Testimony Before the Subcommittee on Oversight and Investigations of the United States House of Representatives Committee on Financial Services

"Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses"
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I. Introduction

Chairman Moore, Ranking Member Biggert, and members of the subcommittee:

My name is Paula Dubberly, Associate Director of the Division of Corporation Finance at the Securities and Exchange Commission, and I am pleased to testify on behalf of the Commission today on the topic of securitization as it concerns commercial real estate. Securitizations can serve as a vehicle for financing commercial real estate, so my comments today will provide an overview of the Commission's work in the securitization area generally, specifically focusing on a recent proposed rulemaking that the Commission published for public comment on April 7, 2010 that proposes significant revisions to the rules governing offers, sales, and reporting with respect to asset-backed securities ("the April 7 proposal").[1]

II. Background

Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities. This financing technique makes it easier for lenders to exchange payment streams coming from the loans for cash so that they can make additional loans or credit available to a wide range of borrowers and companies seeking financing.

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[1] The April 7 proposal is available on the SEC public Web site. See Asset-Backed Securities, Release No. 33-9117 (Apr. 7, 2010)[75 FR 23328] at http://www.sec.gov/rules/proposed.shtml.

At its inception, securitization primarily served as a vehicle for residential mortgage financing. Since then, asset-backed securities have played a significant role in both the U.S. and global economy. At the end of 2007, there were more than $7 trillion of both agency and non-agency[2] mortgage-backed securities and nearly $2.5 trillion of asset-backed securities outstanding.[3] Securitization can provide liquidity to nearly all major sectors of the economy including the residential and commercial real estate industry, the automobile industry, the consumer credit industry, the leasing industry, and the commercial lending and credit markets.[4]

Many of the problems giving rise to the financial crisis involved structured finance products, including residential mortgage-backed securities.[5] Many of these residential mortgage-backed securities were used to collateralize other debt obligations such as collateralized debt obligations and collateralized loan obligations (CDOs or CLOs), types of asset-backed securities that are sold in private placements.[6] As the default rate for subprime

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[2] Agency securities are securities issued by the government-sponsored enterprises, Ginnie Mae, Fannie Mae or Freddie Mac.

[3] See American Securitization Forum, Study on the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets (June 17, 2009), at 16 (citing to statistics on outstanding residential mortgage-backed securities and outstanding U.S. ABS collected by the Securities Industry and Financial Markets Association), available at http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf.

[4] See testimony of Micah Green, President of the Bond Market Association, Before the Senate Basel Committee on Banking Supervision, A Review of the New Basel Capital Accord, (June 13, 2003), available at http://banking.senate.gov/.

[5] A report by the U.S. Government Accountability Office (GAO) notes that 75% of subprime loans were packaged into securities in 2006. See U.S. Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (Jan. 2009) at 26.

[6] CDOs are typically sold as a private placement to an initial purchaser followed by resales of the securities to "qualified institutional buyers" pursuant to Rule 144A. Pools comprising the CDOs may consist of various types of underlying assets including subprime mortgage-backed securities and derivatives, such as credit default swaps referencing subprime mortgage-backed securities, and even tranches of other CDOs.

and other residential mortgages soared, such securities, including those with high credit ratings, lost much of their value.[7] CDOs were noted, in particular, to have contributed to the collapse in liquidity during the financial crisis.[8] As the crisis unfolded, investors increasingly became unwilling to purchase these securities, and today, this sentiment remains, as new issuances of asset-backed securities, except for government-sponsored issuances, have recently dramatically decreased.[9] The absence of this financing option has negatively impacted the availability of credit.[10]

III. The April 7 Proposal

The recent financial crisis highlighted that investors and other participants in the securitization market did not have the necessary tools to be able to fully understand the risk underlying those securities and did not value those securities properly or accurately. The severity of this lack of understanding and the extent to which it pervaded the market and

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CLOs are similar to CDOs except that they hold corporate loans, loan participations or credit default swaps tied to corporate liabilities.

[7] See, e.g., The President's Working Group on Financial Markets, Policy Statement on Financial Market Developments, March 2008 (the "PWG March 2008 Report") at 9 (discussing subprime mortgages and the write-down of AAA-rated and super-senior tranches of CDOs as contributing factors to the financial crisis).

[8] See, e.g., The Report of the Counterparty Risk Management Policy Group III ("CRMPG III"), Containing Systemic Risk: The Road to Reform, August 6, 2008, at 53 (noting that lack of comprehension of CDO and related instruments resulted in the display of price depreciation and volatility far in excess of levels previously associated with comparably rated securities, causing both a collapse of confidence in a very broad range of structured product ratings and a collapse in liquidity for such products). Another type of asset-backed security that is privately offered is asset-backed commercial paper (ABCP), which was increasingly collateralized by CDOs and RMBS from 2004 through 2007. The ABCP market severely contracted during the crisis. See PWG March 2008 Report at 8.

[9] See, e.g., David Adler, "A Flat Dow for 10 Years? Why it Could Happen," Barrons (Dec. 28, 2009) (noting that new securitization issuances, except those sponsored by the government, have largely come to a halt). In 2008 through the end of September, annualized issuance volumes for overall global securitized and structured credit issuance were approximately $2.4 trillion less than in 2006. See Global Joint Initiative to Restore Confidence in the Securitization Market, Restoring Confidence in the Securitization Markets (Dec. 3, 2008) at 6.

[10] Id. In the past 20 months, the Commission is aware of only one registered offerings of residential mortgage-backed securities backed by newly originated loans.

impacted the U.S. and worldwide economy calls into question the efficacy of several aspects of the Commission's regulation of asset-backed securities.

On April 7, the Commission proposed a number of changes to the offering process, disclosure, and reporting requirements for asset-backed securities, which are designed to enhance protection in this market. The April 7 proposal is designed to address issues that contributed to or arose from the financial crisis and to be forward-looking; some of the proposals are designed to improve areas that have the potential to raise issues similar to the ones highlighted in the financial crisis. The April 7 proposal is intended to provide investors with timely and sufficient information, including information in and about the private market for asset-backed securities, reduce the likelihood of undue reliance on credit ratings, and help restore investor confidence in the representations and warranties regarding the underlying assets. Although these revisions are comprehensive and therefore would impose new burdens, if adopted, we believe they would protect investors and promote efficient capital formation.

The April 7 proposal covers the following areas:

(1) revisions to the shelf offering process and criteria and prospectus delivery requirements;

(2) Securities Act and Exchange Act disclosure requirements, including new requirements to disclose standardized asset-level information or grouped account data and a computer program that gives effect to the cash flow provisions of the transaction agreement (often referred to as the "waterfall"); and

(3) changes to the Securities Act safe harbors for exempt offerings and exempt resales for asset-backed securities.

The April 7 proposal, if adopted, would apply to new issuances of asset-backed securities. Therefore, the proposed rules, if adopted, would not impose new requirements on outstanding asset-backed securities. The comment period for the proposed rules expires on August 2, 2010. The Commission looks forward to reviewing and considering all the comments.

The following is a summary of the proposed amendments in these three areas:

A. Revisions to Shelf Offering Process and Criteria

Securities Act shelf registration provides important timing and flexibility benefits to issuers. An issuer with an effective shelf registration statement can conduct delayed offerings "off the shelf" under Securities Act Rule 415 without further staff clearance. Under the Commission's current rules, asset-backed securities may be registered on a Form S-3 registration statement and later offered "off the shelf" if, in addition to meeting other specified criteria, the securities are rated investment grade by a nationally recognized statistical rating organization. Much has been written about the failures of ratings to measure accurately and describe the risks associated with certain of those products that were realized during the financial crisis.[11] The April 7 proposal would repeal the ABS shelf eligibility criterion relying on ratings and establish other criteria for shelf eligibility as well as revise the shelf registration procedure for issuances of asset-backed securities.

[11] See, e.g., The PWG March 2008 Report at 2, 8 (noting that the performance of credit rating agencies, particularly their ratings of mortgage-backed securities and other asset-backed securities, contributed significantly to the financial crisis).

The April 7 proposal would establish the following new requirements for ABS shelf eligibility criteria:

- A certification filed at the time of each offering off of a shelf registration statement, or takedown, by the chief executive officer of the depositor[12] that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities as described in the prospectus;
- Retention by the sponsor of five percent of each tranche of the securitization,[13] net of the sponsor's hedging (also known as "risk retention" or "skin-in-the-game");
- A provision in the pooling and servicing agreement that requires the party obligated to repurchase the assets for breach of representations and warranties to periodically furnish an opinion of an independent third party regarding whether the obligated party acted consistently with the terms of the pooling and servicing agreement with respect to any loans that the trustee put back to the obligated party for violation of representations and warranties and which were not repurchased; and
- An undertaking by the issuer to file Exchange Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.[14]

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[12] We use the term "depositor" to mean the depositor who receives or purchases and transfers or sells the pool assets to the issuing entity. For ABS transactions where there is not an intermediate transfer of the assets from the sponsor to the issuing entity, the term depositor refers to the sponsor. For ABS transactions where the person transferring or selling the pool assets is itself a trust, the depositor of the issuing entity is the depositor of that trust. See Item 1101(e) of Regulation AB.

[13] We use the term "sponsor" to mean the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. See Item 1101(l) of Regulation AB.

The Commission also proposed to replace Forms S-1 and S-3 with new forms for registered ABS offerings -- proposed Forms SF-1 and SF-3 -- and to revise the shelf offering structure for those securities. Form SF-3 would be the form used for ABS shelf offerings.

In addition, investors have expressed concern regarding a lack of time to analyze securitization transactions and make investment decisions. While the Commission historically has not built minimum time periods into its registration process to deliberately slow down the market,[15] and instead has believed investors can insist on adequate time to analyze securities (and refuse to invest if not provided sufficient time), we have been told that this is not generally possible in this market, particularly in an active market. Given many ABS investors' stated desire for more time to consider the transaction and for more detailed information regarding the pool assets, the Commission proposed to revise the filing deadlines in shelf offerings to provide investors with additional time to analyze transaction-specific information prior to making an investment decision. These changes are designed to promote independent analysis of ABS by investors rather than reliance on credit ratings. Under the proposed ABS shelf procedures, an ABS issuer would be required to file a preliminary prospectus with the Commission for each takedown off of the proposed new shelf registration form for ABS (Form SF-3) at least five business days prior to the first sale

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[14] Section 15(d) of the Exchange Act provides that for issuers that do not also have a class of securities registered under the Exchange Act, the duty to file ongoing reports is automatically suspended after the first year if the securities of each class to which the registration statement relates are held of record by less than three hundred persons. As a result, typically the reporting obligation of all asset-backed issuers, other than those with master trust structures, are suspended after they have filed one annual report on Form 10-K because the number of record holders falls below, often significantly below, the 300 record holder threshold.

[15] See, e.g., Section IV.A. of Securities Offering Reform, Release No. 33-8591 (Jul. 19, 2005) [70 FR 44722] (release adopting significant revisions to registration, communications and offering process under the Securities Act and stating that Rule 159 would not result in a speed bump or otherwise slow down the offering process).

in the offering.[16] Under the proposal, issuers would use one prospectus for each transaction and the current practice of using core or base prospectuses plus supplements would be eliminated for offerings of ABS.

B. Securities Act and Exchange Act Disclosure Requirements

In 2004, the Commission adopted a new set of rules prescribing the disclosure requirements for asset-backed issuers.[17] Many disclosure requirements of Regulation AB are principles-based. Regulation AB currently requires that material, aggregate information about the composition and characteristics of the asset pool be filed with the Commission and provided to investors. Market participants have expressed a desire for expanded disclosure relating to the assets underlying securitizations. The April 7 proposal includes additional, and in some cases, revised disclosure requirements for ABS offerings and ongoing reporting.

For each loan or asset in the asset pool, the Commission proposed to require disclosure of specified data relating to the terms of the asset, obligor characteristics, and underwriting of the asset. Such data would be provided in a machine-readable, standardized format so that it is most useful to investors and the markets. The April 7 proposal would require issuers to provide the asset-level data or grouped account data at the time of securitization, when new assets are added to the pool underlying the securities, and on an ongoing basis. The data points the Commission proposed to require for commercial mortgage

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16 Pursuant to Exchange Act Rule 15c2-8(b) [17 CFR 240.15c2-8(b)], with respect to ABS, a broker-dealer is exempt from the requirement that a preliminary prospectus be delivered to prospective investors at least 48 hours prior to sending a confirmation of sale if the issuer of the securities has not previously been required to file reports pursuant to Sections 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or15 U.S.C. 28o). The Commission also proposed to repeal this exception from Rule 15c2-8(b) such that a broker-dealer would be required to deliver a preliminary prospectus at least 48 hours prior to sending a confirmation of sale in connection with an issuance of ABS, including those issued by ABS issuers exempted from the requirement to file reports pursuant to Section 12(h) of the Exchange Act.

17 See the 2004 ABS Adopting Release.

backed securities are primarily based on the definitions included in the CRE Finance Council Investor Reporting Package, current Regulation AB requirements and staff review of current disclosure.

The Commission proposed to require the filing of a computer program (the "waterfall computer program," as defined in the proposed rule) of the contractual cash flow provisions of the securities in the form of downloadable source code in Python, a commonly used computer programming language that is open source and interpretive. The computer program would be tagged in XML and required to be filed with the Commission as an exhibit. Under the proposal, the filed source code for the computer program, when downloaded and run (by loading it into an open "Python" session on the investor's computer), would be required to allow the user to programmatically input information from the asset data file that we have described above. With the waterfall computer program and the asset data file, investors would be better able to conduct their own evaluations of ABS and may be less likely to be dependent on the opinions of credit rating agencies.

The Commission also proposed additional requirements to refine current disclosure requirements for asset-backed securities. Among other things, the Commission proposed to require:

- aggregated and loan-level data relating to the type and amount of assets that do not meet the underwriting criteria that is specified in the prospectus;
- for certain identified originators, information relating to the amount of the originator's publicly securitized assets that, in the last three years, has been the subject of a demand to repurchase or replace;

- for the sponsor, information relating to the amount of publicly securitized assets sold by the sponsor that, in the last three years, has been the subject of a demand to repurchase or replace;
- additional information regarding originators and sponsors;
- descriptions relating to static pool information, such as a description of the methodology used in determining or calculating the characteristics of the pool performance as well as any terms or abbreviations used;
- that static pool information for amortizing asset pools comply with specified (Item 1100(b)) requirements for the presentation of historical delinquency and loss information; and
- the filing of Form 8-K for a one percent or more change in any material pool characteristic from what is described in the prospectus (rather than for a five percent or more change, as currently required).

The Commission also proposed to limit some of the existing exceptions to the discrete pool requirement in the definition of an asset-backed security. This is intended to not only address recent concerns arising out of the financial crisis but also serves to protect against future practices of participants along the chain of securitization that could result in the addition of assets into a securitization pool without a clear understanding of their quality.

C. Privately-Issued Asset-Backed Securities

A significant portion of securities transactions, including the offer and sale of all CDOs and asset-backed commercial paper, is conducted in the exempt private placement market, which includes both offerings eligible for Rule 144A resales and other private

placements.[18] CDOs are typically sold by the issuer in a private placement to one or more initial purchaser or purchasers in reliance upon the Section 4(2) private offering exemption in the Securities Act, which is available only to the issuer, followed by resales of the securities to "qualified institutional buyers" in reliance upon Rule 144A.[19] Subsequent resales may also be made in reliance upon Rule 144A. Rule 144A provides a safe harbor for resellers from being deemed an underwriter within the meaning of Sections 2(a)(11) and 4(1) of the Securities Act[20] for the sale of securities to qualified institutional buyers. If the conditions of the Rule 144A safe harbor are satisfied, sellers may rely on the exemption from Securities Act registration provided by Section 4(1) for transactions by persons other than issuers, underwriters or dealers.[21]

Some have concluded that the events of the financial crisis have demonstrated that a lack of understanding of CDOs and other privately offered structured finance products by investors, rating agencies and other market participants may have significant consequences to the entire financial system.[22] For example, the ratings of these products proved inaccurate,

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[18] CDOs often permit the active management of their pool assets, which could include engaging in activities the primary purpose of which is to protect or enhance the returns of their equity holders. Such CDOs typically would not meet the requirements of Rule 3a-7 under the Investment Company Act because that rule includes conditions that are intended to permit an issuer to engage only in limited activities that do not in any sense parallel typical 'management' of registered investment company portfolios. Accordingly, these CDOs usually rely on one of the private investment company exclusions, both of which condition the exclusion in part on the issuer not making a public offering.

[19] In general, a qualified institutional buyer is any entity included within one of the categories of "accredited investor" defined in Rule 501 of Regulation D, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers not affiliated with the entity (or $10 million for a broker-dealer).

[20] 15 U.S.C. 77b(a)(11) and 15 U.S.C. 77d(1).

[21] See Section II.A. of the Resale of Restricted Securities, Release No. 33-6862 (Apr. 30, 1990) [55 FR 17933].

[22] See, e.g., The PWG March 2008 Report (noting that originators, underwriters, asset managers, credit rating agencies and investors failed to obtain sufficient information or conduct comprehensive risk assessments on instruments that were often quite complex and also noting that downgrades were even more frequent and

which significantly contributed to the financial crisis.[23] This lack of understanding by credit rating agencies, investors, and other market participants indicates that the offering processes and disclosure available in the public and private market were inadequate to provide appropriate investor protection. Further, these securities are issued by special purpose vehicles whose only purpose is holding financial assets, with numerous parties involved in the securitization process. As a result, information about those assets and the structure of the vehicle is critical to an informed investment decision.

The safe harbors of Rule 144A and Regulation D that provide the ability to rely on an exemption from registration do not impose specific requirements on the disclosures provided to investors if those investors meet certain size requirements. However, the financial crisis has called into question the ability of the Commission's rules, as they relate to the private market for asset-backed securities, to ensure that investors had access to, and had sufficient time and incentives to adequately consider, appropriate information regarding these securities.[24]

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severe for CDOs of ABS with subprime mortgage loans as the underlying collateral). See also the Turner Review, at 20 (finding that "the financial innovations of structured credit resulted in the creation of products – e.g., the lower credit tranches of CDOs or even more so CDO-squareds – which had very high and imperfectly understood embedded leverage.").

[23] See id.

[24] An assessment of whether the protections of the Act are needed often focuses on whether the purchasers of securities can "fend for themselves." SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). Historically, whether this test is met turned on whether information necessary or appropriate to make informed decisions is realistically available to the purchasers. See id. The Supreme Court also noted that "We agree that some employee offerings may come within § 4(1), e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement." Id. at 125. See also Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978) (discussing the Supreme Court's observation in Ralston that an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering' and the ruling that an essential requirement is access to the kind of information that registration would disclose).

In the April 7 proposal, the Commission proposed to require enhanced disclosure by asset-backed issuers who wish to take advantage of the safe harbor provisions for these privately-issued securities.[25] In addition, in order to provide additional transparency with respect to the private market for these securities, the Commission proposed amendments to Rule 144A to require a structured finance product issuer to file a public notice on EDGAR of the initial placement of structured finance products that are eligible for resale under Rule 144A.[26] As we believe that the Commission may benefit from the availability of more information about private placements of structured finance products, we proposed to require that in submitting such notice, the issuer undertake to provide offering materials to the Commission upon written request.

IV. Conclusion

The recent financial crisis highlighted the need for further consideration of the effectiveness of the Commission's regulations governing securitizations. We are committed to reinvigorating and reforming these and any other regulations needed to improve investor protections and promote more efficient markets, including the asset-backed markets.

Thank you again for the opportunity to speak with you about these important issues. I am happy to answer any questions you may have.

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[25] The Commission also proposed to make conforming changes to Regulation D, Form D and Rule 144.

[26] "Structured finance products" for this purpose would be more broadly defined than the Regulation AB definition of "asset-backed security" in order to reflect the wide range of securitization products that are sold in the private markets.