1997

Selected Legal Issues Affecting Securitization

Michael S. Gambro
Scott Leichtner

Follow this and additional works at: http://scholarship.law.unc.edu/ncbi
Part of the Banking and Finance Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/ncbi/vol1/iss1/14

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
I. GENERAL OVERVIEW OF SECURITIZATION

A. Introduction

An asset securitization involves the issuance of securities which are secured by or represent ownership interests in a discrete pool of financial assets, such as mortgage loans, automobile loans, credit card receivables, and equipment leases, where investors look to the assets themselves as the principal source of payment on the securities rather than to the credit of either the securities issuer or the entity benefiting from the securitization of the assets.

B. Benefits of Securitization to the Originator/Seller of the Financial Assets

1. Lower Costs of Funds

Securitization is most valuable when the cost of funds, reflected in the yield that investors require to purchase the asset-backed securities, is less than the cost of the originator's other direct sources of funding. A primary goal of securitization, therefore, is to obtain low cost capital markets funding by separating all or a portion of an originator's receivables from the risks associated with the originator. To achieve this goal, the securitization transaction is structured as a sale that would be respected in a bankruptcy or insolvency proceeding of the originator or as a financing by an entity, generally a special purpose vehicle (SPV), that is bankruptcy remote. Bankruptcy remote means that the SPVs only creditors are the investors in the rated securities issued in the securitization, and its relationships with its relevant affiliates are sufficiently arm's length that the assets of the entity would be treated as its assets, rather than those of such af-
affiliate, in the event of a bankruptcy or insolvency proceeding involving any such affiliate.

2. New Sources of Funds

Securitization can be an additional and untapped source of financing for an originator as it may afford the originator access to lenders that would not otherwise be available to it or that would not generally invest in the financial assets being securitized. Increased access to potential investors is of even greater benefit to "risky originators," those with credit ratings below investment grade or that are unrated, as securitization has the potential to bring low cost capital markets financing to these companies that would otherwise be unable to access the capital markets.

3. Off-Balance Sheet Treatment

Because a securitization is often viewed for accounting purposes as a sale of assets rather than a financing, the originator does not record the transaction as a liability on its balance sheet. Consequently, such off-balance sheet funding raises capital without increasing the originator's leverage or debt-to-equity ratio on its financial statements. Securitization may also allow the originator to avoid the consequences of direct borrowing, such as compliance with certain restrictive borrowing covenants and preserving the originator's direct borrowing capacity.

4. Improved Asset/Liability Management

If the originator funds its portfolio of assets with liabilities having differing maturities and does not otherwise hedge its funding obligations, the originator assumes the risk that its cost of funding the assets will not match the earnings attributable to such assets. The securitization of a pool of assets can alleviate this problem by allowing the originator to perfectly match the duration of its assets and its liabilities.

5. Improved Liquidity

Securitization allows institutions to liquidify assets by selling them in a more liquid form or by issuing debt securities using the assets as collateral. The latter type of transaction can enable an institution to convert "underwater" assets to cash without requiring the institution to sell the assets and recognize an immediate loss on the sale.
6. Spreading of Credit Risks

Securitization allows the originator to transfer all or part of the credit risk associated with certain financial assets to a third-party.

7. Assistance in Meeting Increased Capital Adequacy Standards

Securitization assists a financial institution in meeting its capital adequacy standard by shrinking the size of its balance sheet or permitting it to reinvest the proceeds of the securitization transaction in new assets without increasing the size of its balance sheet.

8. Increased Fee Income

For originators which are depository institutions, securitization may lower its dependence on interest income by increasing fee income.

II. SECURITIES LAWS ISSUES

A. The Securities Act of 1933 (the 1933 Act)

1. Exemption from Registration

Section 5(a) of the 1933 Act makes it unlawful for any person to sell a security through instruments of interstate commerce unless a registration statement is in effect with respect to such security. Consequently, a registration statement must be filed with the Securities and Exchange Commission (SEC) and be declared effective before any public offering of pass-through securities may be undertaken. However, Sections 3 and 4 of the 1933 Act exempt from registration an instrument which is (a) not classified as a security, (b) considered an exempt security, or (c) sold in an exempt transaction.

a. Definition of Security

Due to the nature of the instrument and the circumstances under which it is purchased, the instruments issued in a securitization are virtually always treated as securities under federal securities laws.

b. Exempt Securities

Section 3(a)(2) of the 1933 Act exempts a wide variety of securities from the registration requirements of Section 5, including any security issued or guaranteed by any bank, and Section 3(a)(5) of the 1933 Act provides an exemption from registration for any security issued by a savings and loan association or similar institution.
"supervised and examined by State or Federal authority having supervision over any such institution." However, asset-backed securities generally do not fall within these exceptions, because they are generally not obligations of or interests in the sponsoring bank or thrift, nor are they generally guaranteed by banks.

c. Exempt Transactions/Private Offerings

i. Section 4(2)

Section 4(2) of the 1933 Act exempts "transactions by an issuer not involving any public offering." Because this exemption is limited to sales of securities by an issuer, any subsequent resales of securities originally purchased pursuant to Section 4(2) must qualify independently for an exemption from registration. Judicial and administrative interpretations of this section have set forth the following criteria as to whether a transaction does not involve a "public offering":

(a) the offering must be made on a limited basis to selected persons and not pursuant to a general solicitation to the public; (b) the securities must be sold only to persons who either are sophisticated in business matters or able to obtain the type of assistance that will enable them to make informed investment decisions; and (c) prior to making the decision to purchase the securities, the investors must be either furnished with or given access to information of the type that would be obtained through the registration process.

ii. Regulation D

The SEC adopted Regulation D, comprising Rules 501 through 508, as a safe harbor to simplify and clarify the private placement exemptions and to expand their availability. Rules 501 through 503 set forth definitions, terms, and conditions which apply generally throughout Regulation D, while three different bases for exemptions are set forth in Rules 504 through 506.

(a) Rule 506/"Accredited Investors"

Since offerings made pursuant to Rule 504 are limited to $1 million and Rule 505 offerings are limited to $5 million, the majority of private placements of securitization transactions are effected under Rule 506, which is available irrespective of the dollar amount of the offering. The Rule 506 exemption is open to all issuers, including investment companies, for offerings sold to not more than 35 purchasers who are not "accredited investors", as defined in Rule 501, and an unlimited amount of accredited investors. By virtue of
the 1988 amendments to Regulation D, nearly all categories of institutional investors have been granted accredited investor status including:

- Banks; insurance companies; investment companies; savings associations; homestead associations and similar institutions supervised and examined by federal or state authorities, whether acting for their own account or in a fiduciary capacity; broker-dealers registered with the SEC under the Securities Exchange Act of 1934 (the 1934 Act);
- Certain employee benefit plans; corporations, partnerships and business trusts with total assets in excess of $5 million, as long as they were not formed for the purpose of purchasing the securities offered pursuant to Regulation D;
- Trusts, other than business trusts, with total assets in excess of $5 million that have not been formed for the purpose of purchasing the securities offered, and that are directed by sophisticated persons as described in Rule 506; and Employee benefit plans having total assets in excess of $5 million that are established and maintained by state and local governments, as well as agencies and instrumentalities thereof.

(b) Informational Requirements and Prohibitions

Rule 502 specifies, among other things, the type of information that must be furnished to investors in offerings made pursuant to Rule 506, but mandates no specific disclosures if a Rule 506 offering is made solely to accredited investors. Rule 502 further prohibits general solicitation and general advertising in connection with Rule 506 offerings and requires the issuer to exercise reasonable care to assure that securities issued in such offerings are not resold without registration or exemption therefrom.

Rule 503 requires the issuer under a Regulation D offering to file a notice of sales on Form D with the SEC within 15 days after the first sale of securities, although subsequent to 1989 amendments, this filing is no longer a condition to the exemption's availability.

(c) Insignificant Violations of Regulation D

Rule 508 provides that an exemption is available under Regulation D, despite the failure to comply with one of its terms, conditions, or requirements, if (i) the term, condition, or requirement is not intended to protect the particular person or entity seeking to disqualify the issuer from the exemption, (ii) the failure to comply is insignificant to the offering as a whole, and (iii) there has been a reasonable, good faith attempt to comply with all applicable terms, conditions, and requirements of Regulation D. With regard to the second prong...
of the test, Rule 508 states that the requirements pertaining to general solicitation and the limitations on the number of non-accredited investors will be deemed significant to the offering as a whole. Notwithstanding the relief provided by Section 508, any failure to comply with the terms, conditions, and requirements of Regulation D is actionable by the SEC under Section 20 of the 1933 Act.

(d) Integration.

The integration provision of Rule 502, the effect of which is to treat as a single offering two or more similar offerings by the same or affiliated issuers within any six-month period, is important to both issuers interested in issuing multiple series of mortgage-backed securities in both the public and private markets, and to those who may be unsure as to whether a particular issue is more appropriately offered publicly or in reliance upon Regulation D. If a public offering is integrated with an offering under Regulation D, the private offering exemption will be lost, since a public offering by its very nature violates one or more requirements for qualifying under Regulation D; a significant “cooling off” period is required before an abandoned public offering may be offered privately. Note, however, that Rule 152 of the 1933 Act provides a safe harbor pursuant to which the integration provision of Rule 502 is deemed inapplicable when the public offering is made after a Section 4(2) offering.

The five factors which tend to indicate whether two or more separate offerings will be integrated are: (1) there is a single plan of financing; (2) the offerings involve the issuance of a single class of securities; (3) the offerings are made at or about the same period of time; (4) the same kind of consideration is received; and (5) the offerings are made for the same general purpose.

Securitization transactions often involve simultaneous public and private offerings: a public offering of investment grade-rated securities and a private placement of below investment grade-rated securities. The general view is that the integration rule should not apply to these offerings, because the offerings involve different classes of securities and different investor profiles. However, for integration reasons as well as insider trading concerns where potential investors in the below investment grade-rated securities are provided access to information regarding the transaction not available to other investors in the public offering, issuers often attempt to restrict the investors in the below investment grade-rated securities from purchasing in the public offering during such offering and for a period of time thereafter.
iii. **Rule 144A**

Rule 144A creates a non-exclusive safe harbor from the registration requirements of Section 5 of the 1933 Act for resales by persons other than the issuer to institutional investors that meet certain criteria. The issuer itself would have to rely on a separate exemption, such as Section 4(2) or Regulation D, for the initial sale.

(a) **Qualified Institutional Buyers (QIBs)**

Rule 144A exempts resales to QIBs of restricted securities that, (i) when issued, were not of the same class as securities listed on a national securities exchange or quoted in a U.S. automated interdealer quotation system and (ii) are not securities of open-end investment companies or face amount certificate companies required to be registered under the Investment Company Act of 1940 (the 1940 Act). QIBs are institutional investors listed in Rule 144A that own and invest on a discretionary basis at least $100 million ($10 million for registered dealers acting for their own accounts or the accounts of other QIBs) in securities of issuers that are not affiliated with the QIB.

Included within the list of QIBs set forth in Rule 144A are: investment companies and business development companies (as defined in the 1940 Act); small business investment companies licensed by the Small Business Administration; employee benefit plans of states, political subdivisions or instrumentalities thereof; employee benefit plans (as defined under Title I of the Employee Retirement Income Security Act of 1974 (ERISA)); trust funds with bank or trust company trustees the participants of which are solely employee benefit plans that would also qualify as QIBs (except trust funds with IRA and H.R. 10 plan participants); 501(c)(3) organizations (as defined under the Internal Revenue Code); corporations (other than banks, savings and loan associations and similar financial institutions); partnerships; Massachusetts or similar business trusts; investment advisers registered under the 1940 Act; and banks and savings associations. However, in addition to the aforementioned qualifications, the depository institutions must have net worths of at least $25 million.

(b) **Information Disclosure Requirement**

Under Rule 144A(d), for resales of securities issued by companies that are not subject to the reporting requirements of the 1934 Act, the holder of such securities and the prospective purchaser must
have the right to obtain from the issuer, upon request, certain specified information concerning the issuer. Such information must be reasonably current and include (i) a brief statement of the nature of the issuer's business and the products and services offered by it and (ii) 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 it has been in operation. The SEC has stated that for purposes of Rule 144A(d)(4), the servicer of the assets, or the trustee of the trust holding title to the assets, is deemed to be the issuer. Because many asset-backed securities are issued by SPVs, the actual issuer or depositor of the trust may not maintain records after the initial issuance of securities, even though it would retain its issuer obligations under federal securities laws. The SEC in a no-action letter confirmed that the issuer information disclosure requirement could be satisfied by the issuer's contractually requiring the trustee to deliver the required information after the initial issuance.

(c) Interplay Between Regulation D and Rule 144A

Most offerings under Regulation D are subject to restrictions on resale, as issuers relying on the Regulation D exemption for the initial offering of their securities must exercise reasonable care to ensure that purchasers of the securities are not underwriters intent on making a distribution of the securities in the secondary market. Rules 144A(b) and (c), however, provide that a person who offers or sells securities in accordance with Rule 144A shall be deemed not to be engaged in or a participant in a distribution of securities under the 1933 Act.

The benefits of Rules 144A(b) and (c) are the following: (a) allows for an underwritten offering of unregistered securities to QIBs; (b) eliminates a major impediment to the establishment of a liquid secondary market in unregistered "restricted" securities that otherwise could not be resold by the original holders without their satisfying strict holding period requirements of Rule 144; and (c) eases the issuer's burden under Rule 502(d) of Regulation D to utilize reasonable care to assure that the purchasers in a Regulation D offering are not underwriters within the meaning of Section 2(11) of the 1933 Act in that the issuer is allowed to make a sale to a QIB that may intend to resell the security in the secondary market to another QIB.
(d) PORTAL

PORTAL is an automated trading system for Rule 144A securities, serving as a marketplace for distributions and trading of such securities. Access to PORTAL is limited to QIBs, assuring secondary market sellers that participants are eligible purchasers under Rule 144A. The SEC has authorized the establishment by the Depository Trust Company (the DTC) of book entry facilities and other depository services for Rule 144A securities, making such securities eligible for clearance and settlement through the automated securities processing system of DTC. Eligibility of a security in this system is conditioned upon the making of representations by the issuers and transfer agents as to certain characteristics of the securities.

2. Registration Process

For those securities which are neither considered exempt nor sold by means of an exempt transaction, Section 5 of the 1933 Act and its related regulations govern the procedure for complying with the registration process.

a. Registration Statement

If registration is required, a registration statement must be filed with the SEC before securities may be publicly offered and declared effective before they may be sold. Section 7 and Schedule A of the 1933 Act details the information required to be included in registration statements issued by entities other than foreign governments or their political subdivisions. Schedule A requires (i) a description of the registrant’s properties and business, (ii) a description of the significant provisions of the security to be offered for sale and its relationship to the registrant’s other capital securities, (iii) information about the management of the registrant, and (iv) financial statements certified by independent public accountants. The SEC has the power under Section 7 to provide that any of the information or documents specified in Schedule A not be included in a registration statement for a class of issuers or securities for which it believes such information is unnecessary.

i. Form S-3

Form S-3, the short form of registration statement under the 1933 Act, is available to all issuers for public offerings of investment grade asset-backed securities. “Investment grade securities” are securities, which at the time of sale, are rated by at least one nationally
recognized rating agency in one of its four highest ratings categories. Asset-backed securities are securities that are primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms, convert to cash within a finite period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.

ii. Form S-11

Registered offerings of mortgage-backed securities, until relatively recently, often utilized Form S-11, which is a form that can be used by either real estate investment trusts or other issuers whose business is primarily that of acquiring and holding for investment real estate or interests in real estate or interests in other issuers whose business is primarily that of acquiring and holding real estate or interests in real estate (except companies required to be registered under the Investment Company Act of 1940).

iii. Form S-1

Form S-1, which requires the most extensive disclosure, is used for the registration of securities when no other form is available.

b. Shelf Registration

Shelf registration involves the registration of securities for an offering to be made on a continuous or delayed basis in the future, and is routinely used when it is anticipated that one issuer, or a series of affiliated issuers, will participate in a series of similar mortgage related securities offerings in the future. Shelf registration is preferable when an issuer will offer a series of similar issues over time because it eliminates the need to file a separate registration statement for each offering.

i. “Mortgage Related Security”

To the extent a security is a “mortgage related security” as defined in Section 3(a)(41) of the 1934 Act (as added to the 1934 Act by the provisions of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA)), the security may be publicly offered utilizing shelf registration under Rule 415. Prior to the enactment of recent legislation, the requirements for classification as a “mortgage related security” under Section 3(a)(41) included the following:

(i) each mortgage loan used in the transaction was required to be “secured by a first lien on a single parcel of real estate, including
stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure ....” Loans secured by first liens on multi-family properties generally come within the ambit of this definition; (ii) each mortgage loan must be originated by a bank, thrift, credit union, insurance company, or by a mortgagee with a “HUD Eagle;” and (iii) the security must be rated in one of the two highest rating categories by one of the nationally recognized rating agencies. Note that even if a mortgage-backed security does not meet the rating requirement within the definition of “mortgage related security,” it is likely to qualify as an asset-backed security which, if rated at least investment grade, will be entitled to shelf registration, as described below.

(a) Recent Developments

Pursuant to legislation which took effect on December 31, 1996, commercial mortgage-related securities rated in one of the two highest grades by at least one nationally recognized rating agency and backed by first lien mortgages originated by a bank, savings association, credit union, insurance company, similar regulated entity, or HUD-approved mortgagee, will be deemed “mortgage related securities” within the meaning of Section 3(a)(41) of the 1934 Act, as added by SMMEA, and as amended by Section 347(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (the CDRIA). In contrast to the original definition of “mortgage related security” which required each note to be directly secured by a first lien on a single parcel of real estate, the new amendment provides that a mortgage note backing a SMMEA-qualified commercial “mortgage related security” may be directly secured by a first lien “on one or more parcels or real estate upon which is located one or more commercial structures.” Such amendment is consistent with Congress’s stated intent, as reflected in the Conference Report accompanying the CDRIA, to include “multi-family residential loans secured by more than one parcel of real estate upon which is located more than one structure” within the definition of “mortgage related security.”

ii. Investment Grade Asset-Backed Securities

The SEC permits shelf registration for all securities which are, or could be, issued pursuant to Form S-3. The adopting release notes that the definition of “asset-backed security” is intended to be quite broad and encompasses any of the assets included in Rule 3a-7 under
the 1940 Act, such as notes, leases, installment contracts, and interest rate swaps, as well as other financial assets, such as small business loans, credit card receivables, accounts receivable, and franchise or servicing arrangements. The adopting release also indicates that guarantees, letters of credit, financial insurance, and other credit enhancement instruments supporting the underlying pool of assets are included in the definition. Furthermore, investment grade asset-backed securities are eligible for shelf registration, not merely securities rated in one of the two highest rating categories by a nationally recognized rating agency, as is the case for “mortgage related securities.”

c. Asset Concentration

For structured finance transactions in which the securities are backed by a large number of homogenous loans (such as securitizations of auto loans or single family properties), the fact that each individual loan is statistically insignificant allows the rating agencies to rate the transaction based upon a statistical analysis of the pool as a whole. In contrast, commercial mortgage-backed securities offerings generally involve pools of fewer loans, with each individual asset representing a larger percentage of the pool. Such an “asset concentration” poses several additional concerns in the context of commercial mortgage securitizations. First, the SEC has indicated that asset-backed security offerings involving significant asset concentration may signal the involvement of one or more co-issuers pursuant to Rule 140 to the 1933 Act. Second, the SEC has stated that if a significant portion of the asset pool represents the obligations of a single obligor or related obligors, financial information and other disclosures regarding the obligor(s) may be required.

i. Shelf Registration

Care must be taken regarding asset concentration, as the adopting release to the revisions of Rule 415 states that securities backed by assets of a single obligor or group of related obligors are not asset-backed securities for purposes of the rule and are not eligible for shelf registration thereunder. Consequently, an issuer proposing to use Form S-3 for a shelf registration of “asset-backed securities” pursuant to Rule 415 must involve at least two obligors or groups of related obligors.

ii. Co-Registration Under Rule 140

The SEC has taken the position that where the obligations of a
single obligor or group of related obligors constitute at least 45% of the mortgage loan pool backing the offered securities, such obligor or obligors must co-register the securities issuance pursuant to Rule 140 of the 1933 Act. Where the Rule 140 requirements are triggered, securities that otherwise would have been eligible for shelf registration under Rule 415 of the 1933 Act will be, as a practical matter, required to be registered on a separate registration statement because of the need to include the related obligor(s) as a co-registrant. The co-registration requirement thus has the effect of increasing the time and expenses associated with a commercial mortgage-backed securities issuance, as a full registration statement will need to be prepared for each new issue. Additionally, requiring an obligor to co-register pursuant to Rule 140 will cause the obligor to be liable as an issuer under the 1933 Act and the 1934 Act, and may cause it to become subject to the reporting requirements of the 1934 Act.

iii. Financial Statement Requirements

The SEC has taken the position that, in the event that a single mortgage loan exceeds 20% of the pool, audited financial statements for the two most recent fiscal years and audited income statements and statements of cash flows for the three fiscal years preceding the date of the most recent audited balance sheet being filed are required to be filed for the property. In addition, for filings made more than 134 days after the end of the most recent fiscal year, an unaudited interim balance sheet and a corresponding statement of income and cash flows must be provided. Such financial statements and the related accountants' consent are typically included in the registration statement by use of a Form 8-K which is then incorporated by reference into the Form S-3.

Staff Accounting Bulletins 71 and 71A state that where “the amount of a loan exceeds 20% of the amount in good faith expected to be raised in the offering, disclosure would be expected to consist of financial statements for the underlying properties for the periods contemplated by Rule 3-14,” which indicates that for acquired properties, financial statements are for shorter periods.

For asset concentration in the 10-20% range, the SEC has taken the position that financial and other information, but not necessarily financial statement disclosure, regarding the underlying properties is required.

Depending on the facts and circumstances, loans on related properties to a single person or a group of affiliated persons may warrant the same level of disclosure as that required for a single loan.
iv. Form of Securities

The SEC permits the registration of both debt and equity securities on the same registration sheet.

d. Prospectus

Section 10(a) of the 1933 Act sets forth the information required to be included in a prospectus to be provided purchasers or prospective purchasers of securities. The prospectus contains all of the relevant information contained in the registration statement and such other information as the SEC requires as being necessary or appropriate in the public interest or for the protection of investors.

In order to prepare a prospectus in accordance with the requirements of the 1933 Act and the regulations promulgated by the SEC, it is necessary to include all material facts. An omitted fact is material if there is a substantial likelihood that a reasonable investor would consider the information important in determining whether or not to purchase the security. For securitization transactions, the primary information disclosed in the prospectus includes, among other things, a detailed description of the securities' cash flow structure, a description of the credit enhancement, and the federal tax attributes of the securities.

i. Prospectus in Connection With Shelf Registration

With regard to an offering of asset-backed securities pursuant to the shelf registration provisions, industry practice is to file a base prospectus with the SEC describing in general terms the expected characteristics of the securities to be issued in the future. For example, the base prospectus typically describes the types of credit enhancement which might be used, the types of cash flow structures that may be represented by the securities (such as interest-only, principal-only, subordinate, or serial-pay classes), and the possible tax characteristics of the issuer and of the securities. The base prospectus will also describe the types of financial assets that will back the securities, although the SEC has taken the position that a prospectus may have to be filed for each type of asset which backs the securities. For example, securities backed by commercial mortgage loans must have a different prospectus from securities backed by single family mortgage loans.

Together with the base prospectus, the issuer will file a form of supplement to the base prospectus. After the registration statement is declared effective by the SEC, the issuer may issue securities at any
time in the future without additional SEC review, provided each issue conforms generally to the terms of the base prospectus and the transaction-specific details of the offering (such as pricing and underwriting information, mortgage loan statistics, subordination levels, numbers and types of classes, and any matters the base prospectus states will be set forth in the supplement) are included in a supplement filed with the SEC pursuant to Rule 424(b) within two business days following first use.

ii. Computational Materials and Structural and Collateral Term Sheets

Computational materials are computer generated tables and charts illustrating for a class of asset-backed securities the yield, average life, duration, expected maturity, interest rate sensitivity, and cash flow characteristics of the class under a variety of prepayment scenarios. Structural term sheets are brief written descriptions of the securities proposed to be offered setting forth, among other information, the name of the issuer, the size of a potential offering, and the structure of the offering. Collateral term sheets provide descriptive information regarding the assets underlying the structured finance offering.

In connection with the structuring of an asset or mortgage-backed security, these materials are often furnished by investment bankers to potential investors in advance of a prospectus to determine whether investors would be interested in securities having certain investment features.

The SEC has, in no-action letters, stated that it would not recommend enforcement action in connection with the use of these materials in advance of a final prospectus provided certain procedures are followed.

(a) Computational Materials and Structural Terms Sheets

Computational materials and structural term sheets that are provided to investors prior to the availability of a final prospectus must be filed with the SEC on a Current Report on Form 8-K contemporaneously with or prior to the filing of a final prospectus if the following criteria are met:

(i) The materials are generated based on assumptions regarding the payment priorities and characteristics of the securities actually issued and purchased by an underwriter and (ii) Prior to the filing of the final prospectus, (a) the materials are sent to prospective investors who have indicated to the underwriter their intention to purchase the securities or (b) the materials are sent to prospective
investors after the structure of the offering has been finalized.

(b) Collateral Term Sheets

The initial collateral term sheet is required to be filed on Form 8-K with the SEC within two business days of its first use. Any subsequent collateral term sheet which represents a substantive change in the information presented (unless a final prospectus has been provided) must also be filed within two business days of its initial use. The initial and subsequent term sheets must bear a legend indicating that the information contained therein will be superseded by the description of the collateral contained in the related prospectus supplement, and that such information supersedes the information contained in previous term sheets.

(c) Incorporation By Reference

Any computational materials, collateral term sheets, and structured term sheets filed with the SEC on Form 8-K must be incorporated by reference in the issuer’s registration statement. Although both Forms S-3 and S-11 can be used for a shelf registration of securities (i.e., for the issuance of securities from time to time after the effective date of the registration statement, as described above), only Form S-3 permits incorporation by reference. As a result, Form S-3 is the preferred form for shelf registration of asset- and mortgage-backed securities.

iii. Market-Making Prospectuses

Section 4(1) of the 1933 Act exempts from its registration requirements securities transactions by persons other than the issuer, underwriter, or any dealer. Certain transactions by dealers are exempted under Section 4(3) of the 1933 Act. Broker-dealers engaged in securitizations by their affiliates will generally make a market in the securities issued. Depending on the facts and circumstances, secondary market sales by the broker-dealer may be deemed to be transactions requiring registration, because the dealer exemption does not apply unless the dealer is dealing in securities of “another person,” and the SEC takes the view that an affiliate is not “another person.” Therefore, in most asset-backed transactions involving issuers that are affiliates of broker-dealers, a current prospectus is used for such market-making transactions. The SEC has not extended this requirement to residential mortgage-backed securities.
(a) Commercial Mortgage-Backed Securities

While the SEC requires the delivery of a market-making prospectus for certain asset-backed issuances where the market maker is affiliated with the sponsor, the SEC has not required a market-making prospectus for issuances of commercial mortgage-backed securities under the following circumstances which indicate that the broker-dealer would not have special, ongoing knowledge of the underlying assets:

The issuer is not affiliated with the servicer; and the issuer either (a) is not affiliated with the mortgage loan originator or (b) is affiliated with the originator but neither the issuer nor the originator retains significant power to modify, amend, or waive the provisions of the underlying mortgage loans; and neither the issuer nor the originator has special access to information regarding the mortgages (other than information reported to certificateholders).

e. Post-Effective Amendments

A post-effective amendment to the registration statement is required to be filed pursuant to Item 512(a) of Regulation S-K for facts or events that represent a fundamental change in the information presented in the registration statement and for any material change with respect to the plan of distribution. It is important to note the distinction between Rule 424(b) and Item 512(a). The forms of prospectus and prospectus supplements that are part of the registration statement that is declared effective will generally not include transaction-specific details of the offering such as pricing information and information regarding the specific assets that compose the structured finance vehicle. If the missing transaction-details are substantive changes from or additions to a previously filed prospectus, but not facts or events arising after the effective date of the registration statement which represent a fundamental change in the information set forth in the registration statement, then a supplement may be utilized pursuant to Rule 424(b) rather than a post-effective amendment. The distinction is significant, as prospectus supplements may be filed after the supplement is used, whereas securities for which a post-effective amendment is filed cannot be sold prior to the effectiveness of the amendment, which in some cases will be reviewed by the SEC.

B. The 1934 Act

The 1934 Act principally addresses the regulation of securities
sold on exchanges and those professionals who sell such securities.

1. Registration Requirements

Section 12 of the 1934 Act requires registration of securities that (a) are traded on national securities exchanges or (b) are traded in interstate commerce if, within 120 days after the last day of any fiscal year, (1) the issuer has total assets in excess of $1 million and (2) any class of the equity security (other than an exempted security) of the issuer is held of record by at least 500 persons. Since asset-backed securities are not traded on national securities exchanges and the classes of such securities are typically not held by 500 persons or more, issuers of such securities are usually not subject to the registration requirements of the 1934 Act.

2. Reporting Requirements

Section 15(d) of the 1934 Act requires each issuer that has filed a registration statement under the 1933 Act to file with the SEC pursuant to Section 13 of the 1934 Act, among other items, such annual reports and quarterly reports as the SEC may prescribe, including annual reports on Form 10-K, quarterly reports on Form 10-Q, and special event reports on Form 8-K. However, Section 12(h) of the 1934 Act authorizes the SEC to exempt, in whole or in part, any issuer or class of issuers from the reporting requirements of Sections 13 and 15(d). The Commission must base its decision to provide an exemption on its finding, "by reason of public investors, amount of trading interest in the securities, the nature and the extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors." Recognizing the unique nature of securitization structures and the relative lack of materiality of information relating to the issuer, the SEC, pursuant to Section 12(h), has granted exemptions from, or reduced the levels of, the reporting requirements of Section 13 with respect to numerous issuers of asset-backed securities. Consequently, the only required reports, generally, are current reports on Form 8-K which include the payment date statements that get sent to investors periodically and annual reports on Form 10-K. Furthermore, following the year in which the securities are issued, if there are fewer than 300 certificateholders, the reporting obligation is automatically suspended until such time as the number of holders again reaches 300.
C. **Trust Indenture Act of 1939 (the 1939 Act)**

The 1939 Act applies to the offering and sale of debt securities, requiring that all debt securities not subject to exceptions thereunder be supported by trust indentures that satisfy the requirements enumerated in the 1939 Act. The 1939 Act does not apply to securities that are exempt from the registration requirements of the 1933 Act or to equity securities such as asset-backed securities issued in pass-through form. However, asset-backed securities that are issued as debt securities and publicly offered are required to be issued pursuant to a qualified indenture, which must contain provisions regarding the eligibility and qualification of trustees, the preferential collection of claims against the obligor on the security, the furnishing of certain opinions of counsel, officers and accountants, the duties and responsibilities of the trustee prior to and in respect of default, directions and waivers by bondholders, and special powers of the trustee.

D. **The 1940 Act**

The 1940 Act regulates the activities of publicly owned companies engaged primarily in investing and trading in securities. Unless exempt, an investment company must register with the SEC under the 1940 Act and comply with the Act's many substantive requirements. Included among these requirements are provisions governing the management, capital structure, and investment policies of the company. Furthermore, the issuance of multiple classes of securities is restricted and extensive reporting requirements are imposed. Since issuers of asset-backed securities will generally be unable to meet the requirements of the 1940 Act, the availability of a statutory exception to the definition of investment company or exemptive relief from the 1940 Act is critical.

1. **Rule 3a-7**

   a. **General**

Adopted in November 1992, Rule 3a-7 reduces 1940 Act impediments by excluding structured financings from the definition of investment company if certain conditions are satisfied, and the exclusion applies irrespective of the type of assets that are being securitized. The SEC explained that Rule 3a-7 is "intended to recognize the structural and operational distinctions between registered investment companies and structured financings and to address investor protection concerns by codifying requirements currently imposed
b. Requirements

Rule 3a-7 states that any issuer who is engaged in the business of purchasing or otherwise acquiring and holding eligible assets, and who does not issue redeemable securities will not be considered, and thus required to be registered as, an investment company under the 1940 Act provided the following conditions are met:

(1) the securities issued must be fixed-income securities or other securities with payments primarily dependent upon the cash flow from eligible assets. Eligible assets are defined to mean financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or assets designed to assure the servicing or timely distribution of proceeds to security holders;

(2) fixed-income securities sold by the issuer or any underwriter that are rated at the time of initial sale in one of the four highest rating categories by at least one nationally recognized rating agency may be sold without restriction;

(3) any fixed-income securities may be sold to accredited investors as defined in paragraphs (1), (2), (3), or (7) of Rule 501(a) under the 1933 Act and to entities in which all of the equity owners qualify as accredited investors within the aforementioned paragraphs. Those who qualify as accredited investors under the 1933 Act but are excluded from this provision include: natural persons whose net worth or income exceeds a certain enumerated dollar amount; and directors, executive officers, or general partners of the issuer of the securities being offered or sold;

(4) any securities may be sold to QIBs, as defined in Rule 144A of the 1933 Act, and to persons involved in the organization or operation of the issuer or an affiliate of such person provided that the issuer or any underwriter thereof effecting such sale must exercise reasonable care to ensure that such securities are sold and will be re-sold to accredited investors as defined in paragraphs (1), (2), (3), or (7) of Rule 501(a) or QIBs; and

(5) if the issuer issues any securities other than securities exempted from the 1933 Act by Section 3(a)(3) thereof (this section exempts any note, draft, bill of exchange or bankers’ acceptance which arises out of a current transaction and has a maturity of nine months or less at the time of issuance), the issuer must: (a) appoint a trustee that meets the requirements of Section 26(a)(1) of the 1940 Act (which generally provides that the trustee must be a bank which
at all times shall have an aggregate capital, surplus, and undivided profit of a specified minimum amount, not to be less than $500,000), and that is not affiliated with the issuer or with any person involved in the organization of the issuer; which does not offer or provide credit enhancement to the issuer; and that executes an agreement or instrument concerning the issuer's securities containing provisions to the effect set forth in Section 26(a)(3) of the 1940 Act (which provides that the trustee shall not resign until either the trust has been completely liquidated and the proceeds of the liquidation distributed to the security holders of the trust or a qualified successor trustee has been appointed). Note that although Section 26(a) allows for either a trustee or a custodian, the SEC has provided clarification that the issuer may only appoint a trustee; (b) take reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in those eligible assets that principally generate the cash flow needed to pay the fixed-income security holders; and (c) take action necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the outstanding fixed-income securities.

2. Section 3(c)(5)(C)

Prior to the promulgation of Rule 3a-7, issuers of asset-backed securities typically relied upon Section 3(c)(5)(C) of the 1940 Act for exemption from the requirements of the Act. In general, Section 3(c)(5)(C) excepts from the definition of investment company any person that is not engaged in the business of issuing redeemable securities and is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Since Rule 3a-7 is a nonexclusive rule, Section 3(c)(5)(C) may still be relied upon without complying with the requirements of Rule 3a-7. This is helpful in the case of securities representing ownership interests in whole mortgages and securities collateralized by such mortgages, as such securities generally satisfy the exemption provided by Section 3(c)(5)(C).


NSMIA amended the 1940 Act by (a) expanding the private placement exemption of Section 3(c)(1) of the 1940 Act by liberalizing the “look-through” test and (b) creating Section 3(c)(7) as an
additional registration exemption for issuers not making a public offering and whose securities will be owned solely by “qualified purchasers.”

a. Section 3(c)(1) “Look-Through” Test

Section 3(c)(1) of the 1940 Act has traditionally been relied upon by issuers of asset-backed securities that were unable to meet the requirements imposed by either the Rule 3a-7 or Section 3(c)(5)(C) exemptions.

i. Prior to NSMIA

Section 3(c)(1) of the 1940 Act exempts any issuer from the registration requirement of the Act if its outstanding securities (other than short term paper) are beneficially owned by not more than 100 persons and which is not making and does not propose to make a public offering of its securities. Prior to NSMIA, in order to determine whether the 100 person limitation was satisfied, it was necessary to “look-through” all holders of more than 10% of the outstanding voting securities of the issuer. For purposes of the limitation, issuers were required to count the holders of the securities issued by each 10% holder, unless not more than 10% of the value of such 10% holder’s total assets consisted of securities issued by issuers which themselves relied upon Section 3(c)(1) to avoid the registration requirements of the 1940 Act.

ii. Subsequent to NSMIA

Under the provisions of NSMIA, an issuer relying on Section 3(c)(1) of the 1940 Act will be required to count the beneficial owners of securities (other than short-term paper) issued by a 10% holder only if either the 10% holder is itself an investment company or if the 10% holder is able to avoid the registration requirement of the 1940 Act only because it satisfies Section 3(c)(1) or Section 3(c)(7) (discussed below).

b. Section 3(c)(7) “Qualified Issuer” Exemption

NSMIA added Section 3(c)(7) to the 1940 Act, creating an exemption from the registration requirements of the 1940 Act for issuers that are not making and do not propose to make a public offering of its securities and whose outstanding securities are exclusively owned by “qualified purchasers.”
**i. Qualified Purchaser**

Pursuant to Section 3(c)(7) of the 1940 Act, "qualified purchaser" is defined to include the following persons:

(a) a natural person who owns at least $5 million in "investments"; (b) a company which owns at least $5 million in "investments" and which is owned directly or indirectly by two or more related natural persons, estates of such persons or charitable organizations, foundations or trusts established by or for the benefit of such persons; (c) any trust not covered in the preceding paragraph if it is formed for the specific purpose of acquiring the securities, provided the trustee or the person making decisions and each settlor or other person contributing assets to the trust is a "qualified purchaser" under clauses (a), (b), or (d); and (d) any person, acting for its own account or for the accounts of other qualified purchasers, that in the aggregate owns and invests on a discretionary basis at least $25 million in "investments."

**ii. Effects of Section 3(c)(7)**

Section 3(c)(7) eliminates reliance upon the 100 holder limitation of Section 3(c)(1) for those issuers of securities that are owned solely by "qualified purchasers," and also allows an issuer that previously relied on Section 3(c)(1) to switch to the Section 3(c)(7) exemption. An issuer is permitted to switch to the new exemption provided that the holder's of the issuer's securities who acquired their securities on or before September 1, 1996, do not exceed 100 in number and only "qualified purchasers" acquire securities of the issuer after such date. However, concurrent to effecting such change, the issuer must (a) disclose to each beneficial owner of its securities that future investors will be limited to "qualified purchasers" and that there will no longer be a 100 holder limitation and (b) provide each such beneficial owner with a reasonable opportunity to redeem any part or all of its interest in the issuer.

**E. State Securities Laws**

**1. General**

Asset-backed securities are not only required to be registered with the SEC pursuant to the 1933 Act, unless there is an applicable exemption, but such securities must also be registered under state securities or so-called "blue sky" laws. A typical state blue sky statute requires the registration of nonexempt securities sold within the
state and of persons involved in the securities industry, and also prohibits fraud in connection with the offer and sale of the security. However, the provisions of SMMEA preempted blue sky laws with respect to "mortgage related securities," as defined in Section 3(a)(41) of the 1934 Act, obviating the need for state registration of such offerings. Until amended by recent legislation, Section 3(a)(41) defined "mortgage related security" to mean a security that is rated in one of the two highest rating categories by a nationally recognized rating agency, and which represents ownership of or is secured by one or more promissory notes or certificates of interest or participation in such notes that are backed by first lien mortgages on a single parcel of real estate (including stock allocated to a dwelling unit in a residential cooperative housing corporation) originated by a bank, savings association, credit union, insurance company, similar regulated entity, or HUD approved mortgagee.

The provisions of SMMEA did provide the individual states with a window period, which expired on October 3, 1991, in which they could enact legislation to override and, in effect, "opt out" of the federal preemption. Ten states (Arizona, Arkansas, Indiana, Louisiana, Maryland, Minnesota, New Mexico, Oklahoma, South Dakota, and Utah) overrode the preemption, although Arizona and Maryland subsequently adopted exemptions for "mortgage related securities." The remaining eight states all have fairly liberal institutional investor exemptions, thus making registration at the state level a necessity only where the possibility exists of an offering to retail accounts. Further, the availability of institutional investor or other exemptions or the necessity of registration must be considered in the remaining states if the offering involves securities which do not qualify as "mortgage related securities" under SMMEA, even if they are investment grade asset-backed securities which may be offered for federal securities law purposes on a shelf basis. Of course, since "mortgage related securities" are merely a subset of the universe of asset-backed securities, non-SMMEA eligible securities still would be subject to the registration requirements of state blue sky laws.

2. Recent Developments

a. Amendment to Definition of "Mortgage Related Security"

As discussed previously, pursuant to legislation which took effect on December 31, 1996, commercial mortgage related securities rated in one of the two highest grades by at least one nationally recognized rating agency and backed by first lien mortgages originated by a
bank, savings association, credit union, insurance company, similar regulated entity, or HUD-approved mortgagee, will be deemed "mortgage related securities" within the meaning of Section 3(a)(41) of the 1934 Act, as added by SMMEA, and as amended by Section 347(a) of the CDRIA. Such "mortgage related securities" will thereby qualify for special exemptive treatment under state blue sky laws. Unlike the original version of SMMEA which provided the individual states with seven years to override the preemptions of both their blue sky and legal investment laws, the CDRIA gave the states seven years (through September 23, 2001) to override only the preemption of their legal investment laws with regard to SMMEA-qualified commercial "mortgage related securities."

b. NSMIA

Section 102 of recently enacted NSMIA amends the 1933 Act to bar individual states from requiring registration or qualification of, or from prohibiting, limiting, or imposing conditions upon the use of any offering document or other disclosure document with regard to "covered securities." As is relevant to the issuance of asset-backed securities, the term "covered securities" has been defined to include, among other items, (i) securities sold to "qualified purchasers" (as defined previously) or (ii) securities exempt from 1933 Act registration under (a) Rule 506 of Regulation D, or (b) Section 4(1) (transactions not by issuers, underwriters or dealers), or Section 4(3) (dealers' transactions not in connection with an underwriting), provided that the issuer is a reporting company under the 1934 Act. The preemptions for transactions exempt under Section 4(1) and 4(3) of the 1933 Act may remove certain asset-backed securities from state constraints on secondary trading, while the preemptions for securities issuances pursuant to Rule 506 of Regulation D will eliminate most of the restrictive conditions imposed under many state exemptions which purport to coordinate with Rule 506.

Notwithstanding such preemptions, NSMIA authorizes the individual states to require notice filings, consisting solely of documents filed with the SEC, annual or periodic sales reports (if not included in documents filed with the SEC), filing fees, and consent to service of process for each aforementioned "covered security." Furthermore, states may impose or increase filing or registration fees subsequent to the enactment of NSMIA, and states may require fees to be paid and supporting data to be filed as if the issuer were not relying on the preemption. Thus, while NSMIA ends "merit review" and reduces the amount and types of documents required to filed with the states
for “covered securities,” it still preserves the states’ rights to require filings at times that are inconsistent with SEC requirements. States also retain their rights under NSMIA to investigate and bring enforcement actions with respect to unlawful conduct by a broker or dealer in connection with securities transactions.

III. Tax Issues

The primary tax concern with regard to pass-through transactions is the avoidance of taxation of both the investor and the entity issuing the securities. In order to escape corporate taxation at the entity level, a tax-free vehicle must be established, with the choice of vehicle determined, in part, by whether the originator of the assets intends the transaction to be a sale or a financing for federal income tax purposes.

A. Grantor Trust or Fixed Investment Trust

The grantor trust or fixed investment trust is a non-taxable entity for federal income tax purposes. However, in order to attain such classification, the trust cannot (a) have multiple classes of ownership, unless such classes are formed to facilitate a “direct investment” in the trust’s assets and the existence of such classes is merely “incidental” to such purpose and (b) have the power to “vary the investment” of the certificateholders in order to profit from fluctuations in market rates of interest.

B. Real Estate Mortgage Investment Company (REMIC)

1. General

Until the enactment of the FASIT legislation described below, any multiclass mortgage-backed transaction (other than pro rata pay classes, including pro rata pay senior/subordinated structures, which satisfy fixed investment trust requirements) was generally required to be structured as a REMIC to avoid corporate level taxation. Any entity, including partnerships, trusts, corporations, and specifically identified segregated groups of assets that meets the specific requirements imposed by the Internal Revenue Code is permitted to elect REMIC status.

2. Important REMIC Requirements

In order to qualify as a REMIC, all but a de minimis amount of the assets of the REMIC must consist of either “qualifying mort-
gages” or “permitted investments.” Mortgage loans qualify only to the extent they are truly mortgage loans: (a) they must be secured by real estate at origination or upon creation of the REMIC at no worse than a 125% loan-to-value ratio and (b) the sponsor of the REMIC must have no reason to believe that default and conversion into real estate through foreclosure, deed-in-lieu, or otherwise is imminent. Permitted investments generally include only collections on the mortgage loans temporarily held between payment dates, reserve funds held generally to cover defaults on the mortgage loans, and, for a temporary period, property acquired by foreclosure.

The regular interests in the REMIC must bear a qualifying interest rate, which may be a fixed rate or a variable rate based on either an independent index or a weighted average net mortgage rate, in each case plus or minus a spread, and which may be subject to a cap or floor.

Reasonable arrangements must be made to prevent the transfer of residual interests to “disqualified organizations” (generally, wholly tax-exempt organizations).

Since a REMIC is intended to be a fixed pool of mortgage loans, the ability to modify a mortgage loan is restricted unless the loan is in default or default is reasonably foreseeable.

A REMIC must not engage in prohibited transactions, which include receipt by a REMIC of income from nonpermitted assets or the performance of services, and on gain from disposition of REMIC assets other than, generally, defective or defaulted mortgages or pursuant to a complete liquidation of the REMIC. A REMIC must pay a tax equal to 100% of the net income derived from such prohibited transactions.

C. Financial Asset Securitization Investment Trusts (“FASITs”).

1. General

The Small Business Job Protection Act of 1996 created a new type of securitization vehicle, the FASIT, which is a non-taxable, flow-through vehicle which provides certain advantages and disadvantages compared with a REMIC. The FASIT legislation becomes effective on September 1, 1997.
2. FASIT vs. REMIC

a. Benefits of FASITs as Compared with REMICs

The following are the benefits of FASITs:

1. FASITs are permitted to hold all types of "debt obligations," not just qualified mortgages or permitted investments. However, the debt obligations may not have contingent interest of any kind;

2. FASITs are permitted to hold hedging instruments;

3. FASITs are permitted to hold contracts to acquire new permitted assets or substitute new assets for existing assets any time. This allows for reinvestment of cash flows in other financial assets that mature later than the next payment date, which can be used to provide call protection for investors. It also permits construction loans and warehouse liens to be refinanced with permanent securities within the FASIT;

4. FASITs may dispose of loans in order to retire a single class of regular interests;

5. There is no FASIT-level tax on income from foreclosure property; and

6. There are no limitations on reserve funds funded with cash or debt instruments.

b. Requirements Imposed by a FASIT Which Are Not Imposed by a REMIC

Although a FASIT may take the form of a trust, partnership, corporation, or segregated asset pool, all ownership interests must be held by a single owner (or, under regulations, members of the same affiliated group) which is a taxable "C" corporation. The pool sponsor must recognize gain (but not loss) at the time the FASIT is formed on the present value of excess cash flow, including assets pledged as credit support, and subsequently on each transfer of new assets to the FASIT. All income on ownership interest, whether economic or "phantom," is subject to tax without offset for unrelated deductions or for net operating losses of the owner. Interest-only certificates may also be held only by taxable "C" corporations, and all income thereon is also subject to tax without offset for unrelated deductions or net operating losses of the holder.
D. Taxable Mortgage Pools (TMPs)

1. General

Final regulations were issued in August 1995 pursuant to Section 7701(i) of the Internal Revenue Code of 1986 (the “Code”) providing guidance as to whether an entity is subject to the TMP rules of the Code. Until the enactment of FASIT legislation, this Code section served to ensure that the REMIC structure would be the sole vehicle for issuing multi-class securities backed by a pool of mortgage loans. TMPs are subject to corporate income tax at the entity level.

2. Requirements

An entity will be characterized as a TMP if, in general, the following conditions are satisfied:

(a) substantially all (generally, more than 80%) of the entity's assets consist of debt obligations and more than 50% of those obligations consist of real estate mortgages; (b) the entity issues debt obligations with two or more maturities; (c) payments on the debt obligations issued by the entity bear a relationship to payments on the debt obligations the entity holds as assets. Such relationship exists if, under the terms of the debt issued, the timing and amount of payments on such debt are in large part determined by the timing and amount of payments or projected payments on the obligations held by the entity; and (d) the entity does not elect to be treated as a REMIC.

E. Partnerships

Structuring an entity as a partnership, including a trust that is taxable as a partnership, provides an alternative form for avoiding entity level taxation.

1. Partnership/Corporation Classification Prior to the “Check the Box” Regulations

Prior to the enactment of recent regulations, unincorporated organizations engaged in business activities were generally treated as corporations for federal income tax purposes if they possessed three or more of the following “corporate characteristics,” and as partnerships if they possessed two or fewer:

a. Continuity of Life

A corporation may exist indefinitely regardless of the status or
identity of its shareholders, whereas the death, bankruptcy, or incapacity of a partner dissolves a partnership.

b. Free Transferability of Interests

Unlike shares of most corporations, ownership interests in a partnership are generally not transferable without the consent of the other partners.

c. Centralization of Management

Partners are entitled to participate in the day-to-day management of a partnership, whereas the shareholders of a corporation generally are not.

d. Limited Liability

All partners in a general partnership, and the general partner in a limited partnership, have unlimited personal liability for the debts of the partnership, whereas the shareholders of a corporation have limited liability.

2. "Check the Box" Regulations

a. General.

The "check the box" regulations, which became effective on January 1, 1997, simplify entity classification by allowing business entities which are not automatically classified as corporations to elect to be treated as either a partnership or corporation. Certain business entities are automatically treated as corporations under the new regulations, including domestic corporations, entities that are taxable as insurance companies, state-chartered business entities conducting banking activities whose deposits are insured by the Federal Deposit Insurance Act, and TMPs.

Entities may specify an effective date for the election, so long as that date is not more than 75 days prior to, or 12 months after, the date on which the election is filed. If no date is specified, the election is effective on the filing date. Domestic eligible entities that fail to make an election are treated as partnerships if they have two or more members, or are disregarded as entities apart from their owner if they have a single member.
b. Switching Classifications

i. For Elections Made Pursuant to the Regulations

An entity that has elected to be treated as either a corporation or a partnership generally cannot change its classification for a second time in the 60-month period following the initial election. However, if 50% of the ownership interests in the entity change during the 60-month period, the Internal Revenue Service has the authority by private letter ruling to authorize a second change in classification.

ii. Grandfather Rules

In the absence of a contrary election, an entity that is treated as being “in existence” prior to January 1, 1997, will retain the classification it held under the prior four-factor classification regime. More specifically, unless the entity is automatically classified as a corporation under the new “check the box” regulations, the entity’s claimed election will be respected if:

(a) the entity had a “reasonable basis” for its claimed classification; (b) the entity and each of its members recognized the federal tax consequences of any change in the entity’s classification within the 60 months prior to January 1, 1997; and (c) neither the entity nor any of its members were notified in writing that the classification of the entity was under examination by the Internal Revenue Service.

IV. BANKRUPTCY ISSUES

Bankruptcy and insolvency laws play an important role in the structuring of securitization transactions, as the quality of the credit relating to the securities, and in turn the rating of the securities, is derived, in part, in reliance on the knowledge of expected treatment of the issuer of the securities and its assets in the event of a bankruptcy by its parent or sponsor. Thus, the primary goals for structured finance transactions with respect to bankruptcy or insolvency considerations generally are to obtain a higher credit rating for the securities than the credit rating of the originator of the assets that are being securitized and to insulate the securities from the effects of a bankruptcy of the originator.
A. The Bankruptcy Remote SPV

1. General

After identifying the assets to be utilized in the securitization, the originator generally transfers the receivables to a newly formed special purpose corporation, trust, or other legally separate entity, the SPV. To gain acceptance as an issuer of capital market securities, the SPV should be structured as bankruptcy remote, meaning that the SPV is unlikely to be adversely affected by a bankruptcy of the originator.

2. Restrictions Necessary for Maintaining Bankruptcy Remoteness

a. Restriction on Permissible Activities

To achieve bankruptcy remoteness, the SPV’s organizational structure must strictly limit its permitted business activities to that of owning and operating the collateral that is the subject of the securitization.

b. Restriction on Incurring Indebtedness

The SPV must be prohibited from incurring indebtedness, other than ordinary course unsecured trade debt. Thus, the SPV is restricted in its ability to issue guaranties or indemnities.

c. Restriction on Certain Major Decisions

The SPV must be prohibited from dissolving, liquidating, merging, or consolidating and from selling all or substantially all of its assets. An approval from a person not controlled by the SPV or its affiliates is required to amend the SPV’s organizational documents and to commence bankruptcy or insolvency proceedings.

B. True-Sale

For securitization transactions in which the issuer is not bankruptcy remote or to provide further protection for issuances involving bankruptcy remote SPVs, the sale of the securities should be structured as a “true sale” of the underlying assets, such that the assets are removed from the originator’s bankruptcy or insolvency estate and are thus not subject to recapture by the seller or any related bankruptcy trustee or receiver. The presence of an intention to cause a true sale of the assets by the parent or sponsor to the separate entity, as opposed to a financing of those assets by the entity for the parent,
is carefully analyzed in a securitization transaction and will require opinions of counsel as well as indications of intended accounting treatment following the transaction by the parent or sponsor. The legal characteristics and economic substance of the transfer will be the primary determining factors as to whether the transaction is a sale or a loan, not the stated intent of the parties; the parties cannot transform a loan into a sale merely by labeling the transaction a sale.

C. Non-consolidation

The SPV’s operations and relationships with its affiliates must be carried out in such a fashion as to minimize the risk that it might be swept into the bankruptcy of one or more of its affiliates pursuant to the bankruptcy law doctrine of “substantive consolidation.” Substantive consolidation is an equitable doctrine which provides that in order to prevent a perceived injustice, separate legal entities may be disregarded so that the assets and liabilities of such entities may be consolidated and dealt with as if the assets were held by, and the liabilities incurred by, a single entity. The possibility of consolidation of an issuer of asset-backed securities with an insolvent affiliate is avoided, in part, by careful attention at the initial creation of the issuer to the corporate separateness of the issuer and the avoidance of operating procedures or of an operating history suggesting the issuer is the alter ego or instrumentality of the insolvent affiliate.

V. UNIFORM COMMERCIAL CODE (UCC) ARTICLE 9: SECURED TRANSACTION ISSUES

A. General

In most structured finance transactions, even though the transfer of assets from the originator to the financing entity is often structured as a “true sale” for bankruptcy purposes, for further protection of security holders or where the transaction is structured as a financing by an SPV, a perfected security interest under UCC Article 9 is obtained. Article 9 of the UCC applies to the perfection of a security interest in, among other items, accounts, chattel paper, general intangibles, and instruments, each of which are frequently the subject of an asset securitization.
B. Steps for Perfecting a Security Interest

1. Attachment

In order to obtain a valid, perfected security interest in accounts, chattel paper, instruments or general intangibles, the security interest must attach, thus making it enforceable against the debtor. Section 9-203 of the UCC provides that attachment occurs when the following four steps are completed by the prospective secured party:

(a) the secured party must enter into an agreement with the debtor; (b) the security agreement must either be reduced to a writing signed by the debtor that describes the collateral or the secured party must obtain possession of the assets; (c) the secured party must ensure that the debtor has rights in the collateral; and (d) the secured party must give value to the debtor.

2. Perfection

Although a security interest which has attached is enforceable against the debtor, it is necessary to perfect the security interest in order to gain priority vis a vis third parties with respect to any claims to the collateral. Perfection is required by rating agencies and underwriters in structured finance transactions in order to give a secured creditor protection against third parties and to provide notice of the secured party's claim to all potential creditors of the debtor. Generally, the first creditor to perfect its interest in the collateral is the person with the superior right to the proceeds of the liquidation.

a. Financing Statement

The most common and important method for perfecting one's security interest in collateral is through filing a financing statement against the debtor in the state of the debtor's principal place of business. This document does not create the security interest between the parties, but is merely a publicly filed notice alerting subsequent potential creditors of the existence of a prior lien on the collateral.

b. Possession

The creditor may perfect its interest in certain collateral by assuming possession of the collateral. This method of perfection is preferable in the case of chattel paper because a security interest which is perfected by filing can be defeated by a purchaser of chattel paper who gives new value and takes possession in the ordinary course of business. However, it is not always practical to take posses-
sion of all chattel paper that is the subject of a securitization, as is generally the case in a securitization of loans that are small in size, such as auto loans.

VI. ERISA ISSUES

Under ERISA, standards of conduct relative to the administration of private pension plans are imposed on fiduciaries, who have the authority to deal with "plan assets." Accordingly, the determination of what constitutes a "plan asset" is critical. For instance, if in the context of mortgage-backed securities a mortgage underlying a mortgage-backed security were deemed to be a "plan asset," not only would the plan's trustee be treated as a fiduciary, but individuals, such as mortgage bankers who are mortgagees of record and servicers of a mortgage also may be considered fiduciaries subject to the fiduciary responsibility rules of ERISA. Fiduciaries responsible for investing assets of ERISA plans are charged to do so "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Because pass-through certificates represent ownership interests in the underlying assets, to the extent ERISA plans own a sufficient portion of the pass-through certificates issued by any pass-through trust, the underlying assets may be considered "plan assets," and transactions with plan assets by trustees, servicers, and sponsors are severely restricted. As a practical matter, sale of such securities to ERISA plans is generally feasible only if an exemption is available.

A. Prohibited Transaction Class Exemption 83-1 (PTCE 83-1)

PTCE 83-1 permits the acquisition and holding of pass-through certificates backed by a pool of first or second mortgages or deeds of trust, and provides, generally, that the direct or indirect sale, exchange or transfer of certificates in the initial issuance of certificates between the sponsor of a mortgage pool and an employee benefit plan, when the sponsor, trustee, or insurer of such pool is a party in interest with respect to such plan, will not be treated as a prohibited transaction. While this exemption has traditionally been utilized in single-family mortgage-backed pass-through transactions, PTCE 83-1 is not available for commercial or multifamily properties. Furthermore, because "mortgage pool pass-through certificate" is defined for ERISA purposes as a certificate representing a beneficial undivided fractional interest in a mortgage pool entitling the holder of
such certificate to pass-through payments of principal and interest from the pooled mortgages, less any fees retained by the pool sponsor, many mortgage securitization structures may not qualify for the exemption, including:

(a) certificates entitled to receive payments of interest and principal on the mortgage loans only after payments to other classes; (b) certificates that evidence the beneficial ownership in only one tranche of mortgage loans to be deposited in the trust; (c) certificates that evidence beneficial ownership of a specified percentage of interest payments only or principal payments only, or a notional amount of principal or interest payments; and (d) certificates that evidence an interest in a mortgage pool structured as a REMIC.

B. Qualified Professional Asset Manager (QPAM) Exemption

PTCE 84-14 permits various parties who are related to employee benefit plans to engage in transactions involving plan assets, if, among other conditions, the assets are managed by a QPAM who is independent of the parties in interest. QPAMs may be a bank, savings association, or insurance company that has a net worth in excess of $1 million or an investment adviser registered under the 1940 Act that has a net worth of over $750,000 and manages in excess of $50 million of assets. The QPAM exemption is not available for transactions subject to PTCE 83-1.

C. Underwriter Exemptions

1. General

Most major investment banks have obtained individual exemptions from the Department of Labor that allow employee benefit plans to invest in pass-through certificates representing undivided interests in trusts holding single and multifamily residential or commercial property, guaranteed governmental mortgage pool certificates, and certain other receivables. The exemptions are restricted to trusts with respect to which the investment bank possessing the exemption, or any affiliate of the investment bank, is either (i) the sole underwriter, (ii) manager or co-manager of the underwriting syndicate, or (iii) a selling or placement agent. The exemptions also permit the direct or indirect acquisition or disposition of those certificates in the secondary market and the continued holding of certificates acquired by the plan.

2. Restrictions and Conditions Imposed by the Underwriter
Exemption

The restrictions and conditions imposed by the underwriter exemptions are as follows:

(1) the acquisition of certificates by a plan must be on terms that are at least as favorable to the plan as they would be in an arm's-length transaction with an unrelated party; (2) the rights and interests evidenced by the certificates may not be subordinated to the rights and interests evidenced by other certificates of the same trust. Consequently, securities which pay later in a "fast pay-slow pay" arrangement may be considered subordinate, unless all classes become pro rata pay securities in the event of a default on any such class; (3) the certificates must have received a rating that is in one of the three highest generic rating categories from either Standard & Poor's, Moody's, Duff & Phelps, or Fitch; (4) the plan investing in certificates must be an accredited investor, as defined in Rule 501 of Regulation D of the 1933 Act; and (5) no more than reasonable compensation may be paid to underwriters, sponsors, or servicers in connection with the distribution or placement of certificates, the assignment of obligations to the trust, or the provision of services under the pooling and servicing agreement.

D. In-House Asset Manager (INHAM) Exemption

The Department of Labor in 1996 granted a class exemption that permits large pension plans with an INHAM to directly enter into transactions that otherwise might be considered prohibited transactions. The INHAM must be registered as an investment adviser under the 1940 Act and be directly responsible for the management of at least $50 million of the plan's assets. Furthermore, the INHAM must be either a direct or indirect wholly owned subsidiary of a sponsoring employer of the plan or such sponsoring employer's parent organization, or a non-profit membership corporation, a majority of whose members are officers or directors of the employer or parent organization.

VII. Legal Investment Issues.

A. SMMEA

Under SMMEA, "mortgage related securities" (as previously defined) are considered to be legal investments for persons, trusts, corporations, partnerships, associations, business trusts, and business entities (including depository institutions, life insurance companies,
and pension funds) created pursuant to or existing under the laws of
the United States or any state whose authorized investments are
subject to state regulation to the same extent that, under applicable
law, obligations issued by or guaranteed as to principal and interest
by the United States or any agency or instrumentality thereof consti-
tute legal investments for such entities. As with state "blue sky"
laws, this aspect of SMMEA was also subject to state override, and
numerous states have adopted legislation overriding portions of the
legal investment aspect of SMMEA. A number of states adopted
legislation focusing upon the legality of investment for insurance
companies, reflecting the concern regarding the deteriorating finan-
cial health of the insurance industry. Colorado and Maryland have
limited legal investments with respect to state savings associations
and Missouri has similarly limited legal investment for banks and
trust companies.

B. Recent Developments

As previously discussed, pursuant to legislation which became
effective on December 31, 1996, commercial "mortgage related secu-
rities" rated in the two highest categories by at least one nationally
recognized rating agency and backed by first lien mortgages origi-
nated by a bank, savings association, credit union, insurance
company, similar regulated entity, or HUD-approved mortgagee will
be deemed "mortgage related securities" within the meaning of Sec-
tion 3(a)(41) of the 1934 Act, and thereby qualify for legal
investment by the various types of investors enumerated in the previ-
ous paragraph. As was the case under the initial adoption of
SMMEA, the individual states have been afforded seven years
(through September 23, 2001) to override the preemption of their
legal investment laws with regard to SMMEA-qualified commercial
"mortgage related securities."