STRUCTURED FINANCE ASSOCIATION

SFA Research Corner

Where Does Securitization Begin and End? A View from Both Sides of the Regulatory Wall

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Where Does Securitization Begin and End? A View from Both Sides of the Regulatory Wall

Securitization does not have a single regulatory definition. Different rules draw different boundaries, with important implications for how transactions are structured and regulated. As financing structures evolve, where do those boundaries lie, and why do they matter?

In this Research Corner conversation, Rolaine Soril Bancroft, former Chief of the SEC's Office of Structured Finance and now an attorney at Latham & Watkins, draws on her 20 years at the SEC and her experience advising market participants to explore securitization from both sides of the regulatory wall. The discussion examines the regulatory distinctions that shape the market, including their implications for emerging asset classes such as data centers. Rolaine also serves as Co-Chair of SFA's Legal Counsel Committee.

You spent 20 years at the SEC and now advise firms operating within the regulatory framework. What looks different from this side of the regulatory wall?

> As a regulator, visibility is limited to what the market brings to your attention, or what comes up in a disclosure review, examination, or enforcement investigation. While the SEC staff encourages the market to ask questions and is open to providing guidance, many practitioners will shy away from asking a question because of the risk of receiving an answer they might not want to hear. On the private side, I now have to analyze many questions that were never presented to the staff at the SEC. However, because I grew up at the SEC as a securities lawyer, I understand how the staff would approach the analytical exercise and can anticipate their questions and concerns on a particular issue. Because our practice is focused on developing new and innovative structures, a plethora of legal questions come my way.

When you were inside the SEC, what could you see about the securitization market that individual issuers, investors or lawyers might not have been able to see?

> Simply put, the thought process. When the staff analyzes any policy, rule, or investigation, it is stress-testing that position across the entire market. Specialists from across the SEC weigh in on how a decision in one corner might ripple into a seemingly unrelated corner. Having sat in those rooms, I bring different data points not only to the legal analysis, but also to headline and business risk assessment.

Conversely, what was difficult to see from inside the SEC that became much more apparent once you moved to the private side?

> Across the board, the private markets, and that's by design. From inside the SEC, you see the public markets in great detail, but private deals are largely out of view. Once I moved to the private side, I saw how much innovation happens in that space well before it reaches the staff's desk.

How does an issue go from something happening in the market to something that gets the attention of SEC staff?

We all follow many sources — news outlets, financial reporters, trade publications, bloggers — and the staff meets periodically with Congressional staff, trade groups (including SFA), issuers, investors, and other regulators. The SEC also has an intake system called the Tips, Complaints and Referrals system, where anyone can submit information.

The Securitization Perimeter

"Securitization" doesn't have a single regulatory definition. Different frameworks draw the perimeter differently—for example, the Securities Act definition of an asset-backed security, Regulation AB's definition of ABS, the Exchange Act definition used for risk retention, or the scope of Rule 192. When we talk about where securitization begins and ends, which of these different regulatory perimeters do we need to distinguish—and how do they compare with the way the market uses the term? Example?

At its most basic level, securitization is a financing technique in which assets are isolated from their owner by putting them into a box. The box issues asset-backed securities to fund the purchase of those assets from the owner, and cash flows from those assets are used to pay back investors over time. The SEC regulatory framework is triggered because of the issuance of securities. I like to remind folks that there are at least four different definitions in the U.S. securities law framework that need to be analyzed for any securitization, (and one more if issuing offshore) and each was adopted for a different purpose, but they all share common elements. I like to think of the definitions as a bullseye.

The definition with the narrowest scope is "asset-backed security" in Regulation AB. This definition was adopted to define a scope of securitizations that are eligible for a tailor-made disclosure and reporting regime. For example, in lieu of providing financial statements, Regulation AB requires disclosure that is focused on the underlying assets, the determination of cash flow, and parties that are involved in handling the cash. The SEC recognized that the default offering and reporting disclosures did not provide the market with useful or material information at the times necessary to evaluate investments in these instruments. Public offering and disclosure requirements that fall outside the scope would need to be evaluated on a case-by-case basis. Last year, the SEC issued a concept release to request comment on whether securitizations broader than Regulation AB ABS should be able to use the alternative disclosure regime.

In 2010, the Dodd-Frank Act amended the Exchange Act by adding the definition of "asset-backed security." The SEC views this definition as the next larger circle in the bullseye. It sets the bounds for securitizations that are subject to certain rules, such as the credit risk retention and disclosure requirements related to repurchase activity and due diligence reports. These rules apply to both the public and private markets by design. A common example of a securitization that is not a Regulation AB ABS, but is an Exchange Act ABS, is a CLO.

The next circle of the bullseye is the definition of "asset-backed security" in Securities Act Rule 192 because it adds synthetic securitizations to the scope of securities. This definition sets the bounds for securitizations and securitization participants that are prohibited from engaging in conflicted transactions. For example, a synthetic risk transfer note would fit within the Rule 192 definition.

The last circle of the bullseye is Rule 17g-5, which is a conflict of interest rule that applies to NRSROs. One might interpret that because Rule 17g-5 is a rule under the Exchange Act, the Exchange Act ABS definition would apply. However, Rule 17g-5 was adopted in 2009 before the Dodd-Frank Act was enacted in 2010. When the SEC adopted Rule 17g-5, it noted that "[t]his broad category of financial instrument includes, but is not limited to, asset-backed securities such as residential mortgage-backed securities (RMBS) and to other types of structured debt instruments such as collateralized debt obligations (CDOs), including synthetic and hybrid CDOs, or collateralized loan obligations (CLOs)," therefore, it is at least as broad as Rule 192 ABS. Moreover, because the Rule 17g-5 definition is intended broadly to include "a security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction," I believe more structures and asset types like data center ABS and whole business securitizations could fall within scope.

Why do those distinctions matter? What are the practical consequences of a transaction falling within the definition of ABS—or securitization—for one regulatory purpose but not another?

A good example is the guidance we received from the SEC regarding certain data center securitizations. As explained in our analysis, the data center operations and all of its components are in the box of assets that are being securitized. We illustrated that this type of securitization is beyond the scope of an Exchange Act ABS by comparing an investment in a data center ABS to an investment in a real estate company, because the payments to investors depend on the cash flow from operations. In contrast, one element of the Exchange Act ABS definition is that payments depend primarily on the cash flow of a self-liquidating asset.

The regulatory consequence is that the rules that apply to Exchange Act ABS do not apply to certain data center ABS, such as the requirement to hold 5% risk retention. There has been an assumption in the market that we sought the guidance to help our clients avoid holding risk retention altogether, but that was not the intent. The practical reality is that data center ABS deals hold risk retention of around 30% because that is what the market demands. As our letter states, structuring the deal to comply with the rules was done out of an abundance of caution. But, as the market developed, restrictions in the risk retention rules relating to who can hold and how they hold, limited the ability to increase cross-collateralization or include additional retention holders. The other disclosure rules that apply to Exchange Act ABS are inapplicable to this type of securitization, such as disclosures about repurchases for breaches of asset representations and warranties.

How different is that regulatory map from the way practitioners think about securitization?

I have seen a range of interpretations. As with data centers, some market participants that are familiar with securitization will comply with the rules to mitigate regulatory risk. Others, particularly newcomers in emerging asset classes, are isolating assets in an SPV and issuing securities without realizing they may have stepped inside the securitization perimeter. For them, the regulatory regime can be a genuine blind spot.

Structured finance increasingly intersects with private credit, fund finance, asset-based finance and other forms of financing. As those markets converge, where are the traditional boundaries of securitization becoming harder to draw?

I think these interpretive questions have come up across the financing spectrum. For example, analytical questions arise in collateralized fund obligations and rated note feeders. The analysis is more challenging with different types of lease financings. The definition of Exchange Act ABS includes “a lease” in a list of “self-liquidating assets,” so the analysis must consider whether the payments depend primarily on cash flow from a self-liquidating asset. Questions related to residual value and related guarantees must be analyzed carefully, but this is where what we call “regulatory DNA” can be helpful, as Regulation AB provides breakpoints that can inform the Exchange Act ABS analysis. For example, for automobile leases, the residual value should not constitute 60% or more of the original asset pool and for other leases, the threshold is 50%. Additionally, single obligor aircraft lease transactions where the airline’s creditworthiness, rather than the asset pool’s self-liquidating nature, drives investor payments have not been viewed as ABS. But, in the case of residual value guarantees or insurance, the SEC has noted that, depending on the extent of the party’s obligation for such amounts, such obligation may result in that party constituting a significant provider of credit enhancement and additional disclosures, such as financial disclosures, may be required.

When economically similar assets or risks can be financed through very different structures, how should regulators think about the perimeter? Should regulatory treatment continue to turn primarily on the legal structure, or is there a role for looking more closely at economic function?

I think regulators need to look at both. Moreover, the economic reality helps inform the legal analysis. Taking data centers again, voluntary compliance with risk retention was done out of an abundance of caution because it was a new product in the market at the time and the statutory definition of ABS includes the word "lease." But the economic reality is that the investor is investing in an operation. While self-liquidating assets, like leases, may be included in the asset pool along with other revenue-generating types of contracts, those contracts do not represent the total economics of the investment, i.e., the expenses and the liabilities related to operating a data center that reduce incoming cash flows. This economic reality informs whether the holder of the security receives payments that depend primarily on the cash flow from the self-liquidating financial asset. By comparison, this is the economic reality for an investor in a data center CMBS because the payments depend primarily on the cash flow from a mortgage loan.

Looking ahead, do you think we will still be able to draw a meaningful boundary around "securitization"?

The laws evolved over time and the patchwork of definitions has created confusion. I hope that the SEC will align definitions. Now that I am in practice, I believe it would be better to have one broad definition of "securitization" or "asset-backed security" in the securities law. Then, each rule with a different regulatory purpose would have its own requirements, conditions, and exceptions. What keeps securitization interesting is that the market continues to innovate to fulfill the individual needs of borrowers, lenders, and investors. But the common thread in all of these definitions, no matter how complex the structure, is that, at some level, assets (self-liquidating or otherwise) are isolated in a box.