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Securitisation 2024

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USA: Law & Practice
Bjorn Bjerke and Corey Reis
Shearman & Sterling LLP

USA

Law and Practice

Contributed by:
Bjorn Bjerke and Corey Reis
Shearman & Sterling LLP

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Authors

Bjorn Bjerke is a partner in the finance practice at Shearman & Sterling in the New York office. He represents lenders, borrowers, managers and investors in a range of complex financing arrangements across a wide spectrum of asset classes, including securitisations and other structured financings, various shared collateral and second lien structures, repo facilities, commodity, equity, credit and fund-linked derivatives, subscription lines, and a variety of funding arrangements. He also has extensive experience representing investors, creditors and managers in complex restructurings, workouts and acquisitions of distressed and non-performing assets. He is involved in all aspects of deal structuring, negotiation and documentation.

Corey Reis is a senior associate in the finance practice at Shearman & Sterling in the New York office. He focuses his practice on advising financial institutions and corporate borrowers in a broad range of leveraged and structured finance transactions, including securitisations and structured financings, asset-based lending and warehouse facilities, direct lending, acquisition financings and refinancings, restructurings and private banking transactions and high-yield debt issuances.

Shearman & Sterling LLP

599 Lexington Avenue
New York
NY 10022-6069
USA

Tel: +1 212 848 4000
Fax: +1 646 848 4607
Email: bjorn.bjerke@shearman.com
Web: www.shearman.com

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1. Specific Financial Asset Types

1.1 Common Financial Assets

According to data provided by the Securities Industry and Financial Markets Association (SIFMA), the most commonly securitised financial assets are:

- agency MBSs;
- auto;
- commercial loans;
- non-agency residential mortgages;
- commercial mortgage loans;
- equipment leases;
- credit cards; and
- student loans.

1.2 Structures Relating to Financial Assets

Common structures used for the various types of securities previously outlined (see **1.1 Common Financial Assets**) include the following.

Pass-Through Securitisations

These are used in agency-guaranteed securitisation and are described in more detail in **4.12 Participation of Government-Sponsored Entities.**

Double Special Purpose Entity (SPE) Structures

In this structure, one SPE acts as the depositor (typically structured as a limited liability company – LLC) and the other SPE is the issuer (typically structured as a trust). It 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 that such securitisations are registered, they must comply with the Reg 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 0% and 3%, depending on the level of the guarantee.

Titling Trust Structures

This structure is typically used in auto lease securitisations and other lease transactions relating to titled goods. 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 previously described. The issues and regulations are similar to the general securitisation structure in double SPE structure securitisations, but the titling trust may require additional analysis compared to the other entities in the structure, for the purposes of the Investment Company Act exemption.

Master Trust Structures

These 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 these in part to pay interest and principal on the issued notes.

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. As noted in **4.11 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 will structure its loan acquisitions to avoid being engaged in any US trade or business, as discussed in **7. Tax Laws and Issues**.

1.3 Applicable Laws and Regulations

The principal laws and regulations that have a material effect on US securitisation structures are:

- the Securities Act of 1933 (“Securities Act”);
- the Securities Exchange Act of 1934 (“Exchange Act”);
- Regulation AB, as significantly revised and updated in 2014 (“Reg AB II”);
- the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”);
- Regulation RR;
- the Volcker Rule;
- the Investment Company Act of 1940 (“Investment Company Act”);
- SEC Rule 192 under the Securities Act and Dodd-Frank Act (“Rule 192”); and
- the US Bankruptcy Code.

1.4 Special-Purpose Entity (SPE) Jurisdiction

Delaware is the most common organisational jurisdiction for onshore SPEs, due to:

- its market familiarity as a leading corporate jurisdiction;
- ease and low cost of SPE formation and maintenance;
- established body of organisational law;
- stable and predictable legal environment and experienced and sophisticated judicial system;
- deep bench of experienced law firms and legal practitioners, and legislature that is generally responsive to market developments;
- contractual freedom;
- management flexibility;
- ability to utilise different limited liability structures such as statutory trusts and LLCs;
- tax advantages; and
- special bankruptcy remoteness features, such as the ability to contractually restrict fiduciary duties in the SPE's organisational documents.

The most common organisational jurisdictions for offshore SPEs, which are often used in the fund finance and CLO space, are the Cayman Islands, and to a lesser extent, Bermuda. The primary advantages of Cayman and Bermuda include:

- ease and low cost of SPE formation and maintenance;
- their established body of organisational law;
- their stable and predictable legal environment;
- a deep bench of experienced law firms and legal practitioners who may also act as independent directors; and
- tax advantages, including:
  - (a) the ability for US-owned SPEs to avoid entity-level taxation; and
  - (b) the ability to comply with FATCA disclosure and reporting rules and so avoid FATCA withholding taxes.

1.5 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 asset-backed 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.

2. Roles and Responsibilities of the Parties

2.1 Issuers

Issuers are typically SPEs that are restricted from engaging in activities unrelated to securitisation.

2.2 Sponsors

Sponsors are typically in the business that generates the relevant underlying receivables or other financial assets, and will typically organise and initiate the ABS transaction and engage in selection of the relevant assets. The sponsor is responsible for compliance with risk retention and other relevant regulatory requirements.

2.3 Originators/Sellers

Originators generate and/or own the underlying receivables or other financial assets that are to be securitised, and transfer them to the SPE. The obligations arising with respect to such receivables/financial assets are originally owed to an originator or are acquired by a seller before the transfer to the SPE takes place.

Originators include government-sponsored entities (GSEs), captive financial companies of the major auto manufacturers, other financial companies, commercial banks, building societies, manufacturers, insurance companies and securities firms.

2.4 Underwriters and Placement Agents

Underwriters (including initial purchasers in a 144A transaction) and placement agents are registered broker-dealers responsible for placing the ABS. In some securitisation transactions they are also responsible for establishing and preparing the relevant securitisation structure and documentation.

2.5 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, the 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 the correct application of funds in accordance with the applicable priority of payments waterfall.

2.6 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. 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, 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.

2.7 Bond/Note Trustees

Indenture trustees act on behalf of noteholders. Owner trustees typically act on behalf of the holders of any trust certificates issued by an issuer trust (if applicable). Trustees typically 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.

2.8 Security Trustees/Agents

Security trustees/agents hold a security interest in the underlying pledged assets on behalf

of noteholders, and possess or have control of underlying pledged assets on behalf of noteholders in cases where possession or control is required to perfect such security interest.

The firm acting as the bond/note trustee for an issuance typically also acts as a security trustee/agent.

3. Documentation

3.1 Bankruptcy-Remote Transfer of Financial Assets

The typical items of documentation used to effectuate bankruptcy-remote transfers are:

- asset sale agreements;
- participation agreements; and
- asset contribution agreements.

Title is generally not dispositive 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 **6.1 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 limiting repurchase and indemnification obligations consistent with true sale, specifying the intent to treat the transaction 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 Federal Deposit Insurance Corporation (FDIC) has promulgated non-exclusive safe harbour provisions for participations involving covered banking entities in 12 CFR 360.6 which, if complied with, provide additional comfort that the FDIC, when acting as conservator or receiver, will respect such participations as an assignment.

3.2 Principal Warranties

The typical representations and warranties in the sale agreement address:

- satisfaction of specified eligibility criteria when sold;
- absence of other encumbrances;
- transfer of title;
- all required consents and authorisations having been obtained;
- compliance with the law; and
- 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.

3.3 Principal Perfection Provisions

Typical perfection provisions include:

- a requirement on filing financing statements;
- provisions requiring notification and potentially opinions prior to any changes in the name or jurisdiction of the organisation;
- control over securities accounts, deposit accounts and electronic chattel paper;
- delivery or custody of chattel paper, securities and instruments; and
- 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.

3.4 Principal Covenants

The principal covenants in a securitisation transaction vary, based on the relevant document and the type of securitisation. The covenants will typically address payment obligations, collateral maintenance and perfection obligations, rights and related procedures concerning adding and removing underlying assets, reporting obligations, and various negative covenants intended to maintain the integrity of the securitisation. In addition, there will typically be separate covenants relating to the trustees' obligations to act, and rights not to act, in accordance with instructions.

Enforcement is usually a combination of events of default under the indenture, which gives the noteholders the right to direct the indenture trustee to take enforcement actions, and servicer defaults, which give the specified class or classes of noteholders rights to replace the servicer.

3.5 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 the 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 address 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 ("Advisers Act"), such as CLOs, and it involves 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).

3.6 Principal Defaults

Securitisation transactions often have three types of default provisions:

- early amortisation events that cause accelerated pay-downs of principal, and terminate

reinvestment or revolving periods (temporarily or permanently);
- servicer termination events that give rise to a right to terminate the servicer; and
- 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 consent requirements, unless a sale would generate sufficient proceeds to pay the secured notes in full).

Amortisation events typically include:

- shortfalls in reserves or over-collateralisation;
- outstanding amounts exceeding the applicable collateral borrowing value;
- delinquencies or charge-offs in excess of specified thresholds; and
- servicer termination events.

Events of default usually include:

- failure to pay principal or interest due on specified classes of notes after applicable cure periods;
- the trustee failing to have a first-priority perfected security interest in all (or a material portion) of the collateral;
- 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;
- breach of representations or covenants that continue beyond applicable cure periods; and
- the issuer becoming subject to insolvency proceedings.

Servicer defaults or termination events typically include:

- failure, after expiry of the 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.

3.7 Principal Indemnities

Principal indemnities cover losses due to a 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.

3.8 Bonds/Notes/Securities

The primary documentation setting forth the terms of the asset-backed securities or loans in a securitisation are:

- indentures or note purchase agreements, in the case of bonds or notes;
- trust agreements, in the case of trust certificates and equity tranches; and
- credit agreements, in the case of loans.

These agreements will typically set forth key economic, structural and payment terms, such as maturity, coupon, payment dates, the payment waterfall, and borrowing base definitions and concentration limits, as well as transfer limitations. Indentures, note purchase agreements and credit agreements will also include covenants and defaults applicable to the issuer and securitised pool, and set forth the voting rights

of noteholders. Trust agreements will specify the governance of the issuer.

3.9 Derivatives

Outside synthetic derivatives, the most commonly used derivatives are interest and currency exchange derivatives in various forms used to hedge interest and currency risk. For synthetic securitizations, various forms of credit derivative swaps (CDS) are used to transfer the credit risk of the relevant reference portfolio.

3.10 Offering Memoranda

Public offerings of securities: The Securities Act requires the filing with and approval by the SEC of a registration statement and delivery of a written prospectus to potential investors that satisfies the disclosure requirements discussed under **4.1 Specific Disclosure Laws or Regulations**.

Private placements of securities: While not legally required, market practice (and the internal policy of many arrangers) is to deliver an offering memorandum to potential investors that to the extent practicable seeks to comply with, the disclosure requirements applicable to registered offerings, other than asset-level disclosures. See also **4.2 General Disclosure Laws or Regulations**.

Exceptions: Offering memoranda are not typically prepared in securitisations where the SPE's obligations are in the form of loans, or where the securities are privately placed to a small number of sophisticated investors, typically in conjunction with a more bespoke transaction.

4. Laws and Regulations Specifically Relating to Securitisation

4.1 Specific Disclosure Laws or Regulations

Securitisation disclosure requirements are in part governed by generally applicable securities laws, and in part by some ABS-specific requirements. The principal laws that govern securities-related disclosures are the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Securities Act is the principal law governing the offer and sale of securities, and the Exchange Act provides the SEC with broad powers to regulate various market participants and prohibit 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:

- disclosure of the form and determination of retained risk as specified in the risk retention rules;
- 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; and
- disclosure requirements for communications with rating agencies, which, among others, require all information provided to hired Nationally Recognized Statistical Ratings Organizations (NRSROs) in relation to the initial credit rating or any ongoing credit surveillance to be posted to a password-protected website, referred to as the 17g-5 website.

Registered ABS offerings are subject to additional disclosure requirements as set forth in Regulation AB, which 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 includes expanded asset-level disclosure requirements for registered offerings of securities backed by specified asset classes that 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 information must be published at least three days prior to bringing a covered securitisation to market.

Reg AB II enables the SEC to extend the asset-level disclosure requirements to 144A private placements and to additional asset classes. However, the SEC has to date not done so, and the Treasury has recommended against such expansion.

Reg 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. 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.

Reg 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 unless made pursuant to an available exemption – 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, 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.

Only a small minority of new ABS issuances are made in SEC registered form. About 90% of the US securitisation market consists of mortgage-backed securities that were 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 placements, typically in a manner that permits resales in compliance with Rule 144A.

Agency securities and private placements are not subject to ABS-specific disclosure requirements other than the disclosure requirements relating to risk retention, repurchase requests, the third-party due diligence disclosure and rating agency communication requirements. However, such securities offerings generally will look to, and to the extent practicable seek to comply with, the disclosure requirements applicable to registered offerings. However, asset-level disclosures of the level of detail required in Reg AB II offerings are not commonly included in private placements.

4.3 Credit Risk Retention

The Dodd-Frank Act introduced a mandate to the SEC and the bank regulatory agencies to promulgate rules requiring "securitisers" to retain credit risk, which are generally the same but codified in the relevant sections under the Code of Federal Regulations (CFR) for the relevant regulator. For the SEC, the risk retention rules are codified as "Regulation RR" in 12 CFR part 373.

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; and
- "L-shaped" risk retention, by holding a combination vertical and horizontal risk retention that adds up to 5%.

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.

Notably, the DC Court of Appeals ruled in 2018 that subjecting managers of open-market CLOs to the Risk Retention Rules exceeded the statutory authority under Section 941 of the Dodd–Frank Act and consequently such CLOs are currently not subject to the risk retention requirements.

The Exchange Act allocates enforcement authority for the risk retention rules 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.

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 agencies may also impose civil monetary penalties that can range between USD5,000 and USD1 million per day, and it 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 in 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.

4.4 Periodic Reporting

The sponsor must file Form 15-G on EDGAR at the end of any quarter in which 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 attesting 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 subject to additional reporting requirements, including:

- annual reports on Form 10-K (with certain ABS-specific modifications specified in Reg AB II);
- current events on Form 8-K; and
- Issuer Distribution Reports on Form 10-D.

Given that privately placed ABS are not likely to be so widely held that these requirements are triggered, they will, as a practical matter, only apply to securities sold in a registered offering.

Broker-dealers may be restricted from providing price quotations for private debt securities by virtue of Rule 15c2-11 unless certain periodic information and information about the issuer and the offering is made available to the public in a manner that complies with the SEC's no-action letter issued on 30 November 2022. That letter postpones the requirement to comply with the rule until 4 January 2025 subject to satisfying certain requirements with respect to the issuer or the securities. As such, broker-dealers can continue to provide quotations for ABS offered under Rule 144A if they reasonably believe that the issuer will provide the information specified in Rule 144(d)(4) upon request. Such information would normally be "a very brief statement of the nature of the business of the issuer and the products and services it offers; and the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available)." However, in the Rule 144A adopting release, the SEC noted with respect to asset-backed securities that: "Instead of the financial statements and other information required about issuers of more traditional structure, the Commission would interpret the information requirement to mandate provision of basic, material information concerning the structure of the securities and distributions thereon, the nature, performance and servicing of the assets supporting the structures, and any credit enhancement mechanism associated with the structure."

4.5 Activities of Rating Agencies

Registered rating agencies, referred to as NRSROs, are regulated by the SEC. Sections 15E and 17 of the Exchange Act and the rules promulgated thereunder establish a detailed set of records 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.

An NRSRO must:

- post specific portions of its Form NRSRO registration on its website;
- maintain certain records, including in relation to its control structure, for three years;
- furnish certain financial reports, including audited financial statements and an annual certification, to the SEC;
- maintain and enforce written policies and procedures to prevent misuse of material non-public information and to address conflicts of interest; and
- abstain from engaging in certain abusive or anti-competitive conduct.

Exchange Act Rule 17g-5 divides conflicts of interest into two categories:

- conflicts that must be disclosed and managed by the NRSRO; and
- prohibited conflicts.

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 real-time basis information any of them provides to any hired NRSRO in connection with the initial credit rating or subsequent credit surveillance to a password-protected website. The purpose 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 has the power to enforce 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. 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 minimum risk weight that will be given to a securitisation exposure is 20%. Re-securitisations are subject to separate risk weight calculations.

The USA also does not include ABS among high-quality liquid assets (HQLA) in which a bank may invest to cover for its projected net cash outflows over a 30-day period (in the case of the liquidity coverage ratio).

In July 2023, US banking regulators released their proposal for implementing Basel III "Endgame" risk-based capital requirements in the US ("US B3E"). US B3E includes important changes

to the calculation of credit risk weights for securitization exposures, as well as a new operational risk capital charge on certain fees and commissions. These changes would often require banks investing beyond the senior most securitization tranche to hold significantly more regulatory capital for securitised assets than what is required under the current Basel III rules or in other Basel III "Endgame" proposals made by banking regulators in other developed economies. US market participants are concerned that the implementation of US B3E would reduce the ability of banks to participate in the loan securitisation market or to make markets in securitisation bonds. On the other hand, US B3E continues the favorable capital treatment of senior-most securitisation exposures while otherwise increasing the capital requirements for many other bank exposures, thereby incentivizing increased use of securitisation structures.

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 specific RBC formula varies depending on the primary insurance type and focus on asset risk, underwriting risk and other risk. The formulae are focused on capturing the material risks that are common for the particular insurance lines of business.

The NAIC has its own credit rating scale that largely ties to ratings from NRSROs, except for an alternative methodology applied to non-agency RMBSs and CMBSs. As such, the mapping of ABS assets to an NAIC rating will often dictate the attractiveness of a particular asset-backed security for an insurance company.

4.7 Use of Derivatives

Title VII of the Dodd-Frank Act

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.

Regulatory Authorities

The regulatory authority is primarily divided between the Commodity Futures Trading Commission (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, 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 the 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.

For example, the CFTC has issued no-action letters exempting certain securitisation entities, which are operated consistent with SEC Regulation AB or Investment Company Act Rule 3a-7, from the definition of commodity pool. To be eligible for the relief provided under these no-action letters, the securitisation issuer must:

- hold primarily self-liquidating assets;
- make payments based on cash flows and not based on changes in the issuer's assets;
- not acquire or sell assets primarily for the purpose of realising market gains or minimising market losses; and
- only hold derivatives for uses permitted under Regulation AB, such as credit enhancement and to alter the payment characteristics of the cash flow.

The CFTC has also issued various interpretations that allow certain securitisation SPEs that are wholly owned subsidiaries of non-financial entities to avail themselves of certain exceptions from otherwise applicable clearing and margin requirements available to non-financial end users.

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, in November 2023, the SEC finalised Securities Act Rule 192, intended to address conflicts of interest inherent in synthetic securitisations. Under Rule 192, a "securitization participant" (ie, underwriters, placement agents, initial purchasers or sponsors of asset-backed securities (including synthetic ABS) and certain of their subsidiaries and affiliates) may not directly or indirectly, before a year has passed after the closing of the sale of the relevant ABS, engage in any transaction that would involve or result in any "material conflict of interest" (as defined by the SEC) between the securitisation participant and an investor in such ABS. A material conflict of interest occurs if the securitisation participant engages in a "conflicted transaction" for which "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision whether to retain the ABS". Rule 192 provides for a number of exceptions, including for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities. Compliance is required for any ABS offering closing 18 months or more after the rule's publication.

Enforcement and Penalties for Non-compliance

Violations of rules pertaining to security-based swaps 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. Violations of the "swaps" rules promulgated by the CFTC will be subject to enforcement and penalties by the CFTC. Furthermore, the CFTC's authority to penalise manipulation and fraud is similar to the SEC's authority under Section 10(b) of the Exchange Act.

In addition, the CFTC has anti-avoidance authority to treat transactions that are wilfully structured to evade the requirements of the Dodd–Frank Act as swaps transactions, 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 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, to writs or orders mandating compliance, to fines. 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 of up to USD1 million or imprisonment for up to ten years, or both, together with the cost of prosecution (see CEA Section 13).

4.8 Investor Protection

The primary investor protections follow from the general and specific securities laws described in this chapter. As noted in **4.7 Use of Derivatives**, transactions that violate the securities laws may be voidable and may give rise to both private and public enforcement.

4.9 Banks Securitising Financial Assets

Banks are highly regulated entities and are also subject to a separate insolvency regime compared to other entities. 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 transaction by banks. The most relevant of the securitisation-specific rules are:

- the safe harbour provisions of 12 CFR 360.6 relating to transfer of assets in connection with a securitisation, which are discussed in **6.1 Insolvency Laws**;
- the Basel III capital requirements and US B3E proposal discussed in **4.6 Treatment of Securitisation in Financial Entities**; and
- the Volcker Rule discussed in **4.11 Activities Avoided by SPEs or Other Securitisation Entities**.

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.

4.10 SPEs or Other Entities

Organisational Forms of SPEs Used in Securitisations

SPEs used in securitisations can theoretically take almost any organisational form, including an LLC, a corporation, a trust or a partnership. However, as a practical matter, SPEs organised in the USA overwhelmingly tend to be organised as an LLC 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:

- the relevant laws relating to the relevant form of organisation in its jurisdiction of formation;
- the applicable tax laws; and
- 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 de-linking 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 a significant volume of decisions that together provide additional certainty and acceptance.

4.11 Activities Avoided by SPEs or Other Securitisation Entities

Investment Company Act

As a point of departure, any entity of which more than 40% of its relevant assets (ie, excluding cash or US Treasuries) consists of securities within the meaning of the Investment Company Act (a broad term that includes loans) may have to register as an investment company in the absence of an available exemption. Registered investment companies are subject to leverage and capital structure requirements that are incompatible with a securitisation.

The exemptions most commonly used for securitisations are Rule 3a-7, Section 3(c)(5) and Section 3(c)(7).

Rule 3a-7 is available for entities holding primarily 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. The securitisation must also satisfy some additional requirements, including having a trustee with certain minimum qualifications holding either title or a security interest in the assets, and investors in securities that are either below investment grade or not fixed-income securities must satisfy certain qualification requirements.

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 registration exemption for issuers that do not publicly offer their securities, and it limits their investors to "qualified purchasers". The Volcker Rule discussed below has made it less attractive for securitisation SPEs to rely on Section 3(c)(7), although the exemption is still relied on by actively managed CLOs.

The Volcker Rule

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, among others, any security with equity-like returns or voting rights (including the right to replace the investment manager, which is typically a right of the senior-most class of investors in the event of such manager's default). Consequently, in order to be attractive to banks, securitisation entities tended to avoid becoming a "covered fund" under the Volcker Rule. This may change based on amendments to the rule (effective since 1 October 2020), which clarify that a right to remove an investment manager for "cause" (as defined in the rule) is not an ownership interest.

The covered fund definition only captures entities that would have to register under the Investment Company Act, but for the exemption set forth in Section 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 CEA, or that are "substantially similar" commodity pools. Consequently, the traditional means of addressing the Volcker Rule have been to avoid relying on any of these exemptions. If that strategy is not available, there are a number of potential exclusions from the covered fund definition in the Volcker Rule itself, of which the "loan securitisation" exemption is most important in the securitisation context.

While "loans" is a broad term for the purposes of that exclusion, there are significant limitations on an SPE's ability to hold derivatives (other than for the purposes of hedging interest and currency risk) and securities (other than for certain short-term cash-management purposes). However, the recent October amendments to the Volcker Rule allow for a small bond basket, thereby removing one of the restrictions that have prevented CLO managers from engaging in a bond/loan arbitrage that was popular prior to the promulgation of the Volcker Rule.

4.12 Participation of Government-Sponsored Entities

Ginnie Mae, Fannie Mae and Freddie Mac are the principal agencies and GSEs engaged in the securitisation of mortgages. Ginnie Mae does not itself issue MBSs, 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.

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 purchase loans that satisfy their origination criteria and issue securities backed by pools of such loans that are guaranteed by the relevant GSE. In addition, the GSEs issue some risk transfer securitisations that are not guaranteed.

The GSEs traditionally used separate, but similar, platforms to issue their pass-through securities. Starting on 3 June 2019, they have transitioned to a single security and single securitisation platform initiative referred to as Uniform Mortgage-Backed Securities (UMBS). 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. In turn, this has allowed for the emergence of a highly liquid "to-be-arranged (TBA) market", where pools of

MBSs 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.

Agency securitisations represent by far the biggest part of the securitisation market.

4.13 Entities Investing in Securitisation

Investors in securitisations include banks, asset managers, insurance companies, pension funds, mutual funds, hedge funds and high net worth investors. 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 are worth noting.

Banks

The Basel III capital rules penalise banks that invest below the most senior 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

Insurance companies' capital rules are typically 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.

4.14 Other Principal Laws and Regulations

The principal laws and regulations are all mentioned in **1.3 Applicable Laws and Regulations**.

5. Synthetic Securitisation

5.1 Synthetic Securitisation Regulation and Structure

Synthetic securitisations are permitted. The Dodd-Frank Act added a new Section 27B to the Securities Act intended to address certain conflicts of interest. In November 2023, the SEC adopted Rule 192, which implements this provision. Rule 192 creates significant hurdles for synthetic securitisations that are not for the purpose of risk-mitigating hedging activities (see **4.7 Use of Derivatives**).

Regulation

The SEC regulates the offer and sale of securities issued by a synthetic securitisation and the issuer's Investment Company Act exemptions are the same as in a traditional securitisation. The derivatives underlying such securitisation are regulated by the SEC if they reference a single security, a single loan or a narrow-based security index and by the CFTC if they are deemed to be swaps (in which case the SPE may also be a commodity pool).

Principal Laws and Regulations

The offering of securities in a synthetic securitisation is governed by the Securities Act. The SEC has generally indicated that CDSs, the most common type of derivative used in synthetic securitisations, are not self-liquidating financial assets. Consequently, one may 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. This means that risk retention and certain other rules applicable to asset-backed securities would not apply. The nature of the CDS may also impact the Investment Company Act analysis for the issuer.

As noted in **4.7 Use of Derivatives**, both the SEC and the CFTC have comprehensive regulations around entering into derivatives, and such instruments may be subject to clearing, settlement and margin requirements specified in the securities acts and the Commodities Exchange Act.

A primary motivator for synthetic securitisations is regulatory capital relief, and whether a transaction achieves that result hinges, in part, on whether it satisfies the "synthetic securitisation" criteria under the applicable bank capital rules. The Board of Governors of the Federal Reserve System (the "Board") also recently provided guidance (in a response to frequently asked questions under Regulation Q) that direct-issue credit-linked notes may satisfy those requirements.

Principal Structures

In its simplest form, a synthetic securitisation 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. As noted above, the Board may also accept direct issue credit-linked notes (ie, which do not utilise an intermediate SPE or CDS) as a form of synthetic securitisation for the purposes of providing regulatory capital relief.

6. Structurally Embedded Laws of General Application

6.1 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 subject to the broad statutory and equitable powers of the bankruptcy court. The court also has the power to:

- release the creditors' rights to excess collateral;
- allow additional debt to be secured by the collateral;

- substitute collateral; and
- reject executory contracts.

Creditors may also be restricted from exercising rights that are triggered by 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 specific to facts and circumstances, 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 by:

- transferring the securitised assets to the issuer in a perfected true sale;
- reducing the risk of the issuer becoming subject to involuntary or voluntary bankruptcy proceedings; and
- reducing the risk of the issuer becoming substantively consolidated with any affiliates, should they become subject to bankruptcy proceedings.

As an alternative to a true sale structure, it is also possible to transfer exposure to the securitised assets using contracts that are protected against the most troublesome bankruptcy powers.

6.2 SPEs

Establishing a bankruptcy-remote SPE is a key aspect of a typical securitisation transaction.

The transaction documents typically include non-petition clauses that restrict involuntary bankruptcy filings against the SPE.

However, an outright prohibition against the SPE itself voluntarily filing for bankruptcy is unenforceable as being against public policy, and such risk must therefore be mitigated by more indirect means. Limiting the SPE's unrelated activities and restricting the SPE from having employees and unrelated property reduces the risk of unrelated liabilities. Appointing an independent director whose fiduciary duty runs to the SPE and not to its shareholders, and employing an entity type that allows for such redirection of fiduciary duties, reduces the risk of a filing for the benefit of its shareholders.

The independent director(s) also provide(s) important protection against dissolution of the SPE, in part by requiring such a director's participation in a dissolution decision, and in part by providing that such independent director becomes a "springing member" or "springing partner" if the absence of a member or partner would cause dissolution. The number of independent directors should at least be equal to the minimum number of members or partners required to continue the SPE's existence.

Substantive consolidation is an equitable doctrine that permits a bankruptcy court to disregard the separateness of an entity that is not itself in bankruptcy and that provides an alternative pathway for an SPE to become entangled in its affiliate's bankruptcy proceedings. Although the analysis differs somewhat between various US circuits, in general, a bankruptcy court may order substantive consolidation where the separateness of the entities has not been sufficiently respected or where the affairs of the debtor entities are so entangled that unscrambling them will be prohibitive and will hurt all creditors.

Multi-factor Analysis

Under older practice, which still applies in some circuits, the courts may rely on a multi-factor analysis. Consequently, the risk of substantive consolidation is generally addressed by requiring the SPE and its credit to be separate from its affiliates based on factors that speak for substantive consolidation identified in the case law. One list of such factors is collected in the Tenth Circuit opinion of Fish v East, 114 F2d 117 (10th Circuit 1940), as follows:

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

A 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), as follows:

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

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

6.3 Transfer of Financial Assets

For a sale of financial assets to be valid and enforceable against third parties, it has to "attach" and be "perfected", similar to what applies to a security interest in collateral. The rights of a purchaser of such assets attach if:

- "value" has been given;
- the transferor has rights in the relevant asset, or the right to grant rights in the relevant asset; and
- there is a signed agreement that reasonably identifies the relevant rights and assets.

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 available mode of perfection differs, based on the type of asset and type of transfer. Broadly speaking, perfection can be:

- automatic;
- by control (or possession); or
- by the 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. The perfection of a security interest in a financial asset automatically also perfects a security interest in related supporting rights, 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. Nevertheless, since filing a UCC financing statement is easy and cheap, and provides perfection regardless of whether the transfer is respected as a sale or whether it is characterised as a loan, such filing is typically the primary means of perfection.

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 asset will typically not be affected by a subsequent bankruptcy of the seller. On the other hand, if such transfer is treated only as a granting of a security interest in collateral, then bankruptcy of the seller will subject the buyer's rights with respect to such assets to the automatic stay and other bankruptcy powers. In determining whether a transfer is a true sale or a disguised loan, courts look to a number of factors. 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.

Key factors include:

- the parties' intent, though courts typically de-emphasise the language used in a document and instead consider the intent reflected by the economic substance and actual conduct;
- recourse and collection risk, which generally is the most important factor;
- the transferor's retention of rights to redeem the transferred property or to receive any surplus from the asset; and
- the transferor's continued administration and control of the assets, particularly if the obligor is not notified of the sale (however, under current market practice, transferors 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 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:

- the transferor being a debtor of the transferee on or before the purchase date;
- 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
- 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.

It is common to obtain a true sale opinion in securitisation transactions that evaluates the relevant facts in light of the factors outlined above. 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. The opinion will usually identify these key factors and draw a conclusion based on the overall analysis and reasoning in the opinion letter.

6.4 Construction of Bankruptcy-Remote Transactions

Most derivatives, certain mortgage repurchase transactions and many securities contracts are protected against the automatic stay and some of the most troublesome bankruptcy powers. These types of contracts can therefore be used as a means of transferring exposure to the assets underlying 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 nevertheless 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.

It is, however, not common to obtain a bankruptcy opinion for such protected contracts.

6.5 Bankruptcy-Remote SPE

The organisational documents of the SPE and other transaction documents will typically include a provision limiting recourse solely to the SPE's assets and a non-petition covenant that restrict involuntary bankruptcy filings against the SPE, subject to applicable law. Additionally, the transaction documents will also typically include other protections such as the appointment of independent directors whose fiduciary duties run to creditors and whose consent is required for a bankruptcy filing. See **6.2 SPEs**.

7. Tax Laws and Issues

7.1 Transfer Taxes

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 underly-

ing 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 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.

7.2 Taxes on Profit

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 are also generally 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 the 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.

7.3 Withholding Taxes

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 the satisfaction of certain requirements relating to the investor's US activities and the investor's equity, or control 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:

- 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
- 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.

7.4 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 aim to ensure that they are not engaged in loan origination or otherwise treated as conducting a lending or other financial business in the USA.

7.5 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 provides 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.

8. Accounting Rules and Issues

8.1 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, whether, and with whom, to consolidate a securitisation SPE can be 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 even in bankruptcy or other receivership, and a part of that analysis looks to the legal true sale analysis.

8.2 Dealing with Legal Issues

Under the GAAP accounting rules, "a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor and its consolidated affiliates. In addition, a non-consolidation opinion is often required if the transfer is to an affiliated entity" (ASC 860-10-55-18A), although the opinion may not be required if the accountants are comfortable "that the appropriate legal opinion(s) would be given if requested" (55-18B).

The accounting literature includes commentaries on the legal opinion requirements, including the opinion 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. For example, an opinion assuming that the transfer is a true sale for accounting purposes would have to carve out the legal isolation analysis from such assumption. Consequently, a true sale and non-consolidation opinion 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.

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