security" for purposes of the Securities Act and the Exchange Act.

The industry has been focused on obtaining permanent relief against those aspects of the new regulations that are particularly burdensome for securitisation SPEs as well as relief from application of the various new derivatives rules to securitisation transactions entered into prior to the applicable effective date of the rule.

For example, the CFTC has issued no-action letters exempting from the definition of commodity pool certain securitisation entities that are operated consistent with SEC Regulation AB or Rule 3a-7 promulgated under the Investment Company Act. To be eligible for the relief provided under these no-action letters, the securitisation issuer must hold primarily self-liquidating assets for which the use of derivatives is limited to the permitted uses under Regulation AB. Such permitted uses include credit enhancement and the use of derivatives to alter the payment characteristics of the cash flow. In addition, these no-action letters require that the securitisation issuer makes payments based on cash-flows, not based on changes in the value of the entity's assets, and that the issuer is not permitted to acquire or dispose of assets for the primary purpose of realising market gains or minimising market losses (see CFTC Letter 12-14 (12 October 2014) and CFTC Letter 12-45 (7 December 2012)).

The CFTC has also issued an interpretation of the CEA definition of "captive finance company" to include a wholly owned subsidiary of that captive finance company as included among the end-user exception for companies that are not a "financial entity" within the meaning of the CEA. As a result, securitisation SPEs that fit within this definition may elect an exemption from the clearing requirement under the CEA and thereby will also be exempt from the CFTC's and the prudential bank regulators' margin requirements for swaps that are not cleared (CFTC Letter 15-27 (4 May 2015)).

In addition, there are a number of temporary exemptions and legacy exemptions for SPEs to facilitate the transition to application of the margin rules and other relevant rules as they apply to securitisation SPEs, many of which have expired.

It is also worth noting that the non-recourse language typically included in agreements with SPEs, including derivative agreements, would cause such derivatives to fall outside the standard terms for derivatives that are currently centrally cleared and traded, although that may change should swaps with such terms be included as part of a traded standard.

Finally, the SEC has proposed, but not finalised, conflict of interest rules intended to address conflicts of interest inherent in credit default swaps. These rules would have made synthetic securitisations impracticable in many circumstances had they been adopted as proposed. These rules are discussed separately in **8 Synthetic Securitisations**.

Enforcement and Penalties for Non-Compliance

Enforcement of the different aspects of the Dodd-Frank Title VII provisions and related rules is allocated among the relevant agencies. Violations of the security-based swaps rules promulgated by the SEC will be enforced by the SEC and are potentially also subject to private enforcement depending on the relevant violation, similar to other securities law violations discussed above. Similarly, enforcement of margin rules by bank regulatory authorities are subject to the same enforcement authority as discussed in connection with the capital requirements above. The CFTC has the power to enforce violations of the Commodity Exchange Act, which would apply to derivatives that fall within the definition of "swaps" under the Commodity Exchange Act. The Dodd-Frank Act has significantly enhanced the CFTC's anti-manipulation and fraud authority to become similar to that of the SEC under Section 10(b) of the Exchange Act. In addition, the CFTC has expanded authority to treat transactions that are wilfully structured to evade the requirements of the Dodd-Frank Act as swaps and to bring enforcement actions where such transactions fail to satisfy applicable criteria. Furthermore, the attorneys general of the various US states and territories also have certain authority to bring enforcement actions under Section 13a-2 of the CEA where their citizens are adversely affected. The penalties range from injunction or restraining orders, writs or orders mandating compliance, civil penalties up to USD100,000 per violation, or in the case of manipulation or attempted manipulation, a fine of up to USD1 million per violation. The CFTC can also impose equitable remedies, including restitution and disgorgement of gains. Wilful violations and abuse of the end-user clearing exception are felonies punishable by a fine up to USD1 million or imprisonment for up to ten years, or both together with cost of prosecution (see CEA Section 13).

4.7 SPEs or Other Entities

Organisational Forms of SPEs Used in Securitisations

SPEs used in securitisations can theoretically take almost any organisational form, including a limited liability company, a corporation, a trust or a partnership. However, as a practical matter, the SPEs organised in the USA overwhelmingly tend to be organised as a limited liability company or a statutory trust. For certain asset classes it is also typical to use securitisation SPEs organised as foreign corporations in a jurisdiction that does not impose entity-level tax on such corporations. The rules governing such entities will be a combination of (i) the relevant laws relating to the relevant form of organisation in its jurisdiction of formation, (ii) applicable tax laws and (iii) bankruptcy or other applicable insolvency laws.

Factors in Choosing an Entity

The primary factors driving the type and jurisdiction of the securitisation entity will be bankruptcy remoteness and tax. Other important factors include market practice and acceptance. As outlined earlier, common law trusts are disfavoured compared to statutory entities for bankruptcy-remoteness purposes in light of the separate existence afforded to such statutory trusts. US domestic corporations are generally disfavoured in part because of the entity-level tax applicable to corporations and in part because of the mandatory fiduciary duty that directors have to the shareholders, which can cause difficulties in delinking the SPE from its parent.

Delaware statutory trusts (DSTs) and Delaware limited liability companies (DLLCs) are often the entities of choice for securitisations. Delaware is viewed as a favourable jurisdiction for forming business entities. Delaware has up-to-date business entity laws that provide for efficient and quick formation, a sophisticated judiciary and significant volume of decisions that together provides additional certainty and acceptance. DSTs that are structured to qualify as 'grantor trusts' for purposes of applicable treasury regulations will be tax-transparent and will be treated as if the beneficiaries hold their pro rata portion of the underlying assets. Such trusts, properly structured, would also potentially not qualify for bankruptcy filings, thereby creating an additional layer of protection. However, grantor trusts are extremely limited in their ability to vary their investments and in the ability to create different tranches. A DST established as an owner trust with a single beneficiary of the trust certificate will also be disregarded for tax purposes. The same is true for a single-member LLC.

Where an owner trust or an LLC has more than one equity holder for tax purposes, it will be treated as a partnership for tax purposes. Tax-exempt investors and foreign investors will often benefit from investing through a corporation that will block such investor from certain tax consequences that would, or could, result from investing in a US partnership. As such, it is also typical in many securitisations, such as CLOs, for the issuer SPE to be organised in a form that is deemed to be a corporation for US tax purposes, but located in a jurisdiction, such as the Cayman Islands, that does not impose an entity-level tax.

Exemptions to the Investment Company Act

In addition to selecting an organisational form that satisfies relevant tax and bankruptcy remoteness requirements, it is also necessary to ensure that the activities of the SPE and the investors in the SPE are of a type that does not give rise to an obligation to register as an investment company under the Investment Company Act. An entity that has invested more than 40% of its assets in securities within the meaning of the Investment Company Act (a broad term that includes loans) will have to register as an investment company and be subject to a number of restrictions, absent an available exemption. Registered investment companies are subject to leverage and capital structure restrictions that are not compatible with securitisations and contracts entered into by a company that is required to register as an investment company, but which has failed to do so, are voidable. Consequently, all securitisations are structured to fit within an exemption from registration under the Investment Company Act.

The exemptions most commonly used for securitisation entities are Rule 3a-7, Section 3(c)(5) and Section 3(c)(7) under the Investment Company Act. Rule 3a-7 was designed for securitisations and is available for entities where the investments primarily consist of self-liquidating assets that are only sold or purchased in accordance with the terms of the transaction documents and not for the purpose of capturing market gains or avoiding market losses. Rule 3a-7 further requires a trustee to satisfy certain requirements to have ownership of, or a perfected security interest in, the assets of the securitisation entity and requires periodic turnover of cash proceeds from the collateral to an account controlled by the trustee. Finally, Rule 3a-7 imposes restrictions on the investors in any asset-backed security that is not rated or that is rated below investment grade. Any such unrated or below investment grade security that is a "fixed income security" within the meaning of the rule may only be invested in by "qualified institutional buyers" within the meaning of Rule 144A of the Securities Act or the specified subgroup of "accredited investors" commonly referred to as accredited institutional investors. Any unrated or below investment grade asset-backed security that is not a fixed income security within the meaning of Rule 3a-7 may only be invested in by qualified institutional buyers or by a person involved in the operations of, or that is an affiliate of, the issuer.

Section 3(c)(5) of the Investment Company Act is available for issuers securitising accounts receivable, loans to manufacturers, wholesalers, retailers or purchasers of specified merchandise, insurance or services as well as for mortgages and other liens on and interests in real estate as long as a holder of any such issuer's securities does not have the right to require early redemption of such securities.

Section 3(c)(7) of the Investment Company Act is a general exemption from registration that is available to issuers that do not publicly offer their securities and that limits its investors to "qualified purchasers," a term that, as a rule of thumb, requires net investable asset of at least USD5 million for individuals and certain family companies, and at least USD25 million for other entities. Section 3(c)(7) was much more widely used prior to the Volcker Rule becoming effective. However, CLOs that are actively managed and that may buy and sell underlying loans for the purpose of capturing market gains or avoiding market losses continue to rely on Section 3(c)(7) for purposes of their Investment Company Act exemption because such trading of underlying loans is not a permitted activity for an entity that relies on the exemption in Rule 3a-7. Most entities that are "qualified institutional buyers" (QIB) within the meaning of Rule 144A under the Securities Act will also be "qualified purchasers" (QP) and the Depositary Trust Corporation (DTC) accepts fixed income securities that are limited to QIB/QPs for clearing and, consequently, restricting 144A securitisations to investors that are also qualified purchasers does not significantly impact the available pool of investors or the liquidity in the market.

4.8 Activities Avoided by SPEs or Other Securitisation Entities

The Volcker Rule prohibits banks from holding an "ownership interest" in, or sponsoring entities that are, "covered funds" for purposes of the Volcker Rule. Ownership interest is a broad term that captures, amongst others, any security with equity-like returns or voting rights (including the right to replace the collateral manager, which is typically a right of the senior-most class of investors in the event of a collateral manager default). Consequently, in order to be attractive to banks, securitisation entities tend to avoid becoming a "covered fund" within the meaning of the Volcker Rule.

The covered fund definition only captures entities that would have to register under the Investment Company Act but for the exemption set forth in Sections 3(c)(7) or 3(c)(1), or that are commodity pools for which the commodity pool operator has claimed an exemption from registration and record-keeping requirements pursuant to Section 4.7 of the Commodity Exchange Act, or that are "substantially similar" commodity pools. Typically, the basis on which a securitisation entity might become a commodity pool is by entering into any derivative other than a "security-based swap" within the meaning of the Commodity Exchange Act to the extent that the securitisation entity does not qualify under the CFTC no-action letters.

As such, any securitisation entity that can rely on Rule 3a-7 – or any other exemption except for 3(c)(1) or 3(c)(7) – for their registration exemption under the Investment Company Act will not be covered funds for the purposes of the Volcker Rule. On the other hand, CLOs and other securitisations that rely on 3(c)(7) typically must face the choice between not offering a class of securities to banks that confer "ownership rights" within the meaning of the Volcker Rule or finding an exception to the covered fund designation under the Volcker Rule itself. For CLOs the solution is typically to structure the SPE to comply with the "loan only securitisation." Under that exemption, the underlying assets must be composed solely of loans and rights or other assets designed to assure the servicing or timely distribution of proceeds to the holders of the ABS assets or that are incidental to acquiring or holding the loans. "Loan," as defined in the context of the Volcker Rule, is a broad term that captures "any loan, lease extension of credit, or secured or unsecured receivable that is not a security or derivative."

Avoiding Adverse Regulatory Consequences

Practitioners seek to avoid investments that have adverse regulatory consequences on the Investment Company Act treatment and on the Volcker Rule treatment by including appropriate restrictions in the transaction documents. For example, for a securitisation entity relying on Rule 3a-7, there would typically be a provision that restricts the SPE from purchasing or selling assets primarily for the purpose of capturing market gains or avoiding market losses. For an SPE that relies on the loan-only securitisation exception under the Volcker Rule, the transaction documents will typically include investment restrictions aimed at prohibiting the purchase of investments that are not permitted under that exception.

The primary effect of violating the Volcker Rule will be to prohibit banks and banking entities from investing in ABS tranches that are viewed as "ownership interests" for purposes of the Volcker Rule. In addition, by virtue of the protections built into the transaction documents, a violation of the relevant covenants could give rise to remedies under the relevant transaction documents, including potentially causing an early amortisation or an event of default. Furthermore, since the issuer offering documents will typically provide disclosure of the issuer's covered fund status under the Volcker Rule, any violation could also have potential consequences under disclosure liability theories.

Failure to comply with applicable Investment Company Act registration exceptions could result in the SPE violating the Investment Company Act, which could render transactions entered into by the SPE void or voidable and could result in additional sanctions by the SEC.

4.9 Material Forms of Credit Enhancement

The most typical forms of credit enhancements include over-collateralisation, subordination of junior tranches, cash reserves and excess spread (ie, a return on the underlying assets that is greater than the spread required to service the fixed income ABS). The exact levels of credit enhancement will depend on the ratings requirements relating to the desired ratings levels.

In certain asset classes, the securitisations will also include liquidity facilities that can be used to service the outstanding securities during periods of liquidity shortfalls. These can be provided by third-party liquidity providers or as part of the servicing rights and obligations. For example, mortgage-backed securities often impose certain rights and obligations on the servicer or another entity affiliated with the ABS issuer to provide advances that are used to cover payments due on the senior notes in the case of any shortfalls. These advances from related parties can provide important liquidity credit support, but can also adversely impact the substantive consolidation analysis unless structured appropriately.

Guarantees of the ABS issuer's obligations used to be a staple of many securitisations prior to the Global Financial Crisis, but are currently close to extinct. In part this is because most monoline insurance companies failed in the aftermath of the crises and in part because under the Basel III capital rules as implemented in the USA there would be no credit given to a guarantee of a securitisation unless the guarantor meets the "eligible guarantor" requirements within the capital rules. Those criteria include a requirement that the guarantor's "creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees and... that it is not an insurance company engaged predominantly in the business of providing credit protection (such as a monoline bond insurer or re-insurer)."

4.10 Participation of Government Sponsored Entities

Ginnie Mae, Fannie Mae and Freddie Mac are the principal agencies and government sponsored entities (GSEs) engaged in securitisation of mortgages. Each of these entities has at the core of its mission affordable residential housing. In the case of Ginnie Mae, which is a government agency, the focus is on supporting mortgages insured or guaranteed by the Federal Housing Administration (FHA), the US Department of Veterans Affairs (VA), the US Department of Agriculture Office of Rural Development and the US Department of Housing and Urban Development Office of Public and Indian Housing (PIH). Ginnie Mae does not itself issue MBS, but instead provides a guarantee, backed by the full faith and credit of the US government, of securitisations by participating institutions of government insured mortgages. In order to become an approved sponsor of Ginnie Mae Guaranteed securitisations, the participating sponsors must meet certain capital and liquidity requirements, and will be subject to ongoing monitoring.

Fannie Mae and Freddie Mac are GSEs that are chartered by Congress for the purpose of providing a stable source of liquidity for the purchase and refinancing of homes and multi-family rental housing. These GSEs operate differently from Ginnie Mae, in that the GSEs purchase loans that satisfy their origination criteria, referred to as 'conforming loans', from originators and issue securities backed by pools of such loans that are guaranteed by the relevant GSE. Unlike Ginnie Mae, the GSEs guarantee is not backed by the full faith and credit of the US government. However, the market has generally viewed the GSEs as subject to an implicit government guarantee despite express disclaimers to the contrary in the GSEs charters. Since September 2008, both GSEs have been under conservatorship by the Federal Housing Financing Agency (FHFA), which is a statutory process without a termination date designed to put the GSEs in a sound and solvent condition. In addition, the US Treasury has entered into a senior stock purchase agreement with each GSE that provides the GSE with access to guaranteed preferred equity up to the committed amount.

Both Fannie Mae and Freddie Mac typically construct their mortgage securitisations as whole loan purchases for pooling into a multi-lender pool or as a lender swap transaction. In the case of whole loan purchases, the GSE typically will issue guaranteed MBS in the case of Fannie Mae and pass-through certificates (PCs) in the case of Freddie Mac. MBS and PCs are very similar and for the purposes of this discussion, both will be referred to as pass-through securities. The GSEs also create multi-class securitisations, including real estate mortgage investment conduits (REMIC), in which the cash flows on the underlying mortgage assets are divided so as to create several classes of securities, each of which represents a beneficial ownership interest in the assets of the related issuing trust and entitles the holder to a specified portion and priority of the cash flows, with maturity that may match – or be shorter than – the underlying pool of loans and pass-through securities. According to SIFMA, the aggregate amount of agency pass-through securities for 2017 was approximately USD1.4 trillion (and about USD1.2 trillion year-to-date through November 2018), while the aggregate amount of agency CMOs issued in 2017 was approximately USD308.4

billion (and about USD291.4 billion year-to-date through November 2018), which means that out of the USD2.5 trillion US securitisation market, about USD1.7 trillion were agency mortgage-backed securitisations.

Fannie Mae was initially established in 1938 and initially had the role that Ginnie Mae has today. In 1968 Ginnie Mae was separated out from Fannie Mae and Fannie Mae was partially privatised. In 1970 the federal government authorised Fannie Mae to purchase conventional mortgages and, the same year, Congress chartered Freddie Mac as a competitor to Fannie Mae. Fannie Mae's operations are principally governed by the Federal National Mortgage Association Charter Act, which permits Fannie Mae to purchase and securitise mortgage loans secured by single-family and multi-family properties, as well as to service, sell, lend on the security of and otherwise deal in mortgage loans. The single-family loans that Fannie Mae may purchase or securitise are subject to certain requirements, including principal balance limits that are set by the FHFA, although no such limits apply to loans that are insured by the FHA or VA, or on multi-family loans. The Charter Act further requires certain credit enhancements where the loan-to-value ratio exceeds 80% at the time of purchase (typically in the form of insurance by a qualified insurer on the portion of the principal exceeding 80%, a seller's agreement to repurchase the loan in the event of a default or the retention by the seller of at least a 10% participation interest in the mortgage).

The Charter Act also generally provides that Fannie Mae's securities are exempt under the federal securities laws, such that Fannie Mae is not required to file registration statements with the SEC under the Securities Act with respect to any of its securities. Fannie Mae's non-equity securities are also exempt securities under the Exchange Act; however, Fannie Mae's equity securities are not so exempt and as such Fannie Mae is required to file annual and quarterly reports with the SEC on forms 10-K and 10-Q as well as furnish recent reports on Form 8-K.

Freddie Mac's activities are primarily governed by the Federal Home Loan Mortgage Corporation Act (the Freddie Mac Act), which establishes similar authority for Freddie Mac as the Charter Act provides for Fannie Mae.

The agency securitisation model and the related guarantees allow investors to focus primarily on the payment characteristics of the underlying pools of mortgages rather than the credit risk. This, in turn, has allowed for the emergence of a highly liquid 'to-be-arranged (TBA) market' where pools of MBS are deemed to be fungible, and traded, on the basis of a few basic characteristics, such as the issuer, amortisation type (eg, 30 years or 15 years), the coupon rate, the settlement date and the maximum number of mortgage securities per basket. There is a liquid TBA market for settlement up to three months after the trade date. The actual information about the pool to be delivered only needs to be provided two business days prior to settlement. As such, the TBA market permits lenders to lock in rates for mortgages before they are originated, which, in turn, benefits borrowers through lower and more stable rates.

As per the FHFA's strategic plan for the conservatorships of Fannie Mae and Freddie Mac, the GSEs are developing a common securitisation platform under the direction of the FHFA with the goal of enhancing fungibility and liquidity, especially in the TBA market. The FHFA has announced that the new uniform mortgage-backed security will be implemented starting June 2019.

In addition to the guaranteed products, the GSEs have developed various risk-sharing vehicles that allow for risk to be shared with investors, insurance companies or originators, depending on the relevant product.

The agency programmes have allowed for the development of favourable mortgage loan products, such as the 30-year fixed mortgage, and have acted as a buffer against liquidity stresses in the market. For example, during 2008 and 2009, USD2.89 trillion of agency MBS was issued, while no non-agency securitisations occurred during that period.

4.11 Entities Investing in Securitisation

Various studies have shown a relatively diverse ABS investor base, both geographically and based on investor type. Investors include banks, asset managers, insurance companies, pension funds, mutual funds, hedge funds, high net worth investors and others. These investor classes are subject to varying degrees of regulation that may impact the extent to which ABS is an attractive investment. A detailed description for each of these investor classes is beyond the scope of this summary; however, a few points that affect the structuring and offering of ABS securities are worth noting. As discussed above, the Basel rules penalise investments that are not the senior-most positions in a securitisation, which, in turn, will impact the extent to which banks may be willing to invest in mezzanine tranches and below. Banks that are primarily constrained by the leverage ratio, as compared to the risk-weighted assets ratio, will also typically look to ensure that their hurdle rate for the leverage ratio is satisfied, which may make highly rated, but lower-yielding, senior securities less attractive for those banks. The FDIC in 2001 and 2012 introduced additional assessments for "higher risk securitisations" in the form of the Final Rule on Assessments and Large Bank Pricing, and the Final Rule on Changes to the Definitions of Higher-Risk Assets, respectively, where certain exposures to securitisations of predominantly subprime and other high-risk assets may result in higher insurance premiums – further disincentivising affected banks from investing in affected types of securitisations.

Insurance companies are subject to state regulation in terms of permitted investments with relevant buckets and concentration limits applicable to each category of permitted investment. As such, the availability of relevant investment buckets and the rating of the relevant securities will dictate the attractiveness of a securitisation investment for a particular insurance company.

Pension plans are also frequent investors in ABS. The issue where plan money is invested in a securitisation is typically to ensure that the investment will not cause the issuer to be deemed to hold 'plan assets'. An issuer that is deemed to hold plan assets will be subject to stringent conduct standards and potential liability for persons that act as 'fiduciaries' within the meaning of applicable Employee Retirement Income Security Act (ERISA) and tax provisions, and may prohibit the issuer, fiduciaries and their affiliates from engaging in certain transactions (so-called prohibited transactions). The basis on which a sponsor of a securitisation nevertheless may be comfortable accepting plan assets for investment in the ABS will in part hinge on:

- whether the ABS issuance is registered (and the ABS issuer becomes a reporting company under the Exchange Act) or the ABS qualify as debt for ERISA purposes,
- whether the relevant underwriter or initial purchaser of the ABS is the beneficiary of an individual exemption; and
- whether pension investors are restricted such that less than 25% of the securities that could be considered equity for ERISA purposes are held by such investors.

5. Documentation

5.1 Bankruptcy-Remote Transfers

By far the most typical form of documentation for effecting a bankruptcy remote transfer is a purchase-and-sale agreement pursuant to which the underlying financial assets are sold by the originator to the depositor or the issuer at fair market value. The exact form of purchase-and-sale agreement can vary but they typically have the following common features:

- a clear identification of what is being sold;
- an arm's-length purchase price;
- a number of representations and warranties around the qualities of the transferred assets as of the time of transfer;
- additional housekeeping representations and warranties by the seller and buyer;
- representations around information required adequately to perfect the transfer and granting of a security interest in the transferred assets; and
- provisions relating to indemnification and repurchase of assets that, as of the time of sale, did not satisfy the representations made with respect to such asset.

The repurchase obligation for breach of representations relating to the purchased assets as of when they transferred usually allows for a cure period if the relevant cause for such misrepresentation can be cured. It is also fairly typical to include in a purchase-and-sale agreement a precautionary grant of security interest in the transferred assets in the event that the transfer of the assets is recharacterised as a loan, usually coupled with a statement that the parties intend for the agreement to effectuate a true sale.

Since 26 September 2011, NRSROs assigning a credit rating to an asset-backed security are required, pursuant to Exchange Act Rule 17g-7, to disclose information publicly about the representations, warranties and enforcement mechanisms available to investors that were disclosed in the offering document for the relevant ABS and that relate to the asset pool underlying such ABS, including how they differ from the representations, warranties and enforcement mechanisms in the issuance of similar securities. These public disclosures provide a useful source for pulling relevant information about representations and comparisons for the relevant asset class.

Two other forms of documents used to effectuate a true-sale transfer, albeit far less frequently than a purchase-and-sale agreement, are participation agreements that satisfy the true sale criteria and contribution agreements.

Participation agreements typically include purchase and sale provisions that relate to the transfer of a participation in the relevant asset, but are otherwise similar to an ordinary purchase and sale agreement. In addition, the true participation agreement will include provisions to ensure that payments and other distributions received in respect of the underlying asset by the participation seller are promptly transferred to the participation buyer. The participation agreement will also typically include provisions relating to a participation buyer's ability to give consent and otherwise participate in voting actions relating to the underlying asset as well as 'elevation rights' that establish when either party to the participation can call for reasonable efforts to effectuate a full assignment of title as well as confidentiality provisions, indemnification provisions and provisions relating to assignments by the parties. In line with the true sale discussion above, it is important that the participation agreement is drafted in a manner that is consistent with a sale rather than a security interest on these various key points. The Loan Syndication and Trading Association (LSTA) has promulgated forms of participation agreements for syndicated loans with the aim of achieving true sale treatment and which are therefore often adapted in case of sale of participations in other financial assets. A correctly drafted participation agreement will be recognised as a sale for accounting as well as bankruptcy purposes. The FDIC has promulgated non-exclusive safe harbour provisions for participations involving covered banking entities in 12 CFR 360.6 that, if complied with, provide additional comfort that the FDIC, when acting as conservator or receiver, will respect such participations as an assignment of the assets subject to such participation.

True contribution agreements are also at times used to effectuate true sale transfers from a parent to a wholly owned subsidiary. The general theory behind such contribution agreement being that the contributing parent is receiving reasonably equivalent value for the transfer since the value of the equity will increase by the same amount as the value of the transferred assets. Sale and contribution agreements are otherwise a common staple in securitisations involving a two-step transfer. The first leg of the two-step transfer is then typically structured as a true sale for cash of the relevant financial asset from a seller to a bankruptcy-remote special-purpose entity that acts as depositor for the issuer and the second leg of the transfer is a combined sale and contribution of the asset from the depositor to the issuer that does not necessarily satisfy all the requirements of a true sale.

5.2 Principal Warranties

The typical representations and warranties in the sale agreement address:

- the underlying asset satisfying the specified eligibility criteria set forth in the transaction documentation;
- the relevant asset being free and clear of any liens or other encumbrances in all material respects;
- transfer of title;
- all required consents and authorisations having been obtained;
- the underlying financial assets having been originated and serviced in compliance with law in all material respects; and
- various additional tailored representations to reflect specific eligibility criteria, especially those for which a breach can result in liability for the assignee (as may be the case for mortgages that do not fit within the "qualifying mortgage" criteria that provide a safe harbour under ability to repay rules).

The typical enforcement mechanism is notice and indemnification obligations, coupled with a repurchase obligation in the case of a breach of any asset-level representation that has not been cured in a timely manner.

Typically, the power to exercise such rights and remedies are given to the trustee. However, trustees will normally not act in the absence of direction from the required noteholders. The portion of noteholders required to direct the trustee to take action is a negotiated term that may vary between different transactions. However, if the ABS is issued in a registered offering, the portion will be subject to the requirements of Reg AB II, which specifies that the transaction documents cannot require more than 5% of the principal amount of notes to direct the trustee to exercise its remedies.

5.3 Principal Perfection Provisions

Typical perfection provisions include:

- that the relevant transaction document creates a valid and continuing security interest in the relevant financial asset in favour of the relevant transaction party, which security interest is prior to all other liens and is enforceable as such against creditors of and purchasers from the relevant transaction party;
- that the transferor has good and marketable title free and clear of any lien, claim or other encumbrance;
- that within a specified period after the effective date of the relevant transaction document, all applicable financing statements have been filed in the proper filing office in the appropriate jurisdiction under applicable law to perfect the security interest in the relevant asset granted to the relevant transaction party; and
- that there has been no other conflicting sale or pledge of the relevant asset.

If the relevant financial assets include instruments, chattel paper or certificated securities that can be perfected by possession or control, and for which such means of perfection may provide a better protection of priority than a prior perfection by filing, then the perfection representations may also address the delivery of such instrument, chattel paper or securities certificate to an appropriate person to be held for the benefit of the trustee (or other relevant secured party). In some instances the perfection representations relating to chattel paper may also call for the original being marked as pledged to the trustee to reduce the risk that a third-party acquirer obtains possession without actual knowledge of the prior security interest.

5.4 Principal Covenants

The principal covenants in a securitisation transaction vary, based on the relevant document and the type of securitisation. The covenants will typically address payment obligations, collateral maintenance and perfection obligations, rights and related procedures concerning adding and removing underlying assets, reporting obligations, and various negative covenants intended to maintain the integrity of the securitisation. In addition, there will typically be separate covenants relating to the trustees' obligations to act and rights not to act in accordance with instructions. Enforcement is usually a combination of events of default under the indenture, which gives the noteholders the right to direct the indenture trustee to take enforcement actions, and servicer defaults, which give the specified class or classes of noteholders rights to replace the servicer.

5.5 Principal Servicing Provisions
The servicing provisions generally relate to continued collection and servicing of the relevant asset, and typically include a number of reporting, notice and turnover of collections provisions. In securitisations with revolving periods during which there is a constant replenishment period, the servicer will also typically be required to ensure compliance with applicable pool criteria and provide relevant reports in connection with any collateral removal, additions or substitutions. In addition, for some securitisations, there will often be certain obligations around delivery of reports and other relevant information to a back-up servicer.

5.6 Principal Defaults
In many securitisations, the events of default are bifurcated between events that cause early amortisation but not otherwise a right to enforce against the collateral and events that cause both the onset of early amortisation and give rise to a right to enforce against the collateral. In addition, there will typically be separate events of default or termination events that give rise to a right to replace the servicer or collateral manager, or other relevant party to the securitisation transaction.

Amortisation events typically include:

- failure to maintain required reserve amounts, and similar events, and sometimes also failure to pay interest on notes (typically failure to pay interest will also be an event of default, at least for the more senior note classes);
- delinquencies or charge-offs in excess of certain thresholds;
- failure to maintain certain minimum excess collateral requirements;
- servicer termination event; and
- events of default.

Early amortisation will typically continue only for the duration of the relevant amortisation trigger.

Events of default usually include:

- failure to pay principal on the notes when due and failure to pay interest on specified senior note classes, that is continuing after expiration of applicable cure periods;
- insolvency or bankruptcy of the securitisation entity;
- default in material covenants that have not been cured within applicable cure periods; and
- the indenture trustee or other relevant agent for the noteholder failing to have a first priority perfected security interest in the collateral.

Depending on the securitisation transaction, the events of default may also include the occurrence of certain tax or regulatory events relating to the issuer, the occurrence of certain servicer defaults, or the over-collateralisation dropping below a certain threshold.

Servicer defaults or termination events typically include failure, after expiry of applicable cure periods, to turn over collections when required to do so; breach of other covenants; misrepresentations; and servicer insolvency. Such servicer defaults or termination events also often include the occurrence of an event of default under the indenture and the occurrence of certain material adverse events with respect to the servicer.

5.7 Principal Indemnities
Typical indemnification obligations in securitisations include indemnification for damages in case of breach by the seller or servicer of their obligations. In addition, it is typical for the indenture trustee, any owner trustee and other similar agents to have broad indemnification rights other than for their gross negligence or wilful misconduct, coupled with a right not to act (or to refrain from acting) in accordance with instructions that could result in the trustee incurring costs or spending its own funds without the trustee having obtained adequate indemnity. Indemnification obligations by sellers and the servicer are typically enforced through a combination of notice provisions to noteholders, coupled with the trustee having enforcement rights as directed by a requisite portion of the noteholders.

6. Enforcement

6.1 Effectiveness of Overall Enforcement Regime
The enforcement regime for securitisations has been significantly strengthened as a result of rule-making following the Global Financial Crisis. The disclosure rules requiring periodic filing of Form 15E to reflect repurchase activities and the rating agencies' obligation to publish the representations, warranties and related remedies applicable to a transaction have helped to make the market more transparent. Furthermore, the USA also has a long tradition of enforcing violations of the securities laws, including violations of the general anti-fraud rule, 10b-5, which applies to untrue statements of a material fact or omissions of any material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading. As the reporting standards have tightened, the amount of information that investors expect – even in a private placement – has increased and, with that, the need to ensure that the disclosure is correct and sufficiently complete to avoid any 10b-5 liability. Regulation AB II has further enhanced the disclosure and enforcement regime for registered ABS offerings through requirements to provide significant additional disclosures as well as through requirements that facilitate communications among investors relating to enforcement of their rights under the transaction documents.

7. Roles and Responsibilities of the Parties

7.1 Issuers
ABS issuers are typically trusts or other special-purpose entities that are primarily engaging in activities relating to acquiring, holding and disposing of the relevant financial assets in accordance with the transaction documents, issuing notes and pledging the issuer's assets to the trustee for the benefit of the noteholder, making payments on the notes and engaging in related activities. Typically, a servicer or administrator will act on behalf of the issuer in connection with the issuer's performance of its obligations under the transaction documents.

7.2 Sponsors
Sponsors are typically in the business of originating, servicing and/or selling the relevant underlying financial assets. The sponsor is the person who organises and initiates an ABS transaction by selling or transferring assets, directly or indirectly, including through an affiliate, to the issuer. The sponsor effectively will be the entity responsible for compliance with the Risk Retention Rules and will also be the entity responsible for compliance with other relevant regulatory requirements.

7.3 Underwriters and Placement Agents
Underwriters (including initial purchasers in a 144A transaction) and placement agents are registered broker-dealers responsible for placing the securities issued by the securitisation SPE. In many securitisation transactions, the primary underwriter is also responsible for establishing the relevant securitisation structure and documentation.

7.4 Servicers
Servicers are typically the sponsor or an affiliate of the sponsor operating in the same business as the sponsor. In some securitisations, such as open-market CLOs, the CLO manager may be in the business of acquiring, selling and managing the relevant underlying financial asset. The servicer generally will be obliged to continue to service the relevant securitised assets, typically in line with how such assets are serviced outside a securitisation but subject to additional criteria of the securitisation transaction documents. The servicer typically also produces reports and assists in the collection of delinquent loans and sales of charged-off loans. In securitisations that allow for the purchase, sale or substitution of additional underlying assets after closing, the servicer will also typically be responsible for ensuring that such purchases, sales and substitutions are made in accordance with applicable eligibility criteria and other applicable requirements under the transaction documents.

7.5 Investors
Investors constitute a diverse group. In a typical securitisation the investors will have a right to payment and will also have certain rights to direct the trustee to take enforcement actions, and otherwise direct the trustee in accordance with the terms of the transaction documents. Typically, investors will not have responsibilities per se, although they may be subject to certain deemed representations relating to their eligibility to invest in the securitisation. Investors in unfunded ABS tranches will typically have contingent funding obligations and may be required to provide additional credit support or face replacement if their credit drops below agreed levels.

7.6 Trustees
Trustees typically hold title to the underlying pledged assets and act as communications and payment agents. The trustees also undertake other administrative tasks. Trustees typically avoid taking any discretionary actions and are not required to act except to the extent otherwise expressly provided in the transaction documents. The trustees will also typically require that the transaction documents include strong exculpatory language, protecting the trustee from liability in the absence of gross negligence or wilful misconduct, and the transaction documents will also normally include language that expressly protects the trustee from having to take any action, even upon direction, unless the trustee is adequately indemnified and receives certain documents such as opinions or officer's certificates as are specified in the relevant circumstances in the transaction documents.

The trustees tend to be large banking associations that satisfy relevant regulatory and ratings agency criteria. For example, for registered offerings the Trust Indenture Act contains minimum requirements for a trustee. The same is true for the Investment Company Act and Rule 3a-7 promulgated thereunder. There may be other regulatory concerns in a particular transaction that drives the selection of trustees.

8. Synthetic Securitisations

8.1 Synthetic Securitisation
Synthetic securitisations are permitted in the USA. However, synthetic securitisations were maligned after the Global Financial Crisis – in part because of reported instances of conflicts of interests where synthetic securitisations were used to short the market and in part because synthetic securities were viewed as increasing the leverage and interconnectedness in the market, thereby contributing to magnifying the adverse impact of the crisis. Section 621 of the Dodd-Frank Act added a new Section 27B to the Securities Act, intended to address such conflicts of interest. That provision prohibits underwriters, placement agents, initial purchasers, and sponsors and their affiliates (each a "securitisation participant") from engaging in ABS transactions, including synthetic securitisations, that would involve or result in material conflicts of interest. Section 27B requires implementing rules to be passed within 270 days. However,

although the SEC proposed such rules in 2011, they were never finalised. The interpretative guidance from the SEC in the proposed rule would, in most cases, effectively prohibit synthetic securitisations involving derivatives that would benefit a securitisation participant in the case of losses under the underlying financial assets. Since the typical structure and reason for a synthetic securitisation is for the CDS seller to pay a loss amount to (or purchase the underlying asset from) the CDS protection buyer in the case of a credit event, the net effect of the proposed conflict rules would have been to prohibit banks and other owners of reference assets from participating in synthetic securitisation transactions with respect to such assets, which would have been unworkable.

8.2 Engagement of Issuers/Originators

Synthetic securities allow banks to manage their exposure to a particular asset class while permitting the bank to remain the owner of the underlying asset, consistent with the synthetic securitisation operational criteria as adopted in the USA. Synthetic securitisations also create opportunities to arbitrage different positions and in many instances allow for a much cheaper and simpler way of gaining exposures to illiquid assets than an actual true-sale transfer of such assets. In addition, a synthetic securitisation structure need not be fully funded in all instances, which provides opportunities for a more capital-efficient structure than a fully funded true-sale securitisation structure. These benefits have begun to drive a nascent re-emergence of synthetic securitisations.

8.3 Regulation

Synthetic securitisations are regulated by the SEC, similar to traditional securitisations, in terms of the offering and sale of the securities issued by the SPE and in terms of the Investment Company Act status of the SPE itself. If the derivatives through which the SPE gains the synthetic exposures are deemed to be 'security-based swaps' – which would, for example, typically be the case if the CDS or the total return swap (TRS) referenced a single security, a single loan or a narrow-based security index – then the derivative itself is deemed to be a security regulated by the SEC and as such would not result in material differences from a traditional securitisation in terms of who regulates the synthetic securitisation.

On the other hand, CDSs and TRSs that reference broad-based security indexes or that reference two or more loans are swaps, and as such may subject the securitisation entity to regulation by the Commodity Futures Trading Commission (CFTC) as a commodity pool, in the absence of any available exemption or relief. Similarly, service providers or sponsors of a synthetic securitisation that is deemed to be a commodity pool may also be subject to CFTC regulation and may be required to register as a "commodity pool operator" in the absence of available exemptions or relief.

8.4 Principal Laws and Regulations

The offering of securities in a synthetic securitisation will be governed by the Securities Act, but unlike traditional securitisations will typically not be deemed to be ABS other than for purposes of the (unimplemented) Section 27B of the Securities Act outlined above. ABS are defined in the Exchange Act by reference to securities for which the payments depend primarily on the cash-flows from self-liquidating financial assets. Synthetic securitisations typically utilise credit default swaps to create the relevant synthetic exposures and the SEC does not view CDSs to be self-liquidating because payments on such derivatives are triggered only upon the occurrence of a contingency (ie, default). Synthetic securitisations are typically issued as private placements. The regulations applicable to the offerings of investments in synthetic securitisations will be very similar to the regulations applicable to the offering of investments in traditional securitisations.

However, because synthetic securities generally will not fall within the definition of ABS, they will also not be subject to the Risk Retention Rules that apply in traditional securitisations.

Security-based swaps are regulated under the Securities Act, which in some instances may require such derivatives to clear through an exchange and impose certain conduct rules on security-based swap dealers and "major security-based swap participants." The execution and trading of the underlying derivative may also be subject to various clearing and settlement requirements that may impact the relevant SPE's collateral posting requirements should they apply. If the derivatives entered into by the SPE are "swaps" within the meaning of the Commodity Exchange Act and the rules promulgated thereunder, the SPE would fall within the ambit of CFTC jurisdiction as a "commodity pool" unless it qualifies for an exemption or relief from such designation. If the SPE were to become a commodity pool, it would trigger various reporting, record-keeping, registration, oversight and examination requirements, and other conduct requirements for the commodity pool's "principals" and "associated persons."

Similar to security-based swaps, swaps are also subject to significant regulation that may result in the relevant swap being subject to clearing and settlement requirements that may impact the SPE's collateral posting obligations.

8.5 Principal Structures

The principal structure used for synthetic securitisations, in its simplest form, will be similar to that of a traditional securitisation. However, instead of using the proceeds from the notes issued by the SPE to purchase the underlying financial assets, in a synthetic securitisation the proceeds will instead be invested in permitted investments. The SPE will enter into credit default swaps with one or more counterparties.

The SPE will receive cash-flows equal to the combination of the returns on the permitted investments and the protection premiums paid on the credit default swaps. Upon the occurrence of covered credit events, the SPE will liquidate a portion of the permitted investments and pay the amount required under the relevant CDS to the applicable counterparty. This structure has the benefit of being comparable to a traditional securitisation in all material respects other than the manner in which the exposure to the underlying financial asset is transferred to the SPE.

Unlike true sale structures, synthetic securitisations do not require upfront payments of the full notional amount of the underlying financial assets to effectuate the transfer. As such, it is possible to structure synthetic securitisations that are not fully funded up front. In turn, this provides for a more efficient capital structure. Synthetic securitisations are also sufficiently flexible to allow for arbitrage positions and are a more efficient structure for such positions than entering into long and short positions through traditional securitisations.

8.6 Regulatory Capital Effect

One of the principal reasons for entering into synthetic securitisations is regulatory capital relief. A bank that for various reasons determines that it is unable to transfer certain assets to an SPE as part of a traditional securitisation can still achieve beneficial capital treatment under the Basel III securitisation framework for such assets by means of a synthetic securitisation that satisfies the relevant operational requirements under the Basel rules. As implemented in the USA, the Basel III securitisation framework permits a banking entity to adjust its exposure for risk-weighted capital purposes, potentially down to a risk weight of 20%. The operational requirements for a synthetic securitisation require that the relevant credit mitigant for the exposure the bank has under the synthetic securitisation must be financial collateral, an eligible guarantee or a credit default swap that satisfies the criteria for an "eligible credit derivative." The terms of the synthetic securitisation must not contain terms that, as a result of a deterioration of the underlying exposures, would allow for the termination of the credit protection afforded to the bank, require the bank to alter or replace the underlying exposures to improve its credit quality, increase the bank's cost of credit protection or increase the yield payable to parties other than the bank. The securitisation cannot provide for increases in retained first loss position or credit enhancement provided by the bank after inception. Any clean-up calls must be "eligible clean-up calls" as defined in the Basel rules. Finally, the operational requirements also require the bank to obtain a "well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions."

9. Specific Asset Types

9.1 Common Financial Assets

According to data provided by SIFMA, the total outstanding of US asset-backed and mortgage-backed securities as of the end of November 2018 was approximately USD10.11 trillion. The vast majority of this market consists of agency mortgage-backed securities. The issuance of agency mortgage-related securities for 2017 amounted to approximately USD1.71 trillion and year-to-date (YTD) through November 2018 totalled about USD1.5 trillion. The corresponding numbers for non-agency mortgage-related issuance were USD224.0 billion and USD227.3 billion.

ABS issuance for 2017 totalled about USD559.2 billion and for year-to-date through November 2018 totalled USD417.7 billion. Of this, CDO and CLO issuances took the top spot, with issuances of about USD303.1 billion for 2017 (USD170.1 billion YTD through November 2018); followed by auto (about USD101.2 billion for 2017 and USD102.7 billion YTD through November 2018); credit cards (about USD43.3 billion for 2017 and USD30.6 billion YTD through November 2018); equipment (about USD24.4 billion for 2017 and USD24.5 billion YTD through November 2018); and student loans (about USD16 billion during 2017 and USD18 billion YTD through November 2018). The issuance of securitisations in various other asset classes (such as mixed categories, tax liens, trade receivables, boat loans and others that do not fit within one of the prior categories) totalled about USD71.0 billion in 2017 and USD71.8 billion YTD through November 2018.

9.2 Common Structures

Medium and Longer-term Consumer Credit

A common structure used in the securitisation of retail automobile loans, student loans and other consumer loans is a two-tiered structure whereby various originators of the loans (typically affiliated with the securitisation sponsor) will sell loans to a depositor pursuant to a true-sale purchase agreement. The depositor will be an SPV, typically an LLC, structured to be bankruptcy-remote from the sponsor, the originators and its affiliates.

The depositor, in turn, will typically sell the loans to an issuance trust pursuant to a sale agreement. The issuance trust will typically be a statutory trust where the depositor will be the sole beneficiary. The issuance trust will typically not be structured to be bankruptcy-remote from the depositor, but the trust is structured to be bankruptcy-remote from the originators, the sponsor and their affiliates other than the depositor.

The issuer trust will often, but not always, be wholly owned by the depositor, which allows the issuer trust to be a disregarded entity for tax purposes. Where there is more than one certificate-holder, the trust will typically be treated as a partnership for tax purposes, which will require certain additional safeguards to ensure that the trust does not become treated as a publicly traded partnership that is subject to entity-level tax similar to a corporation.

The issuer trust will enter into an indenture, which will have an indenture trustee acting for the benefit of the ABS noteholders. The issuer trust will typically rely on Rule 3a-7 for its Investment Company Act exemption and the indenture will typically include limitations on investors in the various asset classes consistent with the requirements of Rule 3a-7. In addition, where the ABS securities are offered pursuant to a registered offering, the indenture will contain revolving period limitations and other restrictions consistent with the requirements of Reg AB II.

The issuer trust will typically enter into an administration agreement with the sponsor or an affiliate that will act on behalf of the owner trustee in the issuer trust in most actions and will also engage a servicer to service the relevant underlying assets. Often the sponsor, the servicer and the administrator are one and the same entity.

Credit Cards and Other Short-Duration Assets

Typically, these securitisations are structured such that the various accounts that may become subject to securitisations are transferred to a master trust in a true sale/true contribution as and when the receivables are created. Typically the transferor is the bank issuing the credit card, acting as sponsor and depositor. The master trust issues collateral certificates that represent undivided interests in the relevant master trust. The depositor will receive a certificate, as will each relevant issuance trust. The issuance trust will issue notes under an indenture, similar to other asset-backed securitisations, and will use the proceeds to increase its amount of the master trust collateral certificate, with a corresponding reduction in the depositor's ownership of the collateral certificates.

Agency Pass-Through Securities

Typically, the relevant agency will enter into an agreement with one or more originators (depending on the product) and agree to acquire loans that satisfy the origination criteria for the relevant agency or GSE to guarantee the loan and certain other criteria (such as interest rate and duration). These agreements are typically made in the TBA market such that prices and delivery amounts are determined in advance, with the pool of mortgage loans to be delivered within a specified number of months in the future (depending on the TBA contract).

These mortgage loans are then pooled and the originator receives back a trust certificate reflecting a corresponding undivided interest in the pool.

These pass-through certificates can, in turn, be used to create securitisations with more customised cash-flows.

CLOs

Typically, CLOs will acquire syndicated loans pursuant to standard form purchase agreements. The ramp-up of a CLO will typically take place in three stages:

- an initial, warehousing stage, where assets are sold into a warehousing entity, which can be the same CLO entity that subsequently will issue the relevant ABS (if the warehouse is a separate entity, it will typically be merged into the CLO issuer at closing);
- a pre-closing period, during which the CLO has priced but not yet closed, where the CLO will continue to acquire additional loans according to the specified criteria; and
- a post-closing revolving period, when trading into and out of loan positions will continue pursuant to the management strategy of the CLO manager and the restrictions and eligibility criteria specified in the CLO transaction documents.

CLOs typically also include provisions that permit the most subordinated class of CLO securities to direct or approve the refinancing of one or more classes of rated CLO securities after a specified non-call period. CLOs also often include a repricing feature that similarly permits the CLO to reduce the relevant margin payable with respect to the relevant class of CLO securities by allowing the CLO, following the applicable non-call period, to reduce the margin on the relevant class of securities with the consent of the affected holders coupled with a forced transfer of such securities by non-consenting holders.

The management of the CLO issuer will typically be too active for the CLO to qualify for the Investment Company Act Rule 3a-7 exemption and therefore the CLO will typically be structured with investor restrictions that permit the CLO to qualify under the Section 3(c)(7) exemption available to funds that restricts investors to "qualified purchasers." In addition, the CLO will typically include investment restrictions that permit the CLO to qualify for the loan-only securitisation exemption from the covered fund designation under the Volcker Rule.

The CLO manager will enter into a collateral management agreement with the CLO. Open-market CLO managers are no longer subject to the US risk-retention requirements as a result of the DC Circuit Open Market CLO Decision. However, CLO managers that wish to comply with the EU risk-retention rules in order to increase their investor base, or that are not able to take advantage of the DC Circuit Open Market CLO Decision will also typically enter into an agreement with the CLO to comply with the risk retention requirements. In light of the various restrictions on financing and hedging the retained credit risk, the CLO manager and its ownership of CLO ABS have often been highly structured in a manner that permits for additional funding consistent with the Risk Retention Rules. However, this will be less of an issue for managers of CLOs that are not required to comply with the risk-retention requirements.

The CLO issuer will typically be organised as a Cayman Islands exempt company and will generally seek to avoid becoming subject to filing tax returns in the USA. As such, the CLO issuer will typically ensure that its loan acquisitions are timed and structured such that the CLO will not be viewed as engaged in any US trade or business for purposes of the tax rules.

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