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ABCP 2.0:
Short-Term Structured Financing in the New Regulatory Environment

TIMOTHY P. MOHAN, PETER C. MANBECK, JAMES J. CROKE, AND SHARAD A. SAMY

The authors discuss the most significant issues now facing the traditional asset-backed commercial paper market.

Asset-backed commercial paper ("ABCP") was developed in the early 1980s as a means for banks to provide their customers with cost-efficient money market financing (primarily through ABCP offerings to registered money market funds ("MMFs")) of trade receivables, lease receivables and similar commercial assets. ABCP was issued by "conduits" established to finance the assets of multiple borrowers through the structured financing of such borrowers' financial assets. The bank sponsors of these conduits structured the underlying customer financings (on a bankruptcy-remote basis) to a "zero loss" threshold in order both to limit the bank's loss

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exposure and to assure investors that this new product was conservatively structured and adequately collateralized. Because of the diversity of each conduit's financed interests (i.e., each conduit financed multiple different borrowers through individually negotiated structured financings) and the high credit quality to which such financed assets were structured, bank sponsors of these conduits were not required to consolidate these conduits for U.S. generally accepted accounting principles ("U.S. GAAP") or bank regulatory accounting ("RAP") purposes. The sponsor bank typically provided full liquidity and credit support to the issued ABCP, but because its exposure to credit risk or required funding was so low, accountants and regulators were comfortable that the sponsor bank's liquidity and credit exposure was *de minimus*.

Due to the voracious appetite of MMFs for this high quality short-term structured finance product, ABCP quickly became a financing tool for a myriad of asset classes. As described above, early ABCP programs were both conservatively structured and collateralized and "fully supported" by the banks that sponsored the programs. The bank support most often took the form of a committed liquidity facility that would fund in all instances other than an insolvency of the special purpose ABCP issuer (which investors (and rating agencies) agreed was extremely unlikely to occur). Unlike other structured finance products, the presence of committed liquidity and credit support from a highly rated counterparty (i.e., the bank) was an essential element of the credit rating assigned by rating agencies to ABCP. ABCP is a money market instrument that must be timely paid in full in each instance on its maturity date — even a one day delay would constitute a default and would have serious implications for money market investors.

Over time, new bank regulations adopted in the U.S. in the early 1990s prompted bank sponsors of these programs to contractually limit their liquidity and credit exposures to these vehicles. Banks continued their practice of structuring related financings to a "zero loss" threshold, but U.S. banks (and some banks located in other jurisdictions) reduced the amount of credit support provided to support the ABCP from 100 percent to approximately eight to 10 percent, and the terms of bank liquidity facilities provided to these conduits were revised so as to release liquidity banks from any obligation to fund credit losses. These changes were monumental in terms of the revised risk profile of the issued ABCP (i.e., the ABCP was no longer fully supported

by the sponsor bank), but the changes were effected in line with established rating agency short-term rating criteria, and the issued ABCP continued to be rated consistent with the short-term rating of the sponsor bank (which continued to provide partial credit support and full liquidity support (i.e., a commitment to cover liquidity mismatches unless the funding would substantively cover credit losses)). The ABCP market continued to grow and thrive, and global financings of bank customer assets through ABCP became commonplace. Ultimately these changes never resulted in any investor losses from investments in ABCP issued by bank-sponsored ABCP programs of this type (i.e., partial credit support and 100 percent "pure" liquidity coverage).

However, as the ABCP market matured and grew to a size that eventually exceeded the outstanding balance of all term asset and mortgage-backed securities offerings (together "ABS"), this "new model" of pure liquidity and partial credit support was modified further by non-bank sponsors (as well as some bank sponsors) to effect offerings of many different types of structured short-term notes that were not fully — or even significantly — supported by banks or other financial institutions but which also came to be considered "ABCP." Thus, the term ABCP came to include any short-term, highly rated collateralized debt instrument (including those issued by structured investment vehicles ("SIVs"), collateralized debt obligations ("CDOs") and extendible and other short-term liquidity structures). The absence of a bank commitment to fund some substantial "first credit loss" risk, and/or to provide liquidity support in respect of the related ABCP, was an even more monumental shift away from the original "100 percent bank supported" ABCP paradigm, but once again these changes were effected consistent with established rating agency criteria. The issued ABCP continued to receive high short-term ratings from the rating agencies, and money market investors continued to invest in ABCP. The outstanding principal amount of U.S. ABCP grew rapidly in the early 2000s, peaking at approximately $1.2 trillion in the summer of 2007.

These more recent, partially supported or unsupported ABCP programs (and, by association, all ABCP programs) were caught in the economic maelstrom that began in 2007 along with most classes of ABS. During this period, outstanding U.S. ABCP volume dropped precipitously — faster, in fact, than it had risen — before stabilizing at approximately $300 billion.

The decline in ABCP volume can, of course, be attributed in part to

the deterioration of economic conditions and lower customer demand for short-term financing. The decline in volume can also be attributed to the withdrawal from the market of most non-bank sponsored and all unsupported financing structures — there is very little, if any, investor demand for short-term notes of SIVs, CDOs or comparable unsupported market-value structures. It is also the case that due to numerous government policies and programs designed to provide liquidity to the financial markets and keep interest rates low, there is currently a reduced need for banks to finance themselves or their customers through securitization transactions or other capital markets fundings. Most recently, ABCP conduits sponsored by banks with "dented" credits (perceived or real) have also suffered from investors' concerns regarding liquidity and the financial ability of such bank sponsors to support their ABCP conduits.

Notwithstanding the fact that most ABCP conduits have been restructured consistent with the sponsor bank once again providing 100 percent credit and liquidity support for the issued ABCP, because many bank credit ratings have declined significantly over the past few years and banks are from time to time rumored to have large exposures to risks such as sovereign defaults, an ABCP conduit's ability to effectively offer and sell ABCP on any day (particularly longer-dated ABCP) is now often a function of the financial markets' view of the credit strength and liquidity of the bank sponsor of such ABCP conduit.

ABCP of traditional conduits[1] nonetheless continues to be issued in substantial volumes and at attractive financing rates. Investor demand for such paper is bolstered by the fact that traditional ABCP performed well during the credit crunch; indeed, there were no reported defaults of ABCP issued by traditional ABCP conduits. Traditional ABCP conduits thus continue to play an important role in providing short-term funding to the U.S. economy:

- to originators, ABCP offers a cost-effective source of short-term funds where issuance volumes and maturities can be rapidly adjusted to address seasonal needs or yield curve fluctuations;
- to investors, ABCP offers an attractive short-term investment with a strong track record, low default risk and higher yields than those available on many other short-term securities (the latter consideration being

of particular importance to MMFs and other ABCP buyers while short-term rates remain at near-historic lows); and

- to banks, ABCP conduits provide both an efficient means to raise customer financing and a steady source of fee income that can be used to restore depleted capital accounts in anticipation of tighter capital requirements.

The rapidly changing regulatory landscape for ABS (including ABCP) continues to pose the greatest threat to the viability of even traditional ABCP conduits. For example, changes to U.S. GAAP and RAP which have generally required U.S. banks to consolidate the assets of their sponsored ABCP conduits (and to satisfy a "leverage ratio" requirement with respect to such consolidated assets) have removed many of the benefits originally available to U.S. banks which sponsored ABCP conduits. While sound economic policy should favor the continued operation and, indeed, revitalization of the traditional ABCP market,[2] the fact that many of the regulations impacting ABCP conduits are still to be drafted or finalized makes it difficult for market participants to plan new transactions or structures. In some cases, this regulatory uncertainty arises from the seemingly wholesale application of certain new regulations to all ABS (short- and long-term debt alike) when the regulations were in fact likely intended to address catastrophic losses incurred in certain mortgage securitizations and market value securitizations (such as SIVs and market value collateralized debt offerings, rather than traditional ABCP conduits) and/or financial institution investment practices unrelated to ABCP programs.[3]

The most significant issues now facing the traditional ABCP market include the following:

ACCOUNTING CONSOLIDATION

A bank sponsor of an ABCP conduit was traditionally not required to consolidate the conduit or the conduit's assets on the bank's balance sheet under U.S. GAAP. In particular, under the "primary beneficiary" analysis that applied under FIN 46R, banks often eliminated the need to consolidate their sponsored conduits by arranging for the conduit to sell "first loss" notes to an unaffiliated investor who thereby accepted exposure to a major-

ity of the conduit's expected losses. Such arrangements are no longer effective under current accounting rules; instead, under FAS 167 (effective for periods after November 15, 2009) consolidation is generally required. As further described below, this change in accounting treatment adversely affects the regulatory capital treatment of ABCP conduits from a U.S. bank sponsor's standpoint, eliminating one of the prime incentives for these banks to finance assets through ABCP. The changes encourage these sponsors to replace ABCP conduits with other funding sources and some U.S. banks that formerly were major ABCP conduit sponsors have exited the ABCP business. ABCP conduits sponsored and advised by third party non-banks are one such funding source through which certain properly structured bank customer asset financings may be effected without being consolidated by such banks for GAAP purposes.

ENHANCED CAPITAL REQUIREMENTS

U.S. banks are required to hold risk capital based on their U.S. GAAP balance sheet assets. As discussed above, the assets against which capital charges (including, in the U.S., the leverage capital requirement) are calculated by U.S. banks now include any assets consolidated by the bank under U.S. GAAP. In addition, U.S. regulators have stated that banks may not use the Internal Assessment Approach ("IAA") to calculate capital charges for on-balance sheet exposures to ABCP conduits. Further, Section 939A of the Dodd-Frank Act (discussed further below) restricts the use of ratings in U.S. regulations and has been interpreted to preclude the use of the Ratings-Based Approach ("RBA") in determining capital for U.S. banks. Inability to use the IAA and the prospective inability to use the RBA in calculating capital charges forces U.S. banks to use the Supervisory Formula Approach or Simplified Supervisory Formula Approach, which banks have indicated sometimes produces a capital charge that is not sensitive enough to the actual differences in the credit quality of exposures. Finally, the Basel 2 and Basel 3 Capital Accords also increase the capital charges associated with certain bank exposures to ABCP conduits. In particular, re-securitization exposures will be assigned higher risk weights and certain ABCP liquidity facilities will be assigned higher credit conversion factors. A consultative paper issued by the

Basel Committee on Banking Supervision (the "Basel Committee") in December 2012 would further increase capital charges for securitization exposures and would eliminate any special rules for determining capital for ABCP conduit exposures of banks. In particular, the Basel Committee proposes to eliminate the following special treatment of securitization exposures to ABCP conduits:

- Banks that apply the standardized approach ("SA") to calculate required capital will no longer be able to use a risk weight of 100 percent or, if higher, the highest risk weight of any asset in the underlying pool, for second loss positions to ABCP conduits (typically program-wide credit facilities) if such a second loss position is an investment grade equivalent credit risk and is supported by significant first loss protection;
- Banks that apply the SA will no longer be able to apply a 50 percent credit conversion factor for eligible liquidity facilities;[4] and
- Banks that apply the internal ratings-based approach to calculate required capital will no longer be able to use SA risk weights for liquidity facilities.

REMOVAL OF RATINGS REQUIREMENTS FROM REGULATIONS

Section 939A of the Dodd-Frank Act[5] requires that references to ratings be removed from federal regulations and be replaced with alternative creditworthiness standards. In June of 2012, the U.S. bank regulators issued a final rule (effective January 1, 2013) regarding the Section 939A requirement as it relates to the risk-based capital regulations. The final rule amended the regulatory definition of "investment grade" in applicable parts by removing references to credit ratings. Under the revised regulations, to determine whether a security is "investment grade," banks must determine that the probability of default by the obligor is low and the full and timely repayment of principal and interest is expected. To comply with the new standard, banks may not rely exclusively on external credit ratings, but they may continue to use such ratings as part of their determinations. Current capital regulations outside the U.S. refer to ratings in the RBA and provide for reduced risk weights for

certain highly-rated ABS. In addition, non-U.S. bank sponsors may still rely on ratings and the IAA in calculating capital for ABCP exposures. It is possible that the use by U.S. and non-U.S. banks of different criteria in calculating the capital charges associated with ABCP exposures could result in U.S. banks and non-U.S. banks routinely calculating different capital charges for equivalent exposures (which in turn could affect the competitive balance in the industry).

PROPOSED LIQUIDITY COVERAGE REQUIREMENTS

The Basel Committee on Banking Supervision (the "Basel Committee") has proposed to adopt a Basel 3 Capital Accord that would, among other changes, require banks at all times to hold high quality liquid assets in amounts that equal or exceed their "net cash outflow" (calculated over a 30-day time-frame) or, if greater, at least equal to 25 percent of anticipated cash outflows during such period. For this purpose, any committed liquidity or credit support facilities provided by a bank that may be drawn within 30 days to provide for the payment of maturing ABCP would be considered to be cash outflow items and, unless offset by an anticipated cash receipt, would be required to be collateralized by high quality liquid assets. The coverage requirement would make it more difficult and/or expensive for banks to provide liquidity support to ABCP conduits and would particularly increase the cost of issuing short-dated ABCP notes.

The Basel Committee recently announced changes to the proposed liquidity coverage requirements that in many respects softened the anticipated effect of these requirements on banks' financing activities. Among other matters, the Basel Committee broadened the categories of securities that (subject to specified haircuts) will be recognized as "high quality liquid assets" and stated that the liquidity coverage ratio test will be phased in over a five-year period commencing in 2015 (rather than taking full effect in 2015). At the same time, the Basel Committee chose to continue to require banks that engage in structured financing transactions through special purpose vehicles ("SPVs") to assume that they will be unable to refinance any of the structured finance securities in the event of a financial markets stress event. ABCP conduit sponsors therefore will be required to assume that the conduit will use

support facility draws (subject to the terms of the applicable support agreements) to repay all ABCP notes that mature within the 30-day calculation window. Also, the conduit sponsor will not be permitted to credit anticipated payments from the conduit against these presumed cash outflows even if the conduit is contractually obligated to repay sponsor advances within the 30-day period. The Basel Committee in effect is requiring conduit sponsors to calculate their related liquidity coverage requirements under a "worst case" scenario that maximizes assumed cash outflows to the conduit and minimizes cash inflows. This approach will make it much more expensive for banks to provide ABCP support facilities and so will adversely affect the ABCP market. The U.S. regulators have not yet proposed regulations to implement the liquidity coverage requirement (both the details and the timing of implementation in the U.S. will be subject to regulatory discretion). Nonetheless, a number of U.S. and non-U.S. banks have already incorporated some version of the requirement into their internal operating procedures and liquidity management processes.

In response to the anticipated liquidity coverage requirements, sponsors of ABCP conduits have begun developing new products that minimize the impact of the liquidity coverage requirements while providing investors with new investment options. As an example, some sponsors have amended their ABCP conduit's program documents to permit the issuance of callable and/or puttable-callable ABCP. As its name implies, callable ABCP can be redeemed by the issuer at par prior to its legal maturity on a pre-specified call date (or during a pre-specified call period). Callable ABCP is typically structured such that it (i) has a legal maturity greater than 30 days and (ii) is callable at least 30 days prior to its legal final maturity date. The notice period for exercise of the call option in U.S. ABCP programs is typically one business day (the minimum notice allowed by applicable rules of The Depository Trust Company ("DTC")). Assuming that the conduit redeems each callable note not later than the 30th day preceding its legal final maturity date, the callable notes structure enables the conduit sponsor to reduce from 30 days to one day the timeframe over which it will be required to recognize an assumed cash outflow in respect of each conduit note. Stated differently, whereas the liquidity coverage test will require the conduit sponsor to recognize an expected cash outflow throughout the 30-day period immediately preceding

the maturity date of a noncallable ABCP note, it will require recognition of a cash outflow in respect of any callable note that is called prior to the 30th day preceding its maturity date only during the one-day period between the conduit's exercise of the call option and the related early redemption date. Although issuers should expect investors to demand a higher yield on callable notes than on traditional (non-callable) ABCP, the attendant reduction in the sponsor's liquidity coverage obligations may more than offset the higher interest expense.[6]

Puttable-callable ABCP notes provide both the holder with a put option and the conduit with a call option. The put option — by providing investors with a means to shorten the maturity of their notes when they deem it necessary — may enable conduits to place notes with a longer stated term to maturity than would otherwise be possible. The put option may be of particular use in shortening the deemed maturity of the notes for purposes of Rule 2a-7 under the Investment Company Act of 1940, as amended (the "Investment Company Act"). However, as exercise of the put option will require the sponsor to recognize the early redemption date designated by the holder as the relevant ABCP note's *de facto* maturity date for purposes of the liquidity coverage test, puttable-callable notes typically will (i) require the holder to provide more than 30 days' advance notice of any put exercise, and (ii) entitle the conduit immediately to call the note (subject to the one business day notice required by DTC) if the holder exercises its put option. Prompt exercise of the contingent call option by the conduit following an exercise of the put option therefore will enable the sponsor to recognize an expected cash outflow in respect of the applicable puttable-callable note for only one day rather than the 30 days that otherwise would be required. A puttable-callable note also may include a non-contingent call option that is exercisable by the conduit whether or not the holder exercises its put.

A conduit might also be able to provide its sponsor with liquidity coverage relief by issuing extendible notes. The notes will be issued as floating-rate obligations with interest rate step-ups and the holder, rather than the issuer, will have the option to extend or not extend the term of the notes. The notes will specify timeframes (e.g., monthly) during which the holder may exercise its extension right and the deadline for the holder to notify the issuer of an election to extend the notes will in all cases be more than 30 days in advance of the

maturity date then in effect. Accordingly, on any given date the term remaining to the maturity of the extendible notes will exceed 30 days (and the sponsor will not be required to recognize an associated cash outflow for liquidity coverage purposes) as long as the holder continues to extend the notes. Although this structure enables the holder, rather than the sponsor, to control the timing of the maturity date of the notes, the interest rate step-ups will provide the holder with a strong incentive always to exercise its extension right.[7]

Properly structured financings through repurchase agreements financed directly or indirectly through third party non-bank institutional sponsors of ABCP conduits may also enable banks to achieve some LCR benefits.

FDIC ASSESSMENTS

The Dodd-Frank Act requires the Federal Deposit Insurance Corporation (the "FDIC") to calculate its deposit insurance assessments against the consolidated assets minus tangible equity of large banks rather than against their deposit liabilities. The relevant bank assets now include ABCP conduit assets consolidated by these banks under U.S. GAAP, making it more expensive for a U.S. bank to sponsor such a conduit.

CHANGES IN MONEY MARKET FUND REGULATION

MMFs form much of the investor base for ABCP. In 2010, the Securities and Exchange Commission (the "SEC") amended Rule 2a-7 under the Investment Company Act to require MMFs to (i) limit the weighted average maturity of their investment portfolios to 60 days (reduced from 90 days) and (ii) maintain specified percentages of their portfolios in very short-term liquid assets (ABCP held to satisfy this requirement must mature within seven days or, in some cases, one day). The Rule 2a-7 changes make longer-dated ABCP notes less attractive to MMFs. The Rule 2a-7 changes also reduced the percentage of assets that MMFs are permitted to invest in "illiquid" securities from 10 percent to five percent. Because a repo with a term exceeding seven days would be deemed an illiquid security and ABCP would generally not be considered illiquid, a reduction in the amount of funds that MMFs can invest in illiquid repos encourages banks and other financial institutions that previ-

ously obtained funding through execution of reverse repos with MMFs to establish ABCP programs that issue to MMFs ABCP backed by the sponsor's reverse repos with the ABCP issuer. This type of ABCP is sometimes referred to by market participants as "collateralized commercial paper."

When the SEC amended Rule 2a-7 in 2010, it indicated that additional changes would likely follow at some point in time. One such change arises from a provision in the Dodd-Frank Act that requires every federal agency to review rules that use credit ratings as an assessment of credit-worthiness. The Dodd-Frank Act further requires the federal agencies to replace those credit-rating references with other appropriate standards. In March 2011, the SEC proposed amendments to Rule 2a-7 which would eliminate the credit ratings requirements for registered MMF investments. In lieu of the current practice of defining "first tier" and "second tier" securities based on the short-term credit rating assigned to such securities, the amended rule would set forth new requirements:

First, MMFs would have to assess the credit quality of the security and determine that each portfolio security presents minimal credit risks.

Second, MMFs would have to determine whether the portfolio security is a "first tier" or "second tier" security, using new definitions for those terms.

- A security would be "first tier" only if the MMF's board of directors (or its delegate) has determined that the security's issuer has the highest capacity to meet its short-term financial obligations. An MMF would continue to be required to invest at least 97 percent of its assets in "first tier" securities.
- A security would be "second tier" if the MMF's board of directors (or its delegate) has determined the security presents minimal credit risks, even if it is not a "first tier" security.

The press has reported that the SEC has considered but not yet internally agreed on the form further additional changes might take. In November 2012, at the urging of Treasury Secretary Timothy Geithner, the Financial Stability Oversight Counsel ("FSOC") issued the following proposed recommendations for MMF reform, which are not mutually exclusive and could be implemented in combination:

- Remove a special exemption under SEC rules that allows MMFs to maintain a stable net asset value ("NAV") per share and, in its place, provide for MMFs to have NAVs and related share prices, which reflect the actual market value of their portfolio holdings, consistent with requirements for other mutual funds.
- Permit MMFs to maintain stable NAVs, as long as a sufficient NAV buffer is funded, and each investor agrees to put a minimum portion of its assets at risk for thirty days if the investor elects to redeem its shares. This approach would require MMFs to build a buffer of up to 1 percent of assets to absorb day-to-day fluctuations in value. This would be paired with a "minimum balance at risk," which would require that a small amount of a shareholder's investment be made available for redemption on a delayed basis and subject to first losses if a fund suffers losses that exceed the fund's NAV buffer.
- Require MMFs to build a NAV buffer of 3 percent of assets. This NAV buffer could be combined with other measures to enhance the effectiveness of the buffer and potentially increase the resiliency of MMFs. To the extent that these other measures complement the NAV buffer and further reduce the vulnerabilities of MMFs, the size of the NAV buffer could be reduced.

Although the impact that any of these proposed changes would have on sales of MMF shares cannot be known with certainty, some MMF sponsors have expressed concern that investors will find money market shares less attractive if MMFs cannot maintain stable share prices and/or are required to impose limits on the timing or amount of share redemptions. As MMFs constitute much of the investor base for ABCP, any regulatory changes that reduce aggregate MMF balances are also likely to have an adverse impact on the ABCP market.

PROPOSED CHANGES IN DISCLOSURE REQUIREMENTS (REGULATION AB II)

ABCP conduits typically issue their notes in reliance upon the registra-

tion exemptions provided by Regulation D and/or Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"). The SEC has proposed to make Regulation D and Rule 144A unavailable for offerings of ABS (including ABCP) unless the issuer makes available to investors the same information that would be provided if the securities were registered with the SEC. This requirement — if implemented as proposed — would increase the amount of disclosure required to be made in ABCP offering documents to a level that would make it impractical (if not impossible) to effect such offerings of ABCP. The associated cost (particularly because of the need to continually update the disclosure as the assets financed by the program change) could also make the operation of many ABCP programs costly and/or impractical. The SEC re-proposed certain elements of Regulation AB II in July 2011, but to date none of the proposed Regulation AB II provisions have been finalized or implemented.

CHANGES IN DISCLOSURE REQUIREMENTS (REPURCHASE ACTIVITY)

The Dodd-Frank Act requires securitization participants whose transaction documents require the originator and/or sponsor to repurchase assets upon a breach of a representation or warranty to disclose in public SEC filings the volume of the repurchases demanded and made over specified periods. The new disclosure requirements may extend to certain asset originators that obtain ABCP financing but ABCP conduits themselves typically should not need to make the filings. For example, it is common in trade receivables financings for (i) the originator to organize an SPV and sell receivables to it under documents requiring the originator to repurchase the receivables if the originator breaches certain representations or warranties, and (ii) the SPV to sell securities backed by the receivables to an ABCP conduit under documents that do not impose repurchase obligations on any party. Under this structure, the filing requirements appear to apply to the originator (since it is obligated to repurchase assets from the SPV upon a breach of representation or warranty) but not to the ABCP conduit (since the conduit has not itself made any repurchase undertakings and is not the direct beneficiary of any such undertakings made by the originator or the SPV).[8] In any case, Congress

clearly intended the disclosure requirements to help investors evaluate ABS structures that require the investors to rely for the payments on their securities primarily upon the cash flow from the financed assets (e.g., residential mortgage securitizations). The value of the disclosures to ABCP investors (since the investors will rely primarily upon the conduit's ability to refinance its notes or, if the notes are not refinanced, upon the sponsor's liquidity and credit enhancement commitments) is less clear. The SEC to date, however, has not provided an express exemption from the disclosure requirements to either ABCP conduits or originators who obtain ABCP financing.

DISCLOSURE OF DUE DILIGENCE REPORTS

Section 932 of the Dodd-Frank Act imposes an obligation on issuers and underwriters of registered and unregistered ABS to make publicly available the findings of any third party due diligence reports obtained by them. Proposed SEC Rule 15Ga-2 would extend this obligation to private transactions, including ABS financed by ABCP conduits. Although the Dodd-Frank Act does not require issuers and underwriters to obtain such third-party reports, the requirement to publicly disclose any reports that are obtained may discourage issuers and/or dealers from undertaking ABCP transactions. The SEC has, for now, postponed consideration of proposed Rule 15Ga-2.

THE VOLCKER RULE

With limited exceptions, the so-called "Volcker Rule" included in the Dodd-Frank Act prohibits banks from sponsoring "covered funds." A "covered fund" includes any (i) issuer that relies upon the registration exemptions provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act and (ii) commodity pool. Most ABCP conduits rely upon one of those exemptions from the registration requirements of the Investment Company Act, and therefore constitute "covered funds." Some ABCP conduits enter into swap transactions, and so could (as further explained below) be considered to be commodity pools. A bank that acts as the administrator of an ABCP conduit could be viewed as the conduit's sponsor and/or as managing or advising the conduit as to its financing activity.

Although portions of the Volcker Rule are drafted in a way that would appear to permit banks to sponsor ABCP conduits that engage in lending transactions, one feature of the Volcker Rule (a provision commonly referred to as "Super 23A") would prohibit banks from engaging in "covered transactions" with any "covered fund" that the bank sponsors, manages or advises. As the term "covered transaction" will include any loan or other extension of credit, Super 23A would prohibit banks from providing any liquidity or credit support to any of their conduits that constitute "covered funds" or purchasing any commercial paper or assets from such conduits. As a practical matter, this would prevent a bank from sponsoring, managing or advising a traditional multi-seller ABCP conduit that relies upon Section 3(c)(1) or (7) of the Investment Company Act.[9] Accordingly, if the proposed Super 23A provisions remain in the final version of the Volcker Rule, bank-sponsored ABCP conduits would need to rely upon Investment Company Act exemptions other than Section 3(c)(1) or (7) — for example, some conduits may already be able to rely on Section 3(c)(5); others may need to be restructured so they could rely on Rule 3a-7.[10] Banks which finance, or arrange for the financing of, assets through unaffiliated ABCP conduits sponsored, managed and advised by third party non-bank institutional sponsors should not be subject to the Volcker Rule proscriptions in connection with such financings.

To date, the SEC has not provided further guidance regarding the application of the Volcker Rule to securitizations, including ABCP conduits. As a practical matter the deadline for Volcker Rule compliance has been pushed back to July 2014. In April 2012, the Federal Reserve issued a statement clarifying that it will interpret the Volcker Rule to permit banking entities to conform their activities and investments to the Rule's prohibitions and restrictions on or before July 21, 2014.

CHANGES TO FEDERAL RESERVE ACT

Sections 23A and 23B of the Federal Reserve Act impose certain restrictions on transactions between banks and their affiliates. ABCP conduits have traditionally not been considered bank affiliates for purposes of these restrictions. However, with effect from July 2012 the Dodd-Frank Act expanded the scope of Sections 23A and 23B to possibly apply to transactions between

a bank and any ABCP conduit that it advises (other than any such conduit that is a bank subsidiary). It would be very difficult for banks to operate conduits in compliance with Sections 23A and 23B. Among other restrictions, liquidity, credit enhancement, investment management and other contracts agreed between the bank and the conduit would have to be documented on strictly arm's-length terms. It appears that the Federal Reserve Board (the "Board") to date has not treated ABCP conduits as bank "affiliates" for purposes of amended Sections 23A and 23B. At the same time, the Board has not expressly stated that ABCP conduits are not "affiliates." If in the future regulators do apply Sections 23A and 23B to bank/ABCP conduit transactions, certain bank-sponsored ABCP structures will likely no longer be viable unless the conduit is a bank subsidiary.[11]

RISK RETENTION RULES

The Dodd-Frank Act requires the SEC and federal banking regulators to establish risk retention requirements for certain securitization participants by April 2011. This deadline was not met — in March 2011, the SEC (jointly along with other agencies) proposed rules regarding risk retention by securitizers of ABS. To date these proposals have not been implemented. Under the proposals, a securitizer would generally be required to retain the credit risk of at least five percent of each asset it transfers. Asset originators (including possibly sponsors of ABCP conduits) that securitize assets through ABCP conduits will be required to comply with these regulations. The securitization safe harbor rule approved by the FDIC in September 2010 imposes similar risk retention requirements, but the FDIC requirements will automatically conform to the SEC rule when the latter is adopted. The risk retention rules may increase the regulatory capital charges and/or other costs that banks incur when securitizing assets through ABCP conduits.

The SEC and the federal banking regulators endeavored in drafting the proposed rules to take into account the structures historically used in the securitization of different categories of assets and to provide separate risk retention options suited to each such category. In particular, the proposed rules include procedures by which the transaction parties may satisfy the risk retention requirement in relation to "eligible ABCP conduits." Under these

procedures, the conduit sponsor is not itself required to retain credit risk on the securitized assets if:

- each asset originator transfers the assets being securitized to an intermediate SPV that, in turn, issues interests collateralized by the assets to the conduit;
- the asset originator retains not less than a five percent "horizontal" (i.e., first loss) residual interest in the intermediate SPV;
- the sponsor manages the conduit, approves each originator that sells assets to an intermediate SPV and establishes policies governing the assets that may be sold to the intermediate SPVs;
- a depository institution or other "regulated liquidity provider" provides a liquidity commitment to the ABCP conduit covering 100 percent of its maturing ABCP notes; and
- certain other conditions are met.

The regulators clearly intended the proposed guidelines for eligible ABCP conduits to facilitate compliance with the risk retention requirement in traditional multiseller ABCP programs. The guidelines nonetheless contain a number of features that are not consistent with standard conduit operations. Two issues in particular are worth noting. First, the guidelines do not recognize unfunded credit commitments provided by the sponsor to the ABCP conduit as a valid form of credit risk retention. Stated differently, unfunded credit commitments that the sponsor provides to the conduit through a programwide letter of credit or similar facility could not be used to offset or reduce the risk retention obligation of any originator even if the sponsor's credit commitment exceeds five percent of the financing amount. Second, the proposed guidelines would require the sponsor to disclose to each ABCP investor the name of each originator that finances assets through the conduit and the form, percentage and dollar amount of credit risk that each originator has retained. Multiseller conduits do not currently provide such disclosures and any requirement that they do so could make ABCP financing unattractive to many originators.

Market participants sent the regulators a great many comment letters on

the proposed rules including detailed comments on the ABCP provisions. Although the timing for further regulatory action is uncertain, it is probable that the proposed rules will be substantially revised before final rules are approved. Once final rules are approved, ABCP conduit sponsors (and most other securitizers) will be allowed a two-year grace period before compliance with the rules becomes mandatory.

CONFLICTS OF INTEREST

The Dodd-Frank Act prohibits sponsors of ABS and related entities from engaging in transactions for a year and a day following the issuance of the ABS that would involve or result in any material conflict of interest with an investor in the ABS. Depending upon how broadly this provision is interpreted through implementing regulations, ABCP conduit sponsors could be prohibited from providing credit or liquidity facilities to such conduits and/or from underwriting or placing term securitizations of assets for which their sponsored conduits provided a warehouse line or from entering into hedging facilities in connection with transactions entered into by their sponsored conduits. Each of the Volcker Rule and a proposed rule (proposed Securities Act Rule 127B, which would implement the conflicts of interest provisions of the Dodd-Frank Act and new section 27B of the Securities Act), contain provisions regarding how conflicts of interest should be addressed by banks, including in securitization transactions. To date none of these rules has been finalized. Although it is not free from doubt, these proposed rules seem intended to exempt traditional ABCP activities from their scope.

COMMODITY POOLS

The Dodd-Frank Act added a definition of "commodity pool" to the Commodity Exchange Act ("CEA") and specifically listed "swaps" as commodity interests for purposes of that definition. Most securitization vehicles do not finance assets that would traditionally be considered "commodities," but would, after implementation of the Dodd-Frank Act, nonetheless be deemed to hold commodity interests if they enter into swaps (e.g., interest rate or currency swaps), even for hedging purposes. ABCP conduits that

enter into swaps therefore may constitute "commodity pools" for purposes of the CEA. Subject to certain exemptions, the CEA requires the managers or administrators of commodity pools to register as commodity pool operators ("CPOs") with the Commodity Futures Trading Commission (the "CFTC"). It follows that, absent an exemption, the sponsor of any ABCP conduit that engages in swap transactions could be required to register as a commodity pool operator. Any such registration requirement — and the need to comply with related CFTC regulations — would create a further disincentive for sponsors to continue to operate ABCP conduits. In addition, the Volcker Rule (described above), treats all commodity pools as covered funds. Accordingly, even if an ABCP conduit could avail itself of an exemption other than Section 3(c)(1) or (7) of the Investment Company Act, an ABCP conduit would nonetheless be treated as a covered fund (and would be subject to the associated Volcker Rule restrictions on transactions with its bank sponsor) if the conduit enters into swaps that cause it to be treated as a commodity pool.

On October 11, 2012, the Division of Swap Dealer and Intermediary Oversight (the "Division") of the CFTC released interpretive guidance (the "First Interpretive Letter") confirming that certain securitization vehicles are not "commodity pools" that are required to have a registered "commodity pool operator" under the Commodity Exchange Act and the rules of the CFTC. As of the same date, the Division also issued a no-action letter stating that the CFTC would not take enforcement against any entity that comes within the definition of "commodity pool operator" solely because of swap transactions so long as it meets certain conditions, including filing an application for registration, by December 31, 2012.

The First Interpretive Letter concludes that certain securitization vehicles would not be included within the definition of "commodity pool" so that an operator of one of those vehicles would not be a "commodity pool operator" that is required to register. The CFTC imposes five conditions on this exclusion.

> First, the issuer of ABS must be "operated consistent with the conditions set forth in" Regulation AB, or Rule 3a-7 under the Investment Company Act, whether or not the offering is in fact regulated thereunder, so

long as the issuer, the pool assets and the ABS "satisfy the requirements of either regulation." An ABCP conduit will satisfy this condition if it qualifies for the exemption from the definition of "investment company" contained in Rule 3a-7.

Second, the entity's activities must be limited to passively owning or holding a pool of fixed or revolving receivables or other financial assets that by their terms convert to cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders. Most ABCP conduits are actively managed in a manner that would make it difficult to satisfy this requirement.

Third, the entity's use of derivatives must be limited to the uses permitted under Regulation AB, including credit enhancement and using derivatives such as interest rate and currency swaps to alter the payment characteristics of cash flows.

Fourth, the entity must make payments to its security holders only from cash flow generated by pool assets and other permitted rights and assets, not from or otherwise based upon changes in the value of its assets.

Fifth, the issuer may not acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in the market value of the entity's assets.

The First Interpretive Letter does contain language that may be helpful for ABCP conduits that do not qualify for relief under the specific exclusion from the definition of "commodity pool." The Division notes that it:

> tend[s] to agree that certain entities that meet certain…criteria…are likely not commodity pools, such as securitization vehicles that do not have multiple equity participants, do not make allocations of accrued profits or losses ([o]ther than gains or losses from permitted dispositions of defaulted financial assets…) and only issue interests in the form of debt or debt-like interests with a stated interest rate or yield and principal balance and a specific maturity date.

Market participants and their counsel may be able to conclude that some structures that are not within the explicit exclusion provided by the First Interpretive Letter still are not commodity pools, because they meet these parameters.

On December 7, 2012 the CFTC issued an interpretative and no-action letter (the "Second Interpretive Letter") that provides broader relief for many securitization vehicles and transaction parties from commodity pool regulation. In this letter, the Division stated that certain securitization vehicles that cannot qualify for relief under the First Interpretive Letter because they do not satisfy the "operating or trading limitations" in Regulation AB or Rule 3a-7 should nonetheless not be treated as commodity pools so long as their use of swaps is "no greater than that contemplated" by Regulation AB or Rule 3a-7 and the swaps are not used to create an investment exposure. In particular, the Division identified ABCP conduits as an example of a securitization structure that ordinarily should not be deemed to be a commodity pool. It therefore appears that ABCP conduits that execute "traditional" interest rate, currency or timing swaps, but that don't engage in synthetic securitizations or similar transactions, will not constitute commodity pools and their managers will not be required to register as commodity pool operators.

The Division further stated in the Second Interpretive Letter that it will not take enforcement action against the operator of a securitization vehicle for failure to register as a commodity pool operator prior to March 31, 2013. Until that date, operators of securitization vehicles that don't qualify for relief under either the First Interpretive Letter or the Second Interpretive Letter (including, if applicable, managers of ABCP conduits that execute "non-traditional" swaps) were permitted to discuss with the Division whether alternative grounds exist for an exemption. As discussed above, the Volcker Rule (as currently proposed) will impose restrictions on bank sponsorship of and transactions with securitization vehicles that ultimately are deemed to be commodity pools.

JOBS ACT

The "Jumpstart Our Business Startups Act" (the "JOBS Act") was signed into law in April 2012. Among other initiatives intended to facilitate business

formation, the JOBS Act requires the SEC to amend Rule 506 of Regulation D under the Securities Act to permit issuers engaged in privately placing their securities pursuant to Rule 506 to offer the securities through general solicitation and general advertising so long as the issuer takes reasonable steps to verify that all purchasers of the securities are "accredited investors." The SEC has proposed but not yet adopted implementing rules. Under the proposed rules, investors will be deemed "accredited investors" if either (a) they come within one of the categories of persons who are accredited investors under existing Rule 501 of the Act, or (b) the issuer reasonably believes that they meet one of the categories at the time of the sale of the securities.[12] The JOBS Act and the proposed rules further provide that securities sold pursuant to Rule 144A under the Act may be offered to persons other than "qualified institutional buyers" ("QIBs"), including by means of general solicitation, provided that the securities are sold only to persons whom the seller and any person acting on behalf of the seller reasonably believe are QIBs.[13] Most ABCP conduits sell their notes in reliance upon Rule 506 and/or Rule 144A. Accordingly, once the implementing rules become effective, the JOBS Act will enable these ABCP conduits to broaden their marketing activities and, in particular, to solicit potential investors through the internet so long as all sales of the notes are made to accredited investors and/or QIBs as described above.

THE FRANKEN AMENDMENT (THE "RESTORE INTEGRITY TO CREDIT RATINGS" AMENDMENT TO THE DODD-FRANK ACT)

Section 939F of the Dodd-Frank Act, sometimes referred to as the Franken Amendment, required the SEC to carry out a study of the credit rating process for structured finance products, and the feasibility of establishing a system in which a self-regulatory organization would assign rating agencies to determine the credit ratings of structured finance products. The SEC is required to implement such a system — i.e., create a board, overseen by the SEC, that will assign credit rating agencies to provide ratings unless the SEC determines through the course of its study that "an alternative system would better serve the public interest and the protection of investors." The Franken Amendment was to have become effective in the summer of 2012 if the SEC failed to complete its study by that time, but the effective date was delayed. In

December 2012, the SEC issued a statement that concluded that the current system of ratings agency remuneration has resulted in conflicts of interest that have damaged the economy. The SEC further outlined three possible proposals to end the conflicts of interest inherent in the credit rating industry and recommended that the SEC take action to determine which proposal should be adopted.

OTHER REGULATORY CHANGES

Other recent regulatory changes may not require fundamental changes in ABCP structures, but they will increase compliance costs. As an example, Rule 17g-5 of the Securities Exchange Act of 1934, as amended, requires conduits and/or their sponsors to make information concerning the conduit available on a continuing basis to rating agencies not engaged by the conduit to rate its debt. This rule and similar rules could make conduits less profitable to operate.

It is clear from the foregoing that notwithstanding the excellent performance of traditional ABCP conduits throughout the global credit crisis, the ABCP market has suffered greatly and it will face many difficult challenges in the immediate future. Although certain of the increased costs that will impact ABCP sponsors derive from legislation or implementing regulations that have or shortly will become effective in final form, in certain other areas regulators will have considerable leeway to decide whether (and to what extent) new regulations will apply to ABCP conduits. In this regard, we believe that in crafting the applicable regulations regulators should consider a traditional ABCP's role in enhancing market efficiency, its importance in the broader economy and its strong performance record before, during and after the credit crisis.

They should also consider that regulatory uncertainty itself depresses market activity and that the ABCP market (and thus, the overall economy) would greatly benefit from quick and conclusive determinations by the regulators that various regulations principally directed to the term ABS market (e.g., enhanced Rule 144A disclosure requirements) will not be applied to ABCP. Going forward, banks and other financial institutions should be encouraged to consider establishing and operating fully-supported ABCP conduits (not

unlike the original, traditional ABCP conduits that originally populated this space) as the means best suited to provide short-term customer financing on terms that satisfy the different (but not necessarily inconsistent) concerns of regulators, sponsors, originators and investors. Such fully-supported programs could also be established with greater certainty regarding their utility and be more efficient to operate, given that they should not substantively be subject to the numerous pending regulatory initiatives being adopted more generally with respect to securitization.

NOTES

[1] In this context, a traditional ABCP conduit means an ABCP issuer that:

- issues highly-rated notes having fixed maturities not exceeding 365 days (or, in some cases, 397 days) from the issuance date;
- uses the note proceeds to purchase or finance financial assets from one or more originators;
- has access to committed liquidity from one or more highly-rated liquidity providers (usually, the program sponsor) in an amount not less than the face amount (i.e., principal plus interest through maturity) of its outstanding notes; and
- also has access (in most cases) to credit support from one or more highly-rated credit enhancers in an amount sufficient to support the ABCP's ratings.

[2] The government has acknowledged an ABCP's critical role in the economy. At the height of the crisis, the Federal Reserve took several initiatives to support the commercial paper market generally and the ABCP market in particular. Specifically, the Federal Reserve Bank of New York sponsored the Commercial Paper Funding Facility and the Money Market Investor Funding Facility and the Federal Reserve Bank of Boston sponsored the ABCP Money Market Mutual Fund Liquidity Facility, in each case to help ensure that the commercial paper market (including the ABCP market) would remain liquid throughout the crisis. The Federal Reserve was cognizant of the economic dislocation that would result if U.S. operating companies lost access to ABCP financing.

[3] The extent to which regulators will, in fact, take action to limit the application of certain of these regulations on or in respect of ABCP conduits remains unknown.

[4] It is noted that the Basel Committee proposals differ in many significant respects

from the risk-based capital rules for securitization exposures proposed by the U.S. banking regulators in June of 2012. In particular, under the U.S. proposals, SA banks could continue to determine the risk weight of an investment grade equivalent second loss position in ABCP conduit programs using the highest risk weight of any underlying asset (subject to a 100 percent floor). Similarly, an SA bank could apply a 50 percent credit conversion factor to an eligible liquidity facility if it computed the facility's risk weight using any method other than the Simplied Supervisory Formula Approach.

[5] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, H.R. 4173) (the "Dodd-Frank Act").

[6] At the same time, the Basel Committee has indicated that banks may be required to recognize the call date of a callable obligation, rather than its legal final maturity date, as the obligation's maturity date for purposes of the liquidity coverage test if market participants expect the call to be exercised. It follows that banks may not fully benefit from the use of callable notes (in terms of liquidity coverage relief) if their conduits always exercise their call rights and, in particular, if they do so on a fixed schedule (e.g., on the 31st day preceding the legal final maturity date).

[7] Prior to 2008, a number of ABCP issuers (both traditional and nontraditional) were authorized to issue extendible notes whose scheduled maturity dates extended automatically to specified final maturity dates if the issuer for any reason lacked sufficient funds to pay the notes on the scheduled maturity dates. An interest rate step-up would apply during the extension period. Some of these programs utilized a market value structure under which the issuer was expected to realize sufficient value from the sale of assets during the extension period (or from related payments under a market value swap) to pay the extended notes in full on their final maturity dates or on an earlier optional redemption date selected by the issuer. There is almost certainly no longer any market for this type of extendible note.

[8] The SPV may separately be subject to the filing requirements as an "issuer" of asset-backed securities (i.e., the securities that it sells to the conduit). However, under the implementing SEC rule (Rule 15Ga-1 under the Exchange Act) affiliated securitizers are not required to submit duplicate filings in respect of the same transaction. The SPV therefore will not need to submit its own filings if the originator files.

[9] The same problem will exist if the ABCP conduit is a "commodity pool" whether or not it relies upon Section 3(c)(1) or (7). However, under interpretive relief provided by the Commodity Futures Trading Commission, most ABCP conduits should not constitute "commodity pools."

[10] Section 3(c)(5)(A) provides an exemption for issuers principally engaged in acquiring notes, accounts receivables and other obligations representing the sales price of merchandise, insurance, or services, while Section 3(c)(5)(C) similarly

exempts issuers principally engaged in purchasing mortgages or other liens on real estate. Rule 3a-7 provides an exemption for asset-backed issuers that meet certain criteria specified in the Rule (including a requirement that the issuer not dispose of assets for the primary purpose of recognizing market value gains or decreasing market value losses). In this connection, it should be noted that any bank-sponsored ABCP conduit that relies upon Section 3(c)(5) or Rule 3a-7 may itself be deemed a "banking entity" that is subject to the Volcker Rule and its associated restrictions on proprietary trading activities and the ownership or sponsorship of covered funds. As a practical matter, such restrictions should not significantly restrict the operation of traditional ABCP conduits.

[11] As currently drafted, the "Super 23A" provisions in the Volcker Rule would prohibit banks from providing liquidity commitments and/or credit enhancement to conduits that they sponsor, manage or advise and that are "covered funds." These limitations cannot be avoided by organizing the ABCP conduit as a bank subsidiary. *See* "The Volcker Rule" above. If the "Super 23A" provisions are included in the final Volcker Rule, banks' ability to finance assets through ABCP conduits may be limited to financings effected through (i) bank-sponsored ABCP conduits that qualify for Investment Company Act exemptions other than Sections 3(c)(1) and (7), and (ii) ABCP conduits sponsored by third party non-banks.

[12] Regulation D (including Rule 506 therein) provides a safe harbor that issuers engaged in a private placement of securities may follow to ensure that the sale of the securities will be exempt from registration under the Act. Rule 501 defines "accredited investor" to include certain categories of institutional investors and certain high net worth or high income individuals.

[13] Rule 144A exempts from registration under the Act sales of securities made by any person (other than the issuer) to a QIB if certain conditions are met. In general, QIBs are limited to specified categories of institutional investors that hold not less than specified minimum amounts of securities investments.