



## Broadly Defined Term “Structured Finance Product” Creates Uncertainty under SEC Proposal

On April 7, 2010, the Securities and Exchange Commission (the “SEC”) released for comment a set of proposed revisions to Regulation AB and other rules that would significantly revise the offering, disclosure, and reporting regimes for asset-backed securities and other structured finance products.<sup>1</sup> A subset of those proposed revisions (the “Disclosure Rules for Private Offerings”) would address unregistered offers and resales of structured finance products.<sup>2</sup>

In its discussion of the Disclosure Rules for Private Offerings, the SEC states that securitization in the private, unregistered market played “a significant role” in the financial crisis.<sup>3</sup> The Disclosure Rules for Private Offerings represent the SEC’s attempt to remedy what it believes are deficiencies in the information available about CDOs and other privately-issued structured finance products.<sup>4</sup>

Not surprisingly, in order to address a perceived lack of adequate information in a significant component of the capital markets, the SEC drafted the Disclosure Rules for Private Offerings broadly. The Disclosure Rules for Private Offerings would apply to “structured finance products,” which would be a broader term than the proposed revised definition of “asset-backed security” in Item 1101(c) of Regulation AB. The SEC notes that it used the broader term “in order to reflect the wide range of securitization products that are sold in the private markets.”<sup>5</sup> Unfortunately, however, the broad, general language of the proposed definition of “structured finance product” could capture securities that contain structured finance elements (*e.g.*, the use of a special purpose vehicle) but would not traditionally be thought of, or categorized, as structured finance products.

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<sup>1</sup> Asset-Backed Securities, Release Nos. 33-9117; 34-61858, available at <http://www.sec.gov/rules/proposed/2010/33-9117.pdf> (the “Release”). For a description and general discussion of the proposed revisions, see Morrison & Foerster LLP’s News Bulletin entitled “Historic Changes Proposed for ABS Offering Rules,” available at <http://www.mofo.com/files/Uploads/Images/100420ABS.pdf> (the “ABS News Bulletin”).

<sup>2</sup> Specifically, the Disclosure Rules for Private Offerings would amend the safe harbors provided in Rules 144, 144A, and 506 to, among other things, require issuers (i) to provide initial investors and transferees, as applicable, with the right to request the same information — both on an initial basis and, under Rules 144 and 144A, on a periodic basis — that would be required if the offer or resale were registered and (ii) to file with the SEC public notices of initial placements of structured finance products. See the discussion of “Private Offerings of ABS and other Structured Products” in the ABS News Bulletin.

<sup>3</sup> See Release, at 270.

<sup>4</sup> See Release, at 349.

<sup>5</sup> Release, at 275.

## Structured Finance Products

The Disclosure Rules for Private Offerings would define a “structured finance product” to mean (and thus the Disclosure Rules for Private Offerings would apply to):<sup>6</sup>

- (a) a synthetic asset-backed security; or
- (b) a fixed-income or other security collateralized by any pool of self liquidating financial assets, such as loans, leases, mortgages, and secured or unsecured receivables, which entitles the security holders to receive payments that depend on the cash flow from the assets, including —
  - (i) an asset-backed security as used in Item 1101(c) of Regulation AB,
  - (ii) a collateralized mortgage obligation,
  - (iii) a collateralized debt obligation,
  - (iv) a collateralized bond obligation,
  - (v) a collateralized debt obligation of asset-backed securities,
  - (vi) a collateralized debt obligation of collateralized debt obligations, or
  - (vii) a security that at the time of the offering is commonly known as an asset-backed security or a structured finance product.

As an initial matter, one could argue that the SEC intended the Disclosure Rules for Private Offerings to apply to multi-tranche securitization structures utilizing special purpose entity issuers.<sup>7</sup> However, neither of those elements is contained in the proposed definition of structured finance product.

### *Structured Notes*

It is unlikely that traditional structured notes that are issued by a corporate entity would constitute structured finance products.<sup>8</sup> Those securities typically are unsecured obligations of the issuing entity, and thus would not satisfy the collateralized pool element of clause (b) of the proposed definition.<sup>9</sup> However, it is less clear whether a structured note would constitute a synthetic asset-backed security under clause (a). Unlike clause (b), which has qualifying language before the list of specific types of products, clause (a) is simple and express: a synthetic asset-backed security would be a structured finance product. Arguably, to the extent that a traditional structured note is linked to one or more reference assets that could otherwise be included in the pool of financial assets in an asset-backed security (*e.g.*, bonds or loans or indices comprised thereof), a broad interpretation of the term “synthetic asset-backed security” could apply to that structured note, with the obligation of the issuer to make a payment based on the performance of those reference assets representing a synthetic investment in them. Note, however, that this would not be an issue to the extent that a special purpose entity element were read into the proposed definition of structured finance product.<sup>10</sup>

<sup>6</sup> While not expressly included in the proposed definition, the SEC states in the Release that both asset-backed commercial paper and any residual tranche of a structured finance product would qualify as structured finance products. See Release, at footnote 467.

<sup>7</sup> Proposed Form 144A-SF and proposed amendments to Form D would require issuers of structured finance products to provide a brief description of the structure of the securities, including the number of tranches in the securitization. Additionally, in the context of its discussion of CDOs and other privately offered structured finance products, the SEC states that those securities “are issued by special purpose vehicles whose only purpose is holding financial assets . . .” Release, at 21.

<sup>8</sup> Traditional structured notes are issued “on the balance sheet” of the corporate issuer. A noteholder’s return at maturity may be linked to the return of one or more underlying reference assets, rates, currencies, or indices.

<sup>9</sup> The absence of the collateralized pool element is also important because it would preclude application of the catch-all language in clause (b)(viii) of the proposed definition to such securities. Structured notes are often referred to as structured products, which could be confused with the term structured *finance* product.

<sup>10</sup> See, *supra*, footnote 7 and accompanying text.

### *Covered Bonds*

Covered bonds are debt instruments that set aside high quality assets in a collateral pool – either pursuant to ring-fencing laws in the issuer’s jurisdiction or structurally through the use of a special purpose entity – to support the ultimate repayment of the bonds. Unlike traditional asset-backed securities, payments on the collateral pool assets are not passed through to the noteholders. Instead, those assets are only accessed upon a payment default by, or insolvency of, the issuer.

Covered bonds likely would constitute structured finance products under the proposed definition. They clearly satisfy the collateral pool element of clause (b); however, it is less clear whether payments on covered bonds “depend on the cash flow from the assets” in the collateral pool. A typical cash flow in an asset-backed security context would consist of the periodic interest and principal payments that the collateral pool assets generate. In contrast, covered bonds are a corporate obligation of the issuing bank that are secured by a collateral pool. The collateral pool, in a sense, “guarantees” the bank’s obligation, and therefore the noteholders have only a contingent interest in the assets. A broad reading of the “cash flow” element could include payments received from the collateral pool, including liquidation proceeds, subsequent to a default or issuer insolvency under the covered bonds.

### *Hybrid Capital Securities*

To the extent that hybrid capital securities are issued out of a special purpose vehicle where the cash flow from a pool of self-liquidating financial assets supports payments on those securities, they in all likelihood would constitute structured finance products under the proposed definition. For example, payments on trust preferred securities are primarily supported by junior subordinated debentures of the issuer that are sold to, and held by, the issuing trust. Another form of hybrid capital could involve a standby capital facility where the issuing trust invests the issuance proceeds in high grade assets, such as U.S. Treasuries, and agrees to purchase junior subordinated debentures from an entity in exchange for a commitment fee.

### *Pooled Investment Vehicles*

Unlike an asset-backed security, which is a security that is *primarily* serviced by the cash flows of a discrete pool of receivables or other financial assets that by their terms convert into cash within a finite time period, a structured finance product need only be a security collateralized by any pool of self-liquidating financial assets, the payments on which *depend* on the cash flow from those financial assets. As such, arguably fewer assets in the collateral pool need to support only a portion of pass-through payments to the investors under the proposed definition of structured finance product in contrast to the asset-backed security definition. This implies that vehicles with more diverse asset combinations, and thus fewer assets that generate a cash flow for the securities, could be captured by the proposed definition of structured finance product. Accordingly, it is possible that the broad language of the proposed definition of structured finance product would apply to money market funds, fixed income funds, certain hedge funds, and other pooled investment vehicles.

### *Repackaged Products*

It is also likely that clause (b) of the proposed definition would apply to repackaged products, such as those products that involve the repackaging of corporate bonds or corporate bonds and derivatives. For example, an investor may be precluded by its constituent documents from entering into derivatives and want to purchase floating rate debt of a company that only issues fixed rate debt. As a solution, the investor could purchase securities of a trust that contains fixed rate debt of the company and an interest rate swap. Arguably, those repackaged securities would be covered by the proposed definition of structured finance product.

## Conclusion

To the extent that a security constitutes a structured finance product under the proposed definition, the Disclosure Rules for Private Offerings and their increased notice and disclosure requirements would apply to private offerings and resales of those securities under Rules 144, 144A, and 506. However, the Disclosure Rules for Private Offerings would not apply to all safe harbors for private placements and exempt offerings. For example, the SEC acknowledges that the Disclosure Rules for Private Offerings “may make offers and sales pursuant to Section 4(2) . . . or resales pursuant to so-called Section 4(1-1/2) more attractive to issuers.”<sup>11</sup> The Disclosure Rules for Private Offerings also would not apply to the Regulation S safe harbor for offshore sales, although the SEC requests comments on whether it should.<sup>12</sup> These provisions also would not apply to exempt securities, such as securities offered pursuant to Section 3(a)(2). In an ironic twist, the uncertainty surrounding the proposed definition of structured finance product may result in issuers relying less on clear, regulatory safe harbors and more on the traditional statutory private placement and resale exemptions for U.S. offerings and resales, the parameters of which are less clear. We anticipate that additional clarity concerning the proposed definition of structured finance product will emerge as a result of industry comment and further consideration of the SEC’s proposed revisions to Regulation AB and other rules.

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<sup>11</sup> Release, at 361.

<sup>12</sup> See Release, at 287.