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Structured Finance Report

In this issue

U.K. – European CMBS

By **Nadine K. Young**

Intersection and Need

Strong investor demand for CMBS, fuelled by attractive relative spreads and the need for asset diversification, has market participants expecting continued growth in the European (including U.K.) commercial mortgage-backed securities market. This article discusses these expectations, some unique features of European CMBS structures, and the current challenges and recent developments in the market.

Growth Expectations

Total European CMBS issuance for 2005 was EURO 40.7 billion (in 63 transactions), up from EURO 19.4 billion in 2004 (33 transactions) and EURO 11.1 billion in 2003 (23 transactions). While this appears small compared with 2005 total U.S. CMBS issuance of $169.2 billion (EURO 140 billion) in 99 transactions, strong demand, increasing standardization, and the launch of new bank conduit programs indicate broad expectations of continued growth from European CMBS's present 11% share of total European mortgage financings toward the U.S. 40% share.

As the aggregate GDP and population of the EU countries (including the newest accessions) exceed that of the U.S., there is good reason for investor attention to this growing CMBS market.

Little Uniformity of Structures

The U.S. CMBS market incubated in the early '90s in an environment of few alternative sources of debt capital for real estate and a fairly rigid REMIC tax regime, allowing the rating

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agencies and lenders to impose and defend detailed criteria and considerable control over loan structures. In contrast, CMBS in Europe has grown organically in a highly competitive lending environment with pressure on conduit lenders to accommodate borrower structuring needs in order to compete with portfolio lenders.

Most EU deals (more than 50% in 2005) are single borrower deals, where owners of large portfolios use securitization as a source of capital structured to suit their operational needs, with such features as substitutions, liquidating pools, variable payment terms, and complex hedging. As a result, there is little uniformity of deal structure in EU CMBS (the spread premium on EU CMBS issuances over other ABS classes is likely a function of this lack of uniformity); while the fundamentals conform to the rating agency requirements, the details vary widely. Consider, for example:

Cash management and liquidity. Waterfalls in EU CMBS deals can be startling to new investors accustomed to U.S. waterfalls. While the liability-side structures are remarkably simple—fewer classes, IO classes fairly rare, tranched AAA classes only occasionally—the waterfall summaries often run for pages in offering circulars. A long list of credit support and service providers take fees, periodic payments, expenses, and indemnities at the top of the waterfalls, ahead of interest on senior note (most EU CMBS are debt issuance) classes.

Lower note classes may be subject to available funds caps, which limit entitlement to interest when shortfalls arise due to prepayments. In 2005, there was acceleration of the trend toward addressing prepayment risk by various modified pro rata waterfalls, in which a portion of available principal is distributed pro rata across some or all classes, until a specified level of principal reduction is achieved or other trigger events (such as any loss allocation) occur.

Within a single deal, principal on one loan may be distributed sequentially, while on others it is distributed pro rata. Liquidity is provided through a facility rather than through servicer advancing, and it may not cover all classes of securities. The available facility may amortize down as the pool of loans reduces. Appraisal reduction may reduce the overall size of the facility without limiting advancing to lower classes.

Hedging. Most EU CMBS issuances are floating rate notes, notwithstanding that long-term fixed rent leases are the standard source of cash flows and the majority of loans are fixed rate. Those loan interest rates are swapped fixed to floating at the loan or securitization level, and deals often have an overlay of issuer hedges for currency and basis.

Hedge breakage is generally paid at the top of the loan and deal waterfalls; while borrowers are obligated to pay breakage due to prepayment or default on the loan level swaps, often default breakage at the loan level will not be fully recovered and there is no cover for deal level breakage, increasing loss severity.

Multiple Jurisdictions. Most EU CMBS deals (over 70% in 2005) are based on U.K. assets and are Sterling-denominated, with German asset deals in second place at about 10% (some market participants expect the volume of German asset deals to overtake U.K. asset deals in 2006). Origination, structuring, and ratings analyses must take into account the tax, security, enforcement, and insolvency regimes in each applicable jurisdiction.

Withholding tax exposure and restrictions on cross-border asset sales will often dictate the use of an intermediate securitization within the CMBS with, for example, Swiss or Italian loans being held by a Swiss or Italian issuer that issues unsecured notes held by the CMBS issuer along with the loans from other jurisdictions. There are significant jurisdictional differences in expected recoveries, modeled into the analysis (Moody's publishes a ranking of countries by enforcement environments for secured creditors), with the U.K. and Netherlands viewed as the most creditor-friendly, and Italy (mortgage enforcement can take 6-9 years) viewed as the least.

Challenges and New Developments

Prepayments. One of the most surprising aspects of EU CMBS for U.S. investors is the simplicity of the liability-side note structures, with most deals having just a few classes, with BB commonly the lowest, and no "IO" class. This is a direct result of the lack of loan prepayment lockouts characteristic of the EU markets, where CMBS originators compete head-on with portfolio lenders who are not as concerned about prepayment.

The prepayment risk in EU CMBS produces smaller deals (average EURO 650 million) because originators need to move loans off balance sheet more quickly, as total return swaps to hedge warehouse period risk are not affordable with the prepayment risk. Prepayment risk limits the ability to produce multi-jurisdictional deals with their risk of breakage on currency swaps, and also drives the modified pro rata pay structures discussed earlier.

Servicing and servicer advancing. In Europe, there is a very short list (think fewer than 10) of rating agency approved servicers; historically, deals have been serviced by the originating bank. Unlike U.S. servicing compensation, EU servicers get fee strips, while late charges, default interest, and investment income are often paid to originators as deferred purchase consideration. Expectations are that the rating agencies will soon approve servicer advancing, with backup credit support from a rated entity, in place of a liquidity facility.

Transparency and data disclosure. Reporting on EU CMBS deals—historically spotty, inconsistent, and limited in some cases by borrower-negotiated or government-imposed restrictions on disclosure—has become more complete and consistent as a result of industry-wide efforts to improve transparency. The European CMSA recently rolled out its model investor reporting package with the stated goal of increasing the quality and detail of property, loan, and deal reporting. Fitch publishes its Issuer Report Grade, scoring CMBS deals for the quality of their data reporting. Several third party cash flow analysis providers, such as Trepp, have set up shop in Europe.

The recently-issued Market Abuse Directive prohibits, across EU Member States, the use of inside information relating to financial instruments traded on a regulated market, and also imposes on issuers of financial instruments an obligation to publicly disclose price-sensitive inside information as soon as possible across the market as a whole. This latter requirement speaks to recent disclosure issues, particularly regarding prepayments, in secondary CMBS trading. The EU CMBS market participants are acting quickly to develop an industry consensus on the changes needed in reporting; a number of issuers have already eliminated password-protected websites, thus making key transaction information more freely available to the public.

A/B structures. A/B loan structures appeared recently in EU CMBS transactions and quickly became popular, with most 2005 EU CMBS transactions including the senior portion of at least one A/B loan. EU intercreditor terms are beginning to converge with U.S. intercreditors, having initially resembled loan syndication terms with enduring junior lender control rights and rights to force enforcement.

In EU intercreditors, the switch from pro rata to sequential pay is often triggered only by payment default or insolvency, and sometimes only by an enforcement action; trigger events based on transfer to special servicing are rare. Often B loans are not serviced by the servicer of the A loan. Standard & Poor's (London) has published guidelines on A/B loan structuring aimed particularly at limiting junior lender control rights, including recommendations for whole loan servicing, a servicing standard override, a control valuation mechanism, and limits on curing defaults.

Managed CRE CDOs. Investors in B-notes, mezzanine loans, and non-investment grade CMBS have pressed the rating agencies for clearance to issue managed CRE (commercial real estate) CDOs, as a source of longer-term financing to replace their current short-term financing—usually characterized by mark-to-market and margin requirements—not to mention the high cost of funding. Static CRE CDOs don't meet the financing needs of these EU high-yield investors; managed CRE CDOs would allow reinvestment of principal for a limited (perhaps 2-5 years) period, with a specified set of collateral quality tests, and would allow a limited amount of trading authority. Market participants expect to see the first managed CRE CDOs in 2006.

Conclusion

Low default rates—0.22% (as of Q4 2005) in European vs. 1.16% (as of November 1, 2005) in U.S. CMBS—have perhaps contributed to the EU CMBS market's continued divergence from the U.S. model in regard to less-restricted prepayments, less transparency, and less attention to servicing (and particularly special servicing) issues. Strong investor demand and a growing number of new conduit programs serve as counterweights to pressures for change, notwithstanding that these issues are likely to impact overall yields in a real estate down cycle. It is likely that these concerns will receive increased scrutiny from arrangers and investors as the market matures.

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Using OpCo/PropCo in Private Equity Transactions

By **Joseph B. Heil** and **Kahlil T. Yearwood**

Private equity funds are facing increasingly competitive conditions due to the growth of private equity capital, efficient M&A markets, and commoditized financing. Acquiring a target that owns substantial real estate operating assets through an OpCo/PropCo structure offers buyers a means of differentiating themselves, releasing trapped real estate value, maximizing loan proceeds, and reducing financing costs by accessing the efficient and low-cost real estate capital markets.

OpCo/PropCo Structure

The ideal target company has significant real estate assets that are integral to the operation of the business. Examples of these types of businesses include retail owner/operators and nursing home owner/operators. In the simplest iteration, the consolidated company ("Target") owns the real estate and has employees who run the business on that real estate. In an OpCo/PropCo structure, there are two separate companies, possibly with a common parent. The property company ("PropCo") owns the real estate, and as landlord leases the real estate to the operating company ("OpCo").

The OpCo is the tenant under the lease from PropCo and operates the business. The lease from PropCo to OpCo is a "triple-net" lease whereby all of the costs of owning and maintaining the property are borne by OpCo, including capital expenditures, taxes, insurance, etc. PropCo's only role is to collect rent (in most cases debt service will be paid by OpCo on behalf of PropCo or as part of a global cash management system).

Financing the OpCo/PropCo Structure

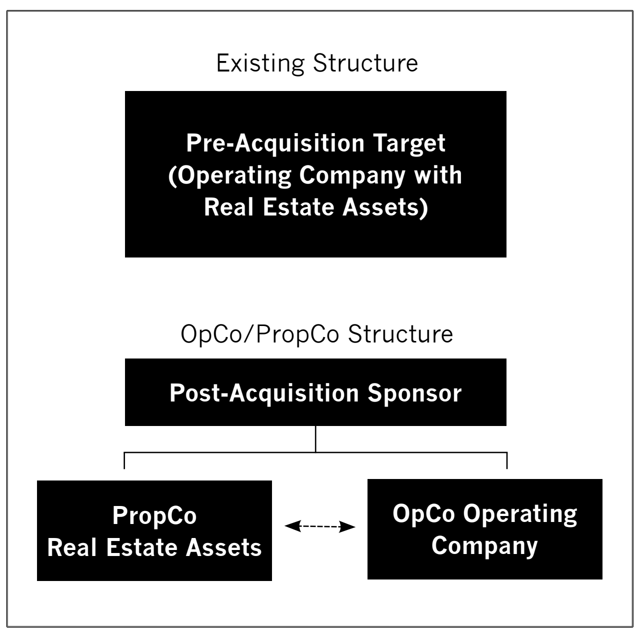
The use of the OpCo/PropCo structure enables the sponsor to finance both PropCo and OpCo separately, maximizing loan proceeds for use in the acquisition. The aggregate cost of capital is reduced because the sponsor is able to access the real estate capital markets which can provide better terms, including higher leverage and lower rates, than the corporate debt market.

Financing PropCo

As part of the acquisition, PropCo will establish a series of bankruptcy remote single purpose entities, each of which will own the fee interest in one parcel of real property (together with all of the applicable furniture, fixtures, and equipment). The property owners will jointly enter into a mortgage loan agreement and receive loan proceeds that can be used for the acquisition. Each property owner will grant a mortgage on its fee interest in the real property to the PropCo lender to secure its obligations under the mortgage loan agreement.

Ordinarily, a real estate capital markets lender would not make a loan to Target as it is an operating company. Target's real estate assets are commingled not only with each other, but also with the other assets of Target. A real estate capital markets lender will make a loan only to a property owner that is a properly structured bankruptcy remote single purpose entity.

The amount that the PropCo lender is willing to lend will be based in large part on loan-to-value and debt service coverage metrics. Real estate capital markets lenders may provide mortgage and mezzanine financing in an aggregate amount exceeding 85% of the appraised value of the properties (this compares favorably to corporate debt lending multiples). The loan amount will also be limited by a debt service coverage test, as the PropCo lender will want to ensure that the rent and lease obligations of the tenant comfortably exceed the debt service and necessary reserves.



Financing OpCo

There are two ways to implement the OpCo structure. In one, an OpCo tenant subsidiary runs the specific business operations at each particular location. In the other, the individual OpCo tenant subsidiaries enter into a management or services agreement with an affiliate that runs the business operations at each location. In either case, OpCo will be able to obtain bank or other capital markets financing which will be a combination of asset based and/or cash flow based financing.

The key differences between the consolidated structure and the OpCo/PropCo structure from the corporate lender's perspective are that OpCo no longer owns the real estate and it has the lease obligations. The OpCo/PropCo financing structure yields a superior result for the sponsor because the corporate lender would typically give the sponsor credit for a significantly lower portion of the appraised value of the real estate than the PropCo lender. By separately financing the real estate, PropCo can finance an asset that could not previously be efficiently financed, and likely on better terms than the general corporate debt.

Challenges in Implementing an OpCo/ PropCo Structure

The OpCo/PropCo structure requires careful planning and attention to several issues that may not be applicable in a traditional financing or acquisition. Because many of the issues are interrelated, they will be particularly difficult to manage if the acquisition, reorganization, and financing are occurring simultaneously. Some of the key issues relate to the leases, cash management, tax, and exit strategy.

The Leases

The most heavily negotiated documents in the transaction will be the leases between PropCo and OpCo. Other than the cash management agreements, the leases are the only documents that memorialize the ongoing relationship between PropCo and OpCo. Additionally, they are one of the few documents that are critical to the cash flow of both PropCo and OpCo. Unlike the consolidated structure, in the OpCo/PropCo leasing structure, the OpCo lender has the added risk that if PropCo defaults on its loan, the lease may be terminated, leaving OpCo with no real estate on which to generate cash flow. The OpCo lender will insist on some leasehold protections which are designed to ensure that the lease stays in place.

There will also be significant negotiation over the terms of the leases and rent escalation provisions. The PropCo lender will require that either all of the leases be cross-defaulted, or there be a master lease structure where all of the properties are jointly leased to OpCo, with subleases to the individual property operators. This type of leasing arrangement will be required to ensure that OpCo does not "cherry pick" by allowing properties that are not profitable to go into default.

Cash Management

Cash management issues and a cash management agreement will require negotiation among the sponsor, the lenders, and the banks where the accounts will be located. Both the OpCo lender and the PropCo lender will want to have control over cash as soon as possible. Further, both the OpCo and PropCo lender will want to get paid first in the event that there is a default under their respective loan agreement. Depending on the Target's industry, there will be specialized cash management issues. For example, a retail OpCo may need to incorporate inventory management and financing concepts, while a nursing home OpCo will need to address issues related to having primarily government payors.

Tax

The tax analysis must examine at least three different periods. First, the reorganization transaction itself must be analyzed, *i.e.*, the transfer of the real estate and/or operations from a combined operating company structure to an OpCo/PropCo structure. Second, the tax treatment of the income of the OpCo and the PropCo after the reorganization must be analyzed. Among other things, a tax efficient structure will prevent double taxation of income and will allow for maximum utilization of depreciation. Third, the likely exit strategies for the sponsor must be analyzed to ensure that the reorganization does not create short term benefits that outweigh larger future tax costs.

Exit Strategies

There will need to be a careful analysis of exit strategies with the sponsor to ensure that properties can be disposed of, net cash flow can be distributed, and new equity can be brought in without triggering change in control provisions. If the PropCo financing put in place at the time of reorganization/acquisition is not permanent financing, the refinancing strategy should be pre-cleared in the lease and loan documents, including provisions for property-by-property releases and refinancing if applicable.

Conclusion

A buyer implementing an OpCo/PropCo structure at the time of acquisition will have the ability to bid more aggressively for the target. We are seeing opportunistic buyers seeking out public companies with substantial real property operating assets that are not structured for maximum efficiency in their financing. These buyers are able to place premium bids because their financing packages use an OpCo/PropCo structure. Of particular interest are businesses in fragmented markets where business owners are not sophisticated financial investors. However, in many cases, while poor structuring of the target provides for increased opportunities, it will likely create additional complications in reorganizing the target into an OpCo/PropCo structure.

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Future Structures of the Islamic Bond Market

By **Abradat Kamalpour**

There has been much activity and discussion recently on Islamic capital market instruments. In fact, Dow Jones and Citigroup recently launched an Islamic bond index called the "Dow Jones Citigroup *Sukuk* Index." *Sukuk* (Islamic capital market instruments) have been the topic of choice in many finance publications and at numerous finance conferences throughout Europe, the Middle East, and the Asia Pacific. One of the key principles of Islamic finance is the prohibition on charging interest (or *Riba*) on money.

Conventional capital market instruments such as bonds, commercial paper, and medium term notes all have a fundamental interest and principal component. So how can it work? Aren't Islamic capital market instruments a contradiction in terms? Can we structure to get around such a fundamental rule?

The Islamic Leasing Solution

A well-established Islamic financing technique, known as the *Ijara* (Islamic compliant lease), which has been considered acceptable by Islamic scholars for other financing transactions, seems to overcome this problem.

The *Ijara* (which is a word derived from the term 'rental' in Arabic) is a structure that utilizes an asset's rental stream to produce a return to the owner of the asset. Economically, an *Ijara* financing works and operates like an amortizing or bullet repayment loan in many respects. However, *Shari'ah* scholars have become comfortable with the arrangement being a sale and an Islamic compliant lease of an asset as opposed to a loan under which principal and interest are payable. The traditional *Ijara* structure had been in use for some time before Islamic capital market instruments started to appear on the scene.

How can the *Ijara* structure be used and adopted for an issue of instruments that have similar economic qualities to standard bonds? What if the party seeking the finance does not wish to own an asset but needs financing for other purposes?

Using Leasing in a Capital Markets Context

An example of successfully adopting the *Ijara* structure for a truly global capital market issue was the Malaysian government's issue of *Sukuk* Trust Certificates in August 2002. The structure used was simple and clean in order to appeal to the broadest possible base of Islamic investors. A special purpose vehicle (SPV) was incorporated in Labuan called the 'Malaysian Global Sukuk Inc.' (MGS).

MGS (owned by a Malaysian state entity) issued *Sukuk* to investors. MGS used the funds raised from investors to purchase a number of parcels of land from another Malaysian state entity. MGS then leased those parcels of land to the Federation of Malaysia. At the expiry of the term of the lease, the Malaysian government has agreed to purchase the parcels of land from MGS at the face value of the initial issue amount of the *Sukuk*.

Pursuant to a declaration of Trust, the land parcels are held by MGS in favor of the *Sukuk* holders. All returns made on the land parcels are conveyed to the

Sukuk holders (including lease payments and the final repurchase proceeds). The cash flow produced is similar to any bond. The lease payments are like coupons and the repurchase proceeds paid at the end of the term are like the principal.

The MGS issue was rated by Standard and Poor's and Moody's. The instruments were listed on the Luxembourg Stock Exchange. The lease payments are determined based on a spread over LIBOR. The Islamic scholars are comfortable with the use of LIBOR as a lease pricing reference mechanism and not as a means of calculating interest.

Can you trade debt above and below par value?

As trading in debt above or below par would obviously breach the Islamic finance principle of not charging interest, and the ability to trade freely in capital market instruments is critical if you would like to create liquidity, there is a potential further problem. However, since the *Ijara Sukuk* represent an interest in the underlying assets and not debts, they can be traded above or below par freely without breaching any Islamic principles.

Is the leasing structure the answer?

Islamic scholars have broadly accepted the *Ijara* structure. However, the structure suffers from some major commercial disadvantages, namely:

- Not all issuers have an appropriate underlying asset available for such a transaction
- The asset is locked up for the term of the transaction; the owner cannot simply sell it
- Even if an issuer does have the underlying asset, depending on the jurisdiction, there could be adverse taxation costs associated with introducing the asset into the structure
- There could be ongoing *Shari'ah* audits in connection with the asset; this can be time-consuming and costly for the issuer

The *Sukuk al Musharaka* Structure

Another structure that is gaining popularity in the market is the "*Sukuk al Musharaka*." This structure involves an SPV issuer entering into a joint venture "*Musharaka*" agreement with the finance seeking party (*Musharaka* Party). The purpose of the *Musharaka* is to generate profits.

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The parties' respective interests in the *Musharaka* are represented by contractual "Units" held by each party. The Issuer will make a funding contribution to the *Musharaka* from funds it raises from the *Sukuk* issue. The *Musharaka* Party will make an in kind contribution to the *Musharaka* (usually including some tangible assets).

The Issuer and the *Musharaka* Party also enter into a Purchase Undertaking pursuant to which the Issuer can require the *Musharaka* Party to purchase a set amount of Units on set dates during the term of the *Sukuk*. The Issuer will receive profit distributions from the *Musharaka* and proceeds from sales of the Units to the *Musharaka* Party. The amounts received are distributed to the *Sukuk* holders in accordance with a set formula.

This structure is viable when the *Musharaka* Party can use its in kind contribution for a profit generating venture. The structure is diagrammed below.

The structure does provide some advantages (especially if the Issuer does not have all of the necessary tangible assets to achieve an *Ijara Sukuk* issue on day one). However, it does still have the following disadvantages:

- It requires tangible assets
- The assets are locked up in the structure for the term of the *Sukuk*
- A profit generating venture/project needs to exist
- The structure is relatively document intensive compared to a conventional bond issue

The Future

To overcome the limitations of the current *Sukuk* structures, innovative structures are being developed by various institutions worldwide. The alternative structures being contemplated are based upon other well-known Islamic financing structures (such as *Istisna, Musawama, Murabahah, Salam*). The biggest challenge that these potential structures face is producing an instrument that can be traded freely in the secondary market without breaching the fundamental principle of not trading in debt above or below par. The *Ijara* structure has been the most effective in solving this issue as the instruments produced represent an interest in an underlying asset that can be traded. Other structures being contemplated to solve the tradability issue are extremely complex and document intensive.

Given the recent growth and potential of this market, and the attraction of this market to Islamic and non-Islamic institutions and corporations as a potential source of funds, it is only a matter of time before viable structures are developed that do not suffer from the commercial disadvantages of the current structures.

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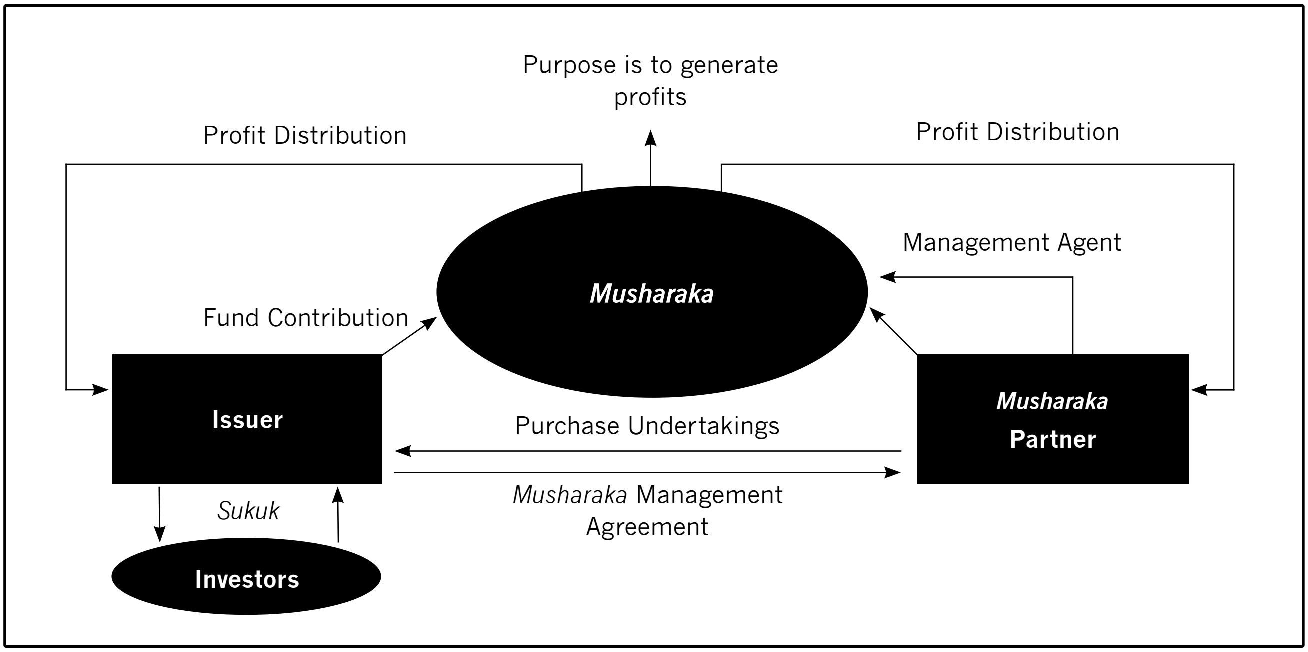

RMBS Update

By **Joonmoo Lee**

Adopted by the Securities and Exchange Commission ("SEC") in December 2004, Regulation AB applies to all public asset-backed securities issuances commencing after December 31, 2005. As many in the industry had anticipated, it has brought with it a number of questions. Like the first quarter of 2006, the next few months promise to be a time of trial and error, both legally and operationally, as those involved in publicly offered residential mortgage-backed securities ("RMBS") transactions seek to clarify certain ambiguities of applicability and implementation.

One requirement of Regulation AB to which participants in the RMBS industry are trying to respond in a standard way is the presentation of "static pool information." The SEC believes that providing static pool data regarding the delinquency and loss history of residential mortgage loans similar to those being securitized will benefit investors in their evaluation of investment in the residential mortgage-backed securities being issued. This has been a particular challenge to some mortgage originators in the industry for whom implementation of a program to collect and maintain such data has been slow and operationally difficult.

Often the problem may lie in the fact that some such originators sell most, if not all, of their loans to whole-loan purchasers on a servicing-released basis and have no ongoing program of tracking the performance of such loans once they are sold. Compliance with Regulation AB has forced the various parties in a securitization transaction involving such loans to coordinate their efforts and resources in establishing a program through which information necessary to put together the required static pool data can be shared and made available. This raises questions regarding the form of information, cost allocation, and liability, among others.

Questions of applicability and degree of disclosure are further aspects of Regulation AB compliance that must be addressed through a market standard. Many of the new disclosure requirements under Regulation AB are subject to a materiality standard. Participants in the RMBS industry need to come to some sort of common understanding as to what type of information regarding a particular transaction party is "material" to an investor's investment decision, and to what degree of detail such information should be disclosed.

In addition, the form of ongoing disclosure and attestations as to compliance with Regulation AB standards is another area that has been the source of much debate and negotiation. For example, in light of Regulation AB, the dovetailing of the duties of the trustee of the issuing entity and the servicer (or master servicer) of the securitized mortgage loans in an RMBS transaction requires negotiating the timing and form of such parties' duties, depending on each party's unique operational structure and interpretation of its disclosure responsibilities.

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Understanding Rule 159 of the Securities Act of 1933

By **Greg Lumelsky**

On June 29, 2005, the Securities and Exchange Commission ("SEC") significantly modified the regulatory framework applicable to the process of offering securities under the Securities Act of 1933 ("1933 Act"). The final rules adopted by the SEC alter in certain respects the liability of offering participants for prospectus disclosure by expressly basing liability under the 1933 Act, and the Securities Exchange Act of 1934 ("1934 Act"), for material misstatements or omissions in a prospectus solely on the information conveyed to an investor at the time the investor becomes committed to purchase securities.

We have been increasingly approached by those of our clients who are active in the Asset Backed Securities (ABS) market to advise them on the implications of the SEC's rulemaking for their securities marketing and underwriting businesses.

To understand why the updated regulatory framework—and new Rule 159 of the 1933 Act in particular—has such an impact on the ABS market, it is worth considering how ABS were issued before the introduction of the new regime. In traditional bond offerings, the only difference between the preliminary prospectus or offering circular and the final, or "black," is typically the inclusion of pricing information in the "black." By contrast, most ABS offerings, including nearly all CDO offerings, are structured contemporaneously with pricing, as both structure and price are fine-tuned in response to market conditions at the time of pricing.

Consequently, it is not possible to create a final prospectus before pricing, as material changes to the deal terms may be introduced up to several days before closing. The SEC has acknowledged this anomalous aspect of the ABS market by issuing a series of no-action letters, known as the Kidder no-action letters, sanctioning a practice that otherwise would have violated the SEC prospectus content and delivery requirements.

New Rule 159 provides that liability for adequacy and accuracy of disclosure attaches at the time of the contract of sale, and that information filed (or, in the case of a private placement, delivered) after the date of a contract of sale is not considered for the purpose of determining liability under the 1933 Act and 1934 Act. Rule 159 provides no express exception for the unique structuring process inherent in ABS offerings.

While acknowledging that market practice in this space continues to vary widely as ABS market participants study the implications of the new regime, a number of our clients have taken concerted steps to address its requirements. One, but by no means only, approach is to ensure, first, that a contract of sale does not occur prior to the pricing date, and second, that every effort be made to substantially finalize the offering documentation prior to the pricing date.

How compliance is ultimately achieved—whether by filing or distributing a second "final red herring" accompanied by a summary of changes from the initial "red," or, if the final offering document reflects material changes (other than pricing terms) to the terms of an offering, by giving investors an opportunity to reconfirm or rescind their purchase commitments based on the new information, or by a combination of these and other approaches—is a decision market participants must make on the basis of all relevant facts and circumstances at the time of a transaction, against the backdrop of a new and, unfortunately, untested regulatory regimen.

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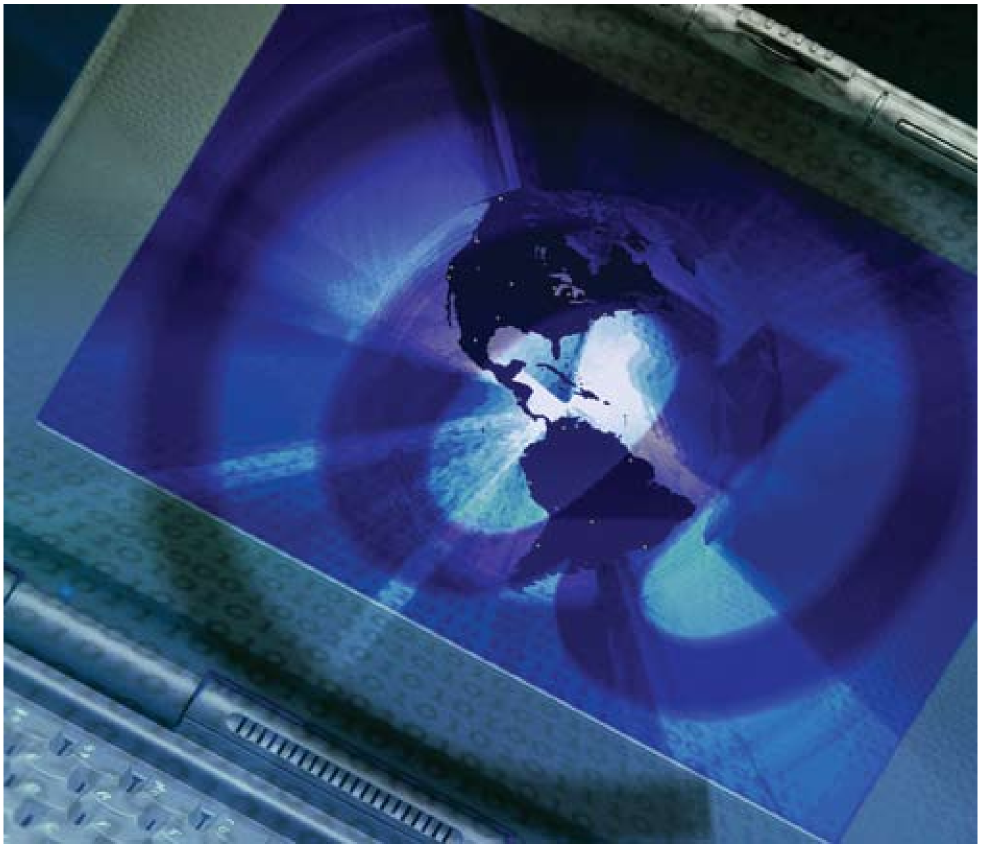

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