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Securitisation

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Contents

1. Structurally Embedded Laws of General Application p.400

1.1 Insolvency Laws p.400
1.2 Special Purpose Entities p.401
1.3 Transfer of Financial Assets p.403
1.4 Construction of Bankruptcy-Remote Transactions p.404

2. Tax Laws and Issues p.404

2.1 Taxes and Tax Avoidance p.404
2.2 Taxes on SPEs p.405
2.3 Taxes on Transfers Crossing Borders p.405
2.4 Other Taxes p.405
2.5 Obtaining Legal Opinions p.406

3. Accounting Rules and Issues p.406

3.1 Legal Issues with Securitisation Accounting Rules p.406
3.2 Dealing with Legal Issues p.406

4. Laws and Regulations Specifically Relating to Securitisation p.407

4.1 Specific Disclosure Laws or Regulations p.407
4.2 General Disclosure Laws or Regulations p.409
4.3 Credit Risk Retention p.410
4.4 Periodic Reporting p.412
4.5 Activities of Rating Agencies (RAs) p.412
4.6 Treatment of Securitisation in Financial Entities p.413
4.7 Use of Derivatives p.415
4.8 Specific Accounting Rules p.416
4.9 Investor Protection p.416
4.10 Banks Securitising Financial Assets p.416
4.11 SPEs or Other Entities p.416
4.12 Activities Avoided by SPEs or Other Securitisation Entities p.417
4.13 Material Forms of Credit Enhancement p.417
4.14 Participation of Government-Sponsored Entities p.418
4.15 Entities Investing in Securitisation p.418

5. Documentation p.419

5.1 Bankruptcy-Remote Transfers p.419
5.2 Principal Warranties p.419
5.3 Principal Perfection Provisions p.419
5.4 Principal Covenants p.419
5.5 Principal Servicing Provisions p.420
5.6 Principal Defaults p.420
5.7 Principal Indemnities p.420
5.8 Other Principal Matters p.420

6. Enforcement p.420

6.1 Other Enforcements p.420
6.2 Effectiveness of Overall Enforcement Regime p.420

7. Roles and Responsibilities of the Parties p.421

7.1 Issuers p.421
7.2 Sponsors p.421
7.3 Underwriters and Placement Agents p.421
7.4 Servicers p.421
7.5 Investors p.421
7.6 Trustees p.421

8. Synthetic Securitisations p.421

8.1 Synthetic Securitisation p.421
8.2 Engagement of Issuers/Originators p.421
8.3 Regulation p.422
8.4 Principal Laws and Regulations p.422
8.5 Principal Structures p.422
8.6 Regulatory Capital Effect p.422

9. Specific Asset Types p.422

9.1 Common Financial Assets p.422
9.2 Common Structures p.422

1. Structurally Embedded Laws of General Application

1.1 Insolvency Laws

If a debtor becomes subject to bankruptcy proceedings, creditors will, with some exceptions, be automatically stayed from collecting and enforcing against the debtor and any posted collateral. Lifting the stay may be time-consuming and costly and until the creditor has received payment it will be subject to the broad statutory and equitable powers of the bankruptcy court, which could permit the court to take actions such as (i) releasing the creditors rights to excess collateral; (ii) adding additional super-priority debt, pari passu debt or junior debt secured by the collateral; (iii) substituting different collateral for the original collateral; and (iv) rejecting executory contracts. Creditors will also be limited in their ability to exercise rights that trigger off a debtor's bankruptcy or financial condition (so-called ipso facto clauses). Unlike many other jurisdictions where bankruptcy effectively amounts to liquidation proceedings, bankruptcy proceedings in the USA also encompass a workout regime (Chapter 11 bankruptcy). Workouts are highly variable and facts and circumstance specific, which makes it difficult to predict the duration of the stay and the impact on a particular creditor.

Consequently, a key aspect of securitisations is to isolate the issuer and its assets from such bankruptcy risks, typically by causing the issuer to (i) purchase the assets to be securitised in a perfected true sale, (ii) reduce the risk that any bankruptcy proceedings are filed by or against the issuer, and (iii) reduce the risk of the issuer becoming substantively consolidated with any affiliates should they become subject to bankruptcy proceedings. Instead of using a true sale structure to transfer the securitised assets, it is also possible to transfer exposure to such assets using contracts that are exempt from the automatic stay and some of the other more troublesome bankruptcy powers, as is typically done in synthetic securitisations. Each of these elements is further discussed below.

True Sale v Secured Loan

If the transfer of an asset is respected as a sale, then such asset will cease to belong to the seller and therefore the buyer's rights in such assets will typically not be impacted by a subsequent bankruptcy of the seller. On the other hand, if such transfer is treated only as a transfer of a security interest in an asset that otherwise continues to belong to the seller, then a bankruptcy of the seller will subject the buyer to the automatic stay and other bankruptcy powers as described above. In determining whether a transfer is a true sale or a disguised loan, courts look to a number of factors. Importantly, the Uniform Commercial Code (UCC) expressly provides in Section 9-202 that title to collateral is immaterial in making that determination. Courts faced with the question have focused on whether the characteristics are predominantly those of a sale or a secured loan. Not surprisingly, the more numerous the secured loan characteristics, the greater the likelihood that the transaction is viewed as such. Conversely, the more numerous the sale characteristics, the greater the likelihood that a purported sale will be respected as such. However, not all factors are given equal weight in this analysis.

Generally, recourse and collection risk is viewed as the most important factor. The greater the degree of recourse retained by the transferor, the greater the likelihood that the transaction will be deemed a secured loan. Courts have consistently held in the context of receivables that where a seller bears all the risk of non-collection from account debtors, the transaction is a secured loan. On the other hand, representations and warranties limited relating to the quality of the asset at the time of sale are generally viewed as consistent with a sale treatment. Consequently securitisation transactions generally are structured to ensure that delinquency risk is borne by the buyer of the asset, while it is typical for the seller to be responsible if the assets do not satisfy representations made at the time of sale.

A transferor's right to redeem the transferred property is also viewed as negative for the sale characterisation and the same is true where the transferor retains a right to receive any surplus from the asset. Securitisation transactions often do permit some de minimis optional repurchase rights by the seller; for example, in order to comply with applicable collateral diversification requirements. However, the right to effectuate such repurchases is typically limited, in particular as they relate to delinquent or defaulted assets.

A seller's continued administration and control of the assets is another frequently cited adverse factor, particularly if the obligor is not notified of the sale. However, under current market practice, sellers often act as servicer of the sold assets and such continued involvement is generally not viewed as dispositive of the loan or sale characterisation.

The parties' intent is another key factor. However, courts typically de-emphasise the language used in a document and instead consider the intent reflected by the economic substance and actual conduct more relevant.

The courts have also identified a variety of other factors that do not fall within the categories above but may be indicative of a secured loan, including (i) the transferor being a debtor of the transferee on or before the purchase date, (ii) the transferor's ability to extinguish the transferee's rights in the transferred assets by payments or repurchase by the transferor or from sources other than collections on the asset, and (iii) the

transferor's obligation to pay the transferee's collection costs for delinquent or uncollectible financial assets.

Some states have sought to bolster securitisations by restricting recharacterisation of a purported sale transaction. However, there is significant uncertainty around a bankruptcy court's acceptance of such statutes and securitisations are therefore typically structured to comply with the judicially created true sale criteria.

True Sale Opinion

It is common to obtain a true sale opinion in securitisation transactions and such opinion is typically required by rating agencies and accountants. Generally the opinion will describe the salient facts and analyse these facts in light of the factors identified by the courts as relevant to the true sale determination. Typically some factors will support the true sale conclusion, while others, in isolation, may be more consistent with a secured loan treatment. 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 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 Transfer

As noted above, a seller can retain title to a financial asset and still effectuate a true sale. It is therefore possible to effectuate a true sale by means of a participation. This is often an attractive means of transferring the financial asset where it is important for the seller to remain the holder of record, such as where the relevant asset is a revolving loan or a delayed draw commitment.

Also, it is worth noting that the form of consideration for a true sale is not limited to cash. The same true sale analysis applies where the asset is contributed in exchange for equity. However, it is important that the value of the consideration and the transferred assets are reasonably equivalent. A transfer for less than equivalent value is a factor that argues for loan treatment and against true sale treatment. 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 to the outline above. While the FDIC's receivership powers may be broader or different in many important respects to that of a bankruptcy court, the FDIC has promulgated non-exclusive safe harbour regulations that, if complied with, provide additional comfort that a sale will be respected by the FDIC (see 12 CFR Section 360.6).

1.2 Special Purpose Entities

Another important securitisation tool used to isolate the collateral is to establish a special purpose entity (SPE) with narrowly circumscribed permitted activities and separateness provisions that protect against substantive consolidation with its affiliates.

Various rating agencies have promulgated requirements with different levels of detail that provide a useful checklist of required separateness provisions that include protections against:

- incurring unrelated liabilities and otherwise becoming subject to involuntary bankruptcy filings;
- automatic dissolution;
- voluntary bankruptcy filing;
- substantive consolidation;
- incurring additional debt;
- owning unrelated property;
- establishing subsidiaries;
- having employees; and
- becoming subject to entity-level tax liability.

The relevant transaction documents typically include non-petition clauses that restrict involuntary bankruptcy petitions against the issuer. The danger of improperly drafted non-petition language was highlighted by the involuntary bankruptcy petition by junior noteholders against the Cayman Islands CLO issuer Zais Investment Grade Limited VII that resulted in the CLO becoming subject to bankruptcy proceedings in New Jersey.

Protecting the SPE against voluntary bankruptcy filings is more challenging. An outright prohibition against such filings is unenforceable as against public policy. However, the risk of such filings being made is sought mitigated by limiting the risk of the SPE becoming insolvent and appointing independent directors whose affirmative vote is required to effectuate a voluntary bankruptcy filing and by otherwise utilising an entity type that allows for a director's fiduciary duty to be turned off or redirected away from the shareholders of the SPE. The importance of such protections was demonstrated by the General Growth companies' bankruptcy proceedings in 2011 where the directors filed a solvent SPE into bankruptcy based on their fiduciary obligation to their bankrupt parent. Delaware limited liability companies are commonly used entities that allow for such flexibility to turn off or redirect fiduciary obligations.

Provisions that limit an entity's ability to effectuate a voluntary bankruptcy filing are prone to be challenged and there are a

number of cases where such provisions have been found to be unenforceable. While those cases involved protections that were included at the request of creditors during a time of distress and therefore readily distinguishable from a typical securitisation transaction, it is important to avoid using provisions or language that was found to be expressly disallowed in these cases.

In assessing the efficacy of the SPE's bankruptcy protections it is also important to examine the incentives that may exist for pulling the SPE into a bankruptcy. For example, where the assets held by the SPE are financial assets that are not critical for the successful reorganisation of the seller, the incentives will be significantly less than cases where critical assets were sought to be removed from the operating entity at the request of existing lenders. One of the most important such incentive-reducing measures, regardless of the asset class, is to ensure that the securitisation noteholders have a perfected security interest in the relevant assets such that the worst outcome is limited to becoming a secured creditor. If the security interest is not perfected, the debtor could potentially gain access to valuable property against an unsecured bankruptcy claim, which creates a much greater incentive for other creditors to seek to capture such assets.

The independent director(s) also provide(s) important protection against dissolution of the SPE, in part by ensuring that their vote would be required for any act that results in dissolution and in part by providing that such independent director acts as a "springing member" or "springing partner" if there otherwise would be an automatic statutory dissolution due to the SPE not having any members, in the case of an LLC, or not having a general partner or a limited partner, in the case of an LP.

Substantive Consolidation

Substantive consolidation is an equitable doctrine that permits a bankruptcy court to disregard the separateness of an entity that itself is not subject to bankruptcy proceedings from that of a bankrupt affiliate. Substantive consolidation provides an alternative pathway for an SPE to become entangled in its affiliate's bankruptcy proceedings. The analysis is fact-specific and differs somewhat between the various US circuits. There are effectively three lines of circuit-level cases that provide the modern statement of the doctrine.

The Second and Ninth Circuits 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 similar test, 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." In re Owens Corning 419 F.3d 195 (3d Circ 2005) (Owens Corning).

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 a multi-factor analysis. One list of such factors 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
- 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):

- degree of difficulty in segregating and ascertaining individual assets and liabilities;
- presence or absence of consolidated financial statements;
- profitability of consolidation at a single physical location;
- commingling of assets and business functions;
- unity of interests and ownership between the various corporate entities;
- existence of parent or intercorporate guarantees or loans; and
- 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."

Substantive consolidation risk is generally addressed by including mandatory separateness provisions and covenants in the SPE's organisational documents and the transaction documents that are derived from case law, in particular the cases that specify lists of factors to be considered as outlined above.

Substantive Consolidation Opinion

Counsel usually provides a non-consolidation opinion. This is typically 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. 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 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 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

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 personal property that collateralises the relevant secured obligation as well as to outright sales 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. 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. Possession is a permissible means of perfecting a security interest in tangible negotiable documents, goods, instruments, money, tangible chattel paper and certificated securities. 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 security interest perfected by control or possession often has higher priority than a security perfected by other means.

A true sale of chattel paper requires perfection by filing or possession and a UCC filing is required to perfect a security interest in accounts unless 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)).

However, as outlined above, distinguishing a true sale from a secured loan is fact specific and can be difficult. 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, it is common to file a UCC financing statement also against the seller relating to the assets sold to a securitisation entity.

1.4 Construction of Bankruptcy-Remote Transactions

Most derivatives, certain mortgage repo transactions and many securities contracts are protected against the automatic stay and some of the most troublesome bankruptcy powers. These contracts therefore provide the SPE with an alternative to a true sale for obtaining bankruptcy-insulated exposures to financial assets. These types of contracts can therefore be used as a means of transferring exposure to underlying assets to a securitisation as an alternative to a true sale. Synthetic securitisations typically use credit default swaps (CDSs) to transfer such exposure. If the CDS counterparty becomes subject to bankruptcy proceedings, the SPE will have the right to terminate and close out each swap entered into with that counterparty, 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 further protect against adverse impact from a counterparty's bankruptcy.

However, the protected rights are construed narrowly. As such, it is important to carefully determine the enforceability of any clause that is triggered by the counterparty's bankruptcy. 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 priority of payment 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.

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

The immediate goal from a securitisation tax perspective is typically to achieve tax neutrality compared to the tax consequences of a traditional financing. Second, to the extent that the securitisation has tax costs, it is important to identify and appropriately address these 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 intended 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.

Consequently, 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 any equity (or securities deemed to be equity for tax purposes) in such partnerships 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 may also 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. 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 the SEC with broad powers 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 floor plan 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.

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. Shelf registration allows for a more streamlined issuance process than using Form SF-1 and is available if, amongst others, the depositor and each affiliated issuer has been current and, with a few exceptions, timely over the past 12 months in its required Securities Act filings and any required Exchange Act reporting for prior registered securitisations relating to the same asset class.

Applicable criteria to be eligible to register the transaction 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%.

The required provisions of the prospectus for registered ABS offerings include:

- 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.

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 obliged 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.

The required asset-level disclosure must be provided in a standardised format in a tagged XML format and filed on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

Regulation AB II deviates from the typical shelf registration practice of using a base prospectus and a supplemental prospectus, and instead requires the filing of one integrated prospectus.

4.2 General Disclosure Laws or Regulations

The general construct of the Securities Act is that an offer or sale of securities has to be registered or has to be made pursuant to an exemption from registration; ie, a private placement. A security that has been issued in a private placement will typically be subject to resale limitations that may restrict the liquidity of the issued securities. However, for investments in securitisations, the typical investor will be a sophisticated entity that satisfies the criteria for being an "accredited investor" or a "qualified institutional buyer" such that private placements are practicable without a significant adverse pricing impact. In particular, transactions that comply with Rule 144A and Regulation S permit "qualified institutional buyers" and foreign persons to freely sell to other "qualified institutional buyers" or other foreign persons. The distinction between the public (ie, registered) market and the private market is discussed in more detail below.

Only a small portion of new securitisation issuances are made in SEC registered form. 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. Most of the remaining ABS are issued in private placement, typically in a manner that permits resales in compliance with Rule 144A. Excluding Agency securitisations there are about four times as many private placements as there are public offerings of ABS, reflecting about 67% of the dollar value of ABS issuances.

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 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. Rule 10b-5 protects sellers as well as purchasers of securities and is therefore broader than Section 17, which only protects purchasers. However, Rule 10b-5 requires scienter, whereas some claims under Section 17 can be brought on the basis of negligence. Furthermore, Section 10b-5 provides for a private right of action for damages

that Section 17 does not. Consequently 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 willful 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.

In addition, there may be available certain 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.

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.

4.3 Credit Risk Retention

The Dodd-Frank Act introduced a mandate to the SEC and the bank regulatory agencies (Treasury, OCC, Federal Reserve and the FDIC) to promulgate rules that require "securitisers" to retain, generally, not less than 5% of the credit risk of any asset they securitise. The SEC, together with the bank regulatory agencies and the Federal Housing Finance Agency and the Department of Housing and Urban Development (collectively, the Agencies) promulgated final joint risk retention rules in 2014, as set forth in Regulation RR under the Exchange Act (the Risk Retention Rules). The Risk Retention Rules require a "sponsor" or one of its "majority-owned affiliates" to retain the required risk exposure in one of the prescribed forms under the rules. For most securitisations, risk retention may take any of three standard forms:

- vertical risk retention by holding of at least 5% of each class of "ABS interests" issued;
- horizontal risk retention by holding junior most interests in an amount equal to at least 5% of the "fair value" of all ABS interests issued as determined in accordance with US GAAP; and
- "L shaped" risk retention, by holding a combination vertical and horizontal risk retention that adds up to 5%.

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 form of risk retention has 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.

The person required to retain the risk is 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)), 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 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" (id at 77609).

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 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 not expired earlier pursuant to the foregoing.

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 Rules would be the same as its general enforcement authority against those for violation of securities laws and regulations and their "control persons", including permanent or temporary cease-and-desist orders, fines, withdrawal of registrations and restrictions on acting as officers or directors of SEC registered companies and otherwise may strip a person or entity of privileges afforded to registered persons. Any Exchange Act violation could also result in equitable remedies, including the right of rescission. If the violation of the Risk Retention Rules also amounts to a disclosure violation, there could be separate SEC or private action on that basis as discussed in **4.2 General Disclosure Laws or Regulations**.

Wilful violations of the Risk Retention Rules may also give rise to federal or state criminal actions.

The Risk Retention Rules do not provide for substitute compliance by foreign issuers that comply with their own jurisdiction's risk retention requirements. A foreign securitisation may therefore find itself subject to both its own and US risk retention requirements. To limit the extraterritorial impact of the US Risk Retention Rules, they contain a safe harbour exemption that applies to securitisations (i) that are not required to be, and are not, registered under the Securities Act; (ii) for which no more than 10% of the value of ABS interests are sold or transferred to US persons or for the account or benefit of US persons; (iii) for which neither the sponsor or issuer is organised under the laws of the USA or any state; and (iv) where no more than 25% of the assets are acquired from majority-owned affiliates organised under the laws of the USA or from an unincorporated branch or office located in the USA.

It is not typical to obtain legal opinions relating to compliance with risk retention rules, although in some circumstances initial purchasers have required a risk retention memorandum from issuer's counsel analysing compliance with the rules.

4.4 Periodic Reporting

The sponsor must file Form 15-G on EDGAR at the end of any quarter where there has been a repurchase demand made under the transaction documents for breach of representations and warranties. If there have been no such requests, an annual Form 15-G filing must be made 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 under the Exchange Act of an annual report on Form 10-K (with certain modifications as further detailed in Reg AB II) and any updates regarding current events on Form 8-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 not sold in a registered offering.

4.5 Activities of Rating Agencies (RAs)

Sections 15E and 17 of the Exchange Act and the rules promulgated thereunder establish a detailed set of records relating to registered rating agencies, referred to as NRSROs, that must be created and disclosed to the SEC, and mandate that some of this information must be made publicly available free of charge, including the assigned credit rating and any subsequent upgrade or downgrade.

Upon becoming an NRSRO, the rating agency must post specific portions of its Form NRSRO on its website. The NRSROs must also maintain certain records, including in relation to its control structure, 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 each fiscal year.

NRSROs are further 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. Exchange Act Rule 17g-5 divides conflicts of interests into two categories: (i) conflicts that must be disclosed and managed by the NRSRO, and (ii) prohibited conflicts. Finally, the rules prohibit NRSROs from engaging in certain abusive and anti-competitive practices.

As part of the conflict rules in 17g-5, an NRSRO is required to obtain a representation from the issuer, sponsor or underwriter of an asset-backed security that it 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. The purpose of these rules is to allow NRSROs that have not been hired to have access to the same information in real-time that is provided to the hired NRSROs.

Rule 17g-7 provides further transparency by requiring the NRSRO to prepare and disclose a comparison of the asset-level representations, warranties and enforcement mechanisms available to investors that were disclosed in the offering document for the relevant ABS and how they differ from the corresponding provisions in other, similar, securitisations.

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.

4.6 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 do not include the pool requirement. The Basel rules distinguish between "traditional" and "synthetic" securitisations and the relevant transaction has to satisfy both the requirements in the respective definitions as well as the related operational requirements. For a traditional securitisation this includes (i) transfer of all or a portion of the credit risk of any underlying exposure to a third party other than through credit derivatives or guarantees; (ii) the performance of the securitisation depending on the performance of the underlying assets; (iii) all or substantially all of the underlying exposures being financial exposures; and (iv) 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. The operational criteria impose further requirements, including that the exposures are deconsolidated for GAAP purposes, the securitisation does not include any early amortisation provisions and the securitised assets are not revolving or delayed credit exposures, and any clean-up calls have to satisfy certain eligibility requirements.

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. In addition, the synthetic securitisation must satisfy the same criteria as items (ii) and (iii) above for traditional securitisations. The operational criteria for synthetic securitisations impose requirements on the type and terms and conditions of the relevant credit mitigants. In addition, the operational criteria restrict various provisions that give rise to early termination of the transaction or result in an increased price or one of the other enumerated adverse adjustments to the transactions In addition, the capital rules require the bank to obtain a well-reasoned opinion of counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions.

The US bank capital rules do not permit the use of the external ratings-based approach to determine the applicable risk weight. As such, where a US bank cannot apply the internal ratings-based approach, the next fall-back for US banks is the standardised approach, whereas other Basel III jurisdictions may use a ratings-based methodology as an intermediate fall-back position. 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). Resecuritisations are subject to separate risk weight calculations.

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 has previously expressed its concerns about the adverse impact this may have on the secondary market and, consequently, liquidity of securitisations and has also noted the punitive treatment of securitisations under the banks' stress-testing requirements and has 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 is 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 Task Force and its working groups and sub-groups, 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.

4.7 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 syn-

thetic securitisations that would have made such securitisations impracticable in many circumstances. These rules are discussed 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 subject to similar enforcement and penalties as other violations of securities laws, as discussed in **4.2 General Disclosure Laws or Regulations**.

The CFTC has the power to enforce violations of the "swaps" rules pursuant to the Commodity Exchange Act. The Dodd-Frank Act has significantly enhanced the CFTC's anti-manipulation and fraud authority to become similar to SEC's authority under Section 10(b) of the Exchange Act. In addition, the CFTC has expanded anti-avoidance 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).

4.8 Specific Accounting Rules

No information has been provided in this jurisdiction.

4.9 Investor Protection

The primary investor protections follow from the general and specific securities laws described in this chapter. As noted above, transactions that violate the securities laws may be voidable and may give rise to both private and public enforcement.

4.10 Banks Securitising Financial Assets

Banks are highly regulated entities and are also subject to a separate insolvency regime compared to other entities and they are therefore not eligible for bankruptcy protection. The comprehensive regulation applicable to banks results in a parallel regulatory structure in the context of banks sponsoring securitisations that will apply to certain aspects of a securitisation transactions by banks. The most relevant of the securitisation specific rules are (i) the safe harbour provisions of 12 CFR 360.6 relating to transfer of assets in connection with a securitisation, which are discussed in **1.1 Insolvency Laws**, (ii) the Basel III capital requirements discussed in **4.6 Treatment of Securitisation in Financial Entities**, and (iii) the Volcker Rule discussed in **4.12 Activities Avoided by SPEs or Other Securitisation Entities** in particular as it relates to the sponsorship and dealings with "covered funds" within the meaning of the Volcker Rule. The banks are also subject to risk retention but the rules are the same as those applicable to non-banking entities. General banking rules may also come into play when structuring a bank-sponsored securitisation, such as restrictions on affiliate transactions set forth in Sections 23A and 23B of the Federal Reserve Act and the implementation thereof set forth in Regulation W.

4.11 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. For a summary of the tax implications, see **2. Tax Laws and Issues**.

Investment Company Act

Registered investment companies are subject to leverage and capital structure restrictions that are not compatible with securitisations and failure to register when required to do so would render their contracts voidable and potentially give rise to other liabilities. It is therefore important to ensure that the SPE can avail itself of a registration exemption.

As a point of departure, if more than 40% of the SPE's relevant assets (ie, excluding cash or US Treasuries) are securities within the meaning of the Investment Company Act (a broad term that includes loans), the SPE might have to register as an investment company. The exemptions most commonly used for securitisation entities are Investment Company Rule 3a-7, Section 3(c)(5) and Section 3(c)(7). 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, and not for the purpose of capturing market gains or avoiding market losses subject to satisfying certain additional requirements such as an eligible trustee holding or having a security interest in the collateral and receiving periodic turnover of cash collections and any instruments that are not fixed income security or not investment grade securities being held by "qualified institutional buyers" or an affiliate of the issuer or, in the case of below investment grade fixed income securities, "institutional accredited investors."

The Section 3(c)(5) exemption 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) provides a general exemption from registration 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 for the reasons outlined below. 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).

4.12 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" under 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 an exemption from registration under the Investment Company Act other than 3(c)(1) or 3(c)(7) 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."

4.13 Material Forms of Credit Enhancement

The most typical credit enhancements include over-collateralisation, subordination of junior tranches, cash reserves and excess yield on the underlying assets compared to what is needed to service the ABS fixed income securities. The exact levels and types of credit enhancement will depend on the ratings requirements relating to the desired ratings levels in addition to commercial constraints on the securitisation.

Some securitisations 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 the Basel III requirements for giving credit to such guarantees (where the guarantee and the guarantor have to each satisfy eligibility criteria) and the collapse of the monoline insurance companies during the crisis have made such guarantees a less common form of credit enhancement.

4.14 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 affordable residential housing as a core mission. 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 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", and issue securities backed by pools of such loans that are guaranteed by the relevant GSE. 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.

The GSEs traditionally used separate, but similar, platforms to issue their pass-through securities. Starting 3 June 2019 they have transitioned to a single security and single securitisation platform initiative referred to as Uniform Mortgage-Backed Securities (UMBSTM). Each GSE will issue and guarantee separate UMBS. There is no commingling of issuances by different GSEs within a single UMBS but a related product, "Supers", contains a mixture of UMBS, which may contain issuances from both GSEs. 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 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, allows borrowers access to lower, locked-in rates.

Multiclass structures referred to as REMICs (Real Estate Mortgage Investment Trusts) or CMOs (Collateralised Mortgage Obligations) contain a blend of whole-loans and agency pass-through securities that allow for the issuance of securities with short, medium and long-term maturities. Agency securitisations represent the biggest part of the securitisation market by far. According to SIFMA, the aggregate amount of such securitisations issued year-to-date through November 2019 was USD1,519.2 billion in pass-through securities, and USD257.6 billion in CMOs. 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 to the point that even during 2008 and 2009, USD2.89 trillion of agency MBS was issued, while no non-agency securitisations occurred during that period.

4.15 Entities Investing in Securitisation

Investors in securitisations include banks, asset managers, insurance companies, pension funds, mutual funds, hedge funds, high net worth investors and others. A detailed description of the regulatory and other investment drivers for each of these diverse 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. For example, the Basel III capital rules penalise banks that invest below the senior-most position in a securitisation, thereby impacting banks' willingness to invest in mezzanine tranches and below. Banks that are primarily constrained by the leverage ratio, as compared to the risk-weighted assets (RWA) ratio, will also typically view highly rated, but lower-yielding, senior securities as less attractive investments, whereas insurance companies and banks that are primarily constrained by the RWA requirements may find the highly rated senior tranche highly attractive due to the small amount of regulatory capital required. Furthermore, FDIC insured banks may face higher insurance premiums for taking on exposures in securitisations collateralised predominantly by sub-prime and other high-risk assets, which reduces the attractiveness of such securitisations. Insurance companies' capital rules typically are more closely tied to ratings. In addition, insurance regulations typically specify concentration limits for various categories of investments. Insurance companies are also often focused on obtaining longer duration assets. The flexibility to structure securitisations to such needs often makes securitisations particularly attractive to insurance companies.

5. Documentation

5.1 Bankruptcy-Remote Transfers

The typical documentation used to effectuate bankruptcy-remote transfers are (i) asset sale agreements, (ii) participation agreements and (iii) asset contribution agreements. As noted above, title is not dispositve of ownership nor is it necessary for the consideration to be in the form of cash. Contributions to SPEs in exchange for a corresponding increase in the value of any equity held in such SPE would typically also be good consideration. The key is for the relevant documentation to satisfy the true sale criteria discussed in **1.1 Insolvency Laws** (clear identification of sold asset, arm's-length price, representations and warranties as of time of transfer, provisions to ensure perfection of transfer, indemnification and repurchase obligations consistent with true sale, intent for the transaction to be treated as a sale and, if applicable, a back-up security grant consistent with true sale).

Participation agreements 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. 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. 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.

5.2 Principal Warranties

The typical representations and warranties in the sale agreement address (i) satisfaction of specified eligibility criteria when sold, (ii) absence of other encumbrances, (iii) transfer of title, (iv) all required consents and authorisations having been obtained, (v) compliance with law, and (vi) various additional tailored representations.

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 is given to the trustee with provisions that entitle the trustee to obtain directions backed by indemnification. In private deals, the investor vote required for certain actions is primarily a negotiated point, although in registered securitisations these requirements are more prescribed. For example, Reg AB II 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 (i) requirement on filing financing statements; (ii) provisions requiring notification and potentially opinions prior to any changes in names or jurisdiction of organisation; (iii) control over securities accounts, deposit accounts and electronic chattel paper; (iv) delivery or custody of chattel paper, securities and instruments; and (v) representations that the secured party has a perfected security interest. There may also be additional representations relating to the nature and characteristics of the relevant assets. 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 instruc-

tions. 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 provisions relating to reporting, notice and turnover of collections. 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. The agreement will also often contain provisions that define the servicing standard and further addresses the relevant role and any additional obligations of the servicer. Where the securitisation involves securities within the meaning of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), such as CLOs, and involve more active or discretionary management of the collateral, the agreement would also typically address requirements and prohibitions under the Advisers Act and rules promulgated thereunder. In CLOs the servicing agreement is typically referred to as a Portfolio Management Agreement, Collateral Management Agreement or Investment Management Agreement (or similar term).

5.6 Principal Defaults

Securitisation transactions often have three types of default provisions: (i) early amortisation events that cause accelerated pay-downs of principal and terminate reinvestment or revolving periods (temporarily or permanently); (ii) servicer termination events that give rise to a right to terminate the servicer; and (iii) events of default that give rise to a right to accelerate the transaction and exercise remedies, including the ability to enforce against collateral (sometimes with collateral sales being subject to additional voting requirements unless a sale would generate sufficient proceeds to pay the secured notes in full).

Amortisation events typically include (i) shortfalls in reserves or overcollateralisation; (ii) outstanding amounts exceeding applicable collateral borrowing value; delinquencies or charge-offs in excess of specified thresholds; and (iii) servicer termination events.

Events of default usually include (i) failure to pay principal or interest on one or more specified classes of notes after applicable cure periods; (ii) the trustee failing to have a first priority perfected security interest in all (or material portion) of the collateral; (iii) the issuer becoming a covered fund under the Volcker Rule, required to register under the Investment Company Act, or subject to entity-level taxes and potentially other regulatory events; (iv) on the notes when due and failure to pay interest on specified senior note classes, that is continuing after expiration of applicable cure periods; (v) breach of representations or covenants that continue beyond applicable cure periods; and (vi) the issuer becoming subject to insolvency proceedings.

Servicer defaults or termination events typically include failure, after expiry of applicable cure periods, to turn over collections when required to do so; misrepresentations or breach of covenants; insolvency; and, often, the occurrence of an event of default.

5.7 Principal Indemnities

Principal indemnities cover losses due to breach by the seller or servicer of their obligations. In addition, it is typical for trustees to be entitled to indemnification under the transaction for any losses and liabilities that may arise other than as a result of their own gross negligence or wilful misconduct and the trustee will also be entitled to indemnification in connection with any directions given by noteholders.

5.8 Other Principal Matters

Other principal matters typically addressed in the documentation include (i) calculation of the borrowing base, including description of the relevant assets and concentration limits; (ii) collateral repurchase rights and other collateral adjustment matters; (iii) optional and clean-up call rights, including no-call periods and prepayment fees; (iv) establishment of relevant accounts and priority of payment waterfall; (v) investments of collections; and (vi) amendment rights.

6. Enforcement

6.1 Other Enforcements

No information has been provided in this jurisdiction.

6.2 Effectiveness of Overall Enforcement Regime

The enforcement regime of regulators and noteholders has been significantly strengthened following post Global Financial Crisis legislation and rulemaking. USA has a long tradition of regulatory enforcement actions, private rights of action and equitable remedies in the case of securities law violations, as discussed in **4. Laws and Regulations Specifically Relating to Securitisation**. The additional disclosure and transparency requirements and requirements in registered securitisations to enhance communication among noteholders have resulted in a relatively efficient enforcement regime.

7. Roles and Responsibilities of the Parties

7.1 Issuers

Issuers are typically SPEs that are restricted from engaging in activities unrelated to the securitisation and which are typically structured to not have any employers. Instead a servicer or administrator will typically act on behalf of the issuer.

7.2 Sponsors

Sponsors are typically in the business of originating, servicing and/or selling the relevant underlying financial assets and also organising and initiating the ABS transaction and engaging in selection of the relevant assets. 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 ABS securities. In some securitisation transactions they are also responsible for establishing and preparing the relevant securitisation structure and documentation.

7.4 Servicers

Servicers are typically the sponsor or an affiliate of the sponsor. The servicer will typically be responsible for collecting payments under, and ensuring that the issuer complies with, obligations relating to the collateral. In some securitisations, such as CLOs, the servicing role may be quite active, consisting of purchasing and selling relevant assets, participating in any workouts as required and otherwise managing the collateral in accordance with the terms of the transaction. The servicer typically also produces periodic reports and interfaces with the trustee to ensure correct application of funds in accordance with the applicable priority of payments waterfall.

7.5 Investors

Investors constitute a diverse group. In a typical securitisation the investors will have a right to payment and investors will also have certain rights to direct the trustee to take enforcement actions, and the controlling class of noteholders will thereafter have enhanced ability to direct the trustee in accordance with the terms of the transaction documents. Typically, investors will not have responsibilities per se as much as rights, although investors 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

Indenture trustees act on behalf of noteholders and typically also act as trustees for the collateral. Owner trustees typically act on behalf of the holders of any trust certificates issued by an issuer trust (if applicable). Trustees typically have a security interest in the underlying pledged assets and act as communications and payment agents. The trustees also undertake other specified administrative tasks, but typically avoid taking any discretionary actions other than pursuant to a direction from the relevant noteholders. The trustees tend to be large banking associations that satisfy relevant regulatory and ratings agency criteria such as requirements under the Trust Indenture Act (for registered ABS issuances) and as required by Investment Company Act Rule 3a-7 where the issuer relies on that exemption.

8. Synthetic Securitisations

8.1 Synthetic Securitisation

Synthetic securitisations allow the securitisation to gain exposure to financial assets that are not held directly by the securitisation entity and are inherently very flexible structures. Synthetic securitisations were maligned after the Global Financial Crisis – in part because the structure allows for leveraged exposure to the relevant reference asset (such that multiple securitisations may include exposures to the same asset) and also because some synthetic securitisations were used to take short exposures to the securitised assets. The Dodd-Frank Act added a new Section 27B to the Securities Act intended to address some of these conflicts of interest by prohibiting certain securitisation participants 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, no such regulations have been finalised, although the SEC launched a proposed set of rules in 2011. These rules would effectively have ended synthetic securitisations and were never finalised.

8.2 Engagement of Issuers/Originators

Synthetic securities allow the owner of a financial asset to manage its exposure to such financial assets by transferring risks to the counterparty while being permitted to remain the owner of the underlying asset. 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. As noted above, the Basel capital rules

recognise synthetic securitisations as a means of transferring risk and reducing capital charges and these benefits are driving a re-emergence of synthetic securitisations.

8.3 Regulation

The SEC regulates the offer and sale of securities issued by a synthetic securitisation and also any investment company act exemptions the same as in a traditional securitisation. The derivatives invested in by the synthetic securitisation to gain exposure to the underlying assets would be regulated by the SEC if they reference a single security, a single loan or a narrow-based security index. On the other hand, if the derivative references broad-based security indexes or two or more loans or other assets, they would be swaps and subject to regulation by the CFTC, which could result in securitisation also becoming a commodity pool subject to regulation by the CFTC.

8.4 Principal Laws and Regulations

The offering of securities in a synthetic securitisation will be governed by the Securities Act. However, these securities may potentially not be viewed as "asset-backed securities" for purposes of the Exchange Act, in which case the Risk Retention Rules would not apply. The SEC has generally indicated that CDSs, the most common type of derivative used in synthetic securitisations, are not self-liquidating financial assets. Consequently, it may be possible to conclude that the payments to the holders of the issued securities do not depend primarily on the cash flow from self-liquidating assets, in which case the issued securities fall outside the "asset-backed security" definition in the Exchange Act. The nature of the CDS may also impact the Investment Company Act analysis for the issuer.

The execution and trading of the underlying derivative may also be subject to various clearing and settlement requirements that may impact the issuer's collateral posting requirements should they apply. If the derivatives are "security-based swaps", then these questions are regulated by the SEC under the Exchange Act and rules promulgated thereunder. Otherwise, if the derivatives are swaps regulated by the CFTC, then these questions are regulated under the CEA and the rules promulgated thereunder.

If the SPE were to become a commodity pool, then it would trigger various reporting, record-keeping, registration, oversight and examination requirements, and other conduct requirements under the CEA and the rules promulgated thereunder for the entity that is deemed to be the commodity pool operator and its "principals" and "associated persons." Similarly, absent an exemption, each commodity pool must also identify a commodity trading adviser (CTA) that will be required to register with the CFTC and will be subject to regulation under the CEA and the rules promulgated thereunder.

8.5 Principal Structures

In its simplest form, a synthetic securitisation mimics a traditional securitisation other than the manner in which the exposure to the relevant financial asset is transferred to the issuer. Instead of acquiring the underlying financial assets, the issuer will invest the proceeds from issuing securities in permitted investments and sell CDS protection on a particular financial asset. The issuer will receive cash flows from the permitted investments and the CDS protection premiums. If a credit event occurs under a CDS, then the SPE will fund its payment obligation with proceeds from the permitted investments.

Synthetic securitisations do not require upfront payments of the full notional amount of the underlying financial assets to effectuate the risk transfer. As such, it is possible to structure synthetic securitisations that are not fully funded upfront. In turn, this provides for a more efficient capital structure.

8.6 Regulatory Capital Effect

One of the principal reasons for entering into synthetic securitisations is regulatory capital relief as discussed in greater detail in **4.6 Treatment of Securitisation in Financial Entities**. Under the US bank capital regulations, a bank can use synthetic securitisations to reduce its risk exposure to a financial asset while still remaining the holder of record and synthetic securitisations have the potential of reducing the risk weight of any retained senior position down to 20%.

9. Specific Asset Types

9.1 Common Financial Assets

According to data provided by SIFMA, the most common financial assets securitised during 2019 (with approximate YTD issuance numbers through November 2019 in parentheses) are (i) agency mortgage-backed securities (USD1,776.8 billion), (ii) auto (USD116.5 billion), (iii) CLO (USD71.6 billion), (iv) RMBS (USD61.3 billion), (v) CMBS (USD49.6 billion), (vi) equipment leases (USD31.1 billion), (vii) credit cards (USD20.1 billion), (viii) student loans (USD14.1 billion) and (ix) other assets (USD48.3 billion).

9.2 Common Structures

Common structures used for the various types of securities outlined above, include the following.

- (i) Pass-through securitisations, which are used in agency guaranteed securitisation and are described in more detail in **4.14 Participation of Government Sponsored Entities**.
- (ii) A double SPE structure where the entity that originates the relevant financial assets (or its affiliate) acts as sponsor, servicer and administrator for the securitisation. One

SPE acts as depositor (typically structured as an LLC) and the other SPE is the issuer (typically structured as a trust). This structure is typically used for retail auto loans, equipment leases, student loans, consumer loans and a number of other asset classes. The issuer trust will typically issue notes to investors and trust certificate(s) to the depositor. To the extent such securitisations are registered, they have to comply with the Regulation AB II requirements described in **4.1 Specific Disclosure Laws or Regulations** and otherwise the general disclosure requirements described in **4.2 General Disclosure Laws or Regulations** apply. Student loans originated under the Federal Family Education Loan Program (FFELP) benefit from a government guarantee and securitisations of such loans will therefore have a reduced risk retention requirement of between zero and 3% depending on the level of the guarantee.

- (iii) A titling trust structure, which is typically used in auto lease securitisations and other lease transactions relating to titled goods. In this structure a titling trust is established to originate the lease and hold title to the leased assets. Instead of selling the assets and leases to be securitised to a particular issuer, the titling trust segregates such leases and assets and issues special units of beneficial interests (SUBIs) that represent the interest in such segregated pool. The structure is otherwise typically similar to the two-tier structure described in clause (ii) above. The issues and regulations are similar to the general securitisation structure in clause (ii) securitisations, but the titling trust may require additional analysis for purposes of the Investment Company Act exemption compared to the other entities in the structure.
- (iv) Master trust structures, which are typically used in dealer floor plan securitisations and credit card securitisations. The credit from the master trust is revolving in the sense that as the dealer inventory is sold or the credit card customer repays their balance, as applicable, funds are paid to the master trust. These funds are used to service interest and principal on the issued securitisation notes and are otherwise available to acquire new receivables or loans, as applicable. The structure allows for multiple series of securities to be issued that all share in assets of the master trust. Each series of notes typically has a revolving period during which no principal is paid on the notes, with the notes paying down once the amortisation period starts. The structure also allows for some series to be in their revolving period while other series are in their amortisation period. The master trust receives the proceeds from the repaid loans and uses those proceeds in part to pay interest and principal on the issued notes.
- (v) CLO-type structures. The CLO is actively managed and will acquire and maintain a diversified pool of underlying loans that is managed to conform to a number of concentration limits for the pool with the goal of maximising return while maintaining the required pool diversification and other relevant transaction criteria. The CLO is actively managed. As noted in **4.12 Activities Avoided by SPEs or Other Securitisation Entities**, this has impacts on the Investment Company Act and Volcker Rule analysis. Open-market CLOs will not be subject to US risk retention requirements, as discussed in **4.3 Credit Risk Retention**. The CLO issuer will typically be organised as a Cayman Island company and structure its loan acquisitions in a manner that avoids it being engaged in any US trade or business, as discussed in **2. Tax Laws and Issues**.

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