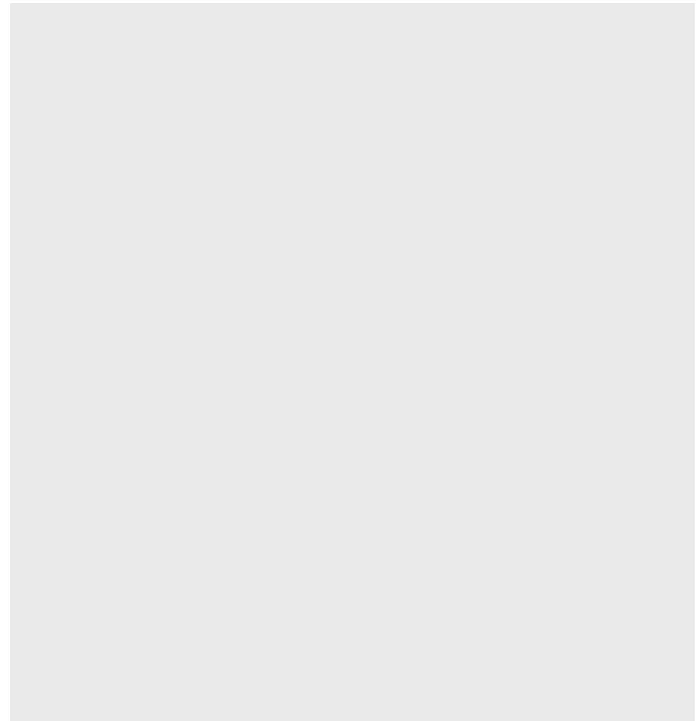
By Michael K. Feldman

Slow and steady wins the race

The credit crisis did not hit Canada as hard as the United States. As a result, its regulators took their time before reacting and have now proposed a measured approach to regulating the securitization industry. However, their rules still need some fine-tuning.



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Making regulations is a bit like making furniture. In the children's story *Goldilocks and the Three Bears* Goldilocks struggled to find a bed that was neither too soft nor too hard. Eventually, of course, she settled on one that was "just right." The Canadian Securities Administrators (CSA) appear to have largely succeeded in crafting a similar level of comfort with the comprehensive set of new rules for securitized products that they unveiled in April after a two-and-a-half-year study.

The CSA, which represent each of the provincial and territorial securities regulators in Canada, have successfully avoided many of the mistakes made by the U.S. lawmakers who drafted legislation for publicly distributed asset-backed securities (ABS). But certain details of Canada's securitization proposals need refinement — primarily, as I argue below, the sections dealing with exempt distributions, where the CSA still need to provide greater flexibility.

One reason why the Canadian securitization proposals are not as cumbersome as those in the United States is because the 2007 credit crisis did not hit Canada as hard. The country's financial markets calamity was the collapse of the $32 billion third-party ABCP market. Exploring new rules for the sale of ABCP was thus what the CSA initially decided to focus on when it released its consultation paper in October 2008.

This was the only regulatory initiative undertaken in Canada for asset-backed securities. By comparison, the U.S. government and regulators have been hyperactive: sections of the far broader Dodd-Frank Act are devoted to securitization and the Securities and Exchange Commission (SEC) has already issued several rules and released other draft rules as a result. In addition, the SEC has proposed amendments to Regulation AB, known as RegAB II, though that appears to have taken a back seat of late. And the Federal Deposit Insurance Corporation has issued its new safe harbor rules for bank-sponsored securitizations.

The slower pace of rule-making adopted by the CSA has allowed them to reflect upon U.S. securitization initiatives and seek a more balanced approach. The CSA's prospectus and continuous disclosure proposals are largely based on the requirements of RegAB with very few additional elements adopted from the latest bout of U.S. regulatory initiatives. In general, these provisions can be fairly summarized as an uncontroversial update of securitization disclosure requirements to meet the standards that have been in effect in the United States for five years. Many of the prohibitions or obligatory requirements contained in the U.S. securitization initiatives are dealt with instead as disclosure items under the CSA's securitization proposals (*see box on page* 33).

The CSA's proposals for exempt distributions of securitized products, however, are less benign. Like the provisions of RegAB II that would apply to private placements, the exempt distribution rules under the CSA's proposals would, if left intact, probably inhibit the private placement securitization market much more than the CSA apparently intends, according to the background sections of their proposals.

The proposals would eliminate all of the existing prospectus exemptions for securitized products, including ABCP, and replace them with a single "securitized product" exemption.

The exemption has three components. First, sales may only be made to "eligible securitized product investors" (ESPIs), essentially a slightly more restrictive list than the current "accredited investor" designation. Next, the issuer must deliver an information memorandum to each investor and also make it available to prospective investors in the secondary market. Finally, the issuer must prepare and deliver periodic continuous disclosure reports essentially as if the distribution of ABS or ABCP had been executed through the terms of a prospectus.

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Crisis Reaction

The securitized product exemption is largely a reaction to the 2007 credit crisis where thousands of Canadian retail ABCP investors found themselves holding illiquid ABCP and unable to gain access to crucial information concerning the assets backing their ABCP or the conditions surrounding the ability of ABCP conduits to draw on liquidity lines. Under the Canadian securitization proposals, information memoranda for short-term securitized products, including ABCP, would have to be in a prescribed form.

The details of the form are outside the scope of this article but they should be sufficient to address the concerns arising out of the 2007 credit crisis. Although the requirement for information memoranda for short-term securitized products would be new, much of the information required, such as an information memorandum and continuous disclosure for ABCP, is already being provided privately to investors by bank-sponsored ABCP conduits in their monthly reports.

There are a few areas where the form of information memoranda for short-term securitized products arguably goes too far. For example, it is proposed that sponsors must describe the material terms of existing program documents and transaction agreements. This could be quite an onerous task for a multi-seller ABCP conduit. Yet it is unlikely that it would provide much useful information to investors.

The most problematic aspect of the exempt distribution rules, though, appears to be a requirement for the sponsor to certify that the information memorandum contains no misrepresentation. Since sponsors of ABCP conduits rely on the servicers of their various programs to provide the information required for the information memorandum, this will effectively make the sponsor of an ABCP conduit a guarantor for the servicers. The sponsor could, of course, have recourse back to the servicers. But that would be cumbersome, introduce an additional layer of unnecessary risk and would probably limit accessibility to ABCP conduits to only the most creditworthy of servicers.

There is no prescribed form for information memoranda for other securitized products, but they must "disclose sufficient information about the securitized product and securitized product transaction to enable a prospective purchaser to make an informed investment decision." This is a novel and vague standard for offering document disclosure.

The securitized product exemption has a few other bugs to work out, too. The definition of ESPI does not include conduits — in other words, trusts — administered by an ESPI. So under the current proposals, bank-sponsored ABCP conduits may only purchase asset-backed securities if the deal is offered by prospectus.

Another requirement may well stifle the ABS private placement market: the CSA is proposing that the information memoranda for all securitized products must be certified by at least one underwriter to contain no misrepresentations, to the best of the underwriter's knowledge. Currently, underwriters and other agents do not take responsibility for disclosure in private placement offering documents. Forcing them to do so may undermine their desire and ability to participate.

Finally, many private placements of ABS are to sophisticated investors who do not require or desire an information memorandum, particularly where the sale is to a single investor. At the very least, a subset of ESPIs ought to be able to opt out of the information memorandum and continuous disclosure requirements of the securitized product exemption and instead negotiate for whatever disclosure they require.

Market participants have had time to make their views known: the comment period for the Canadian securitizations proposals ends on July 1. Revised proposals should come before the end of 2011, with a further comment period thereafter. Once that is over, the CSA are likely to promulgate the final rules in the first half of 2012. Thankfully, most of the rules are nowhere near as onerous as the restrictions U.S. legislation seeks to impose. And with a few adjustments, it should be possible to rejig the proposed Canadian exempt distribution rules to make them much more accommodating.

The views expressed are those of the author and do not necessarily represent the views of ASF.

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Canada structures ABSolutely better rules

The bulk of proposals contained in the Canadian Securities Administrators' (CSA) securitization proposals strike the right balance for all participants. What follows is a run through the main differences between proposed rules in the United States and Canada.

▪ Risk Retention

The Canadian securitization proposals contain no requirement that securitizations be structured in a particular manner, such as requiring risk retention of an arbitrary amount by the sponsor or an originator. Instead, a prospectus must disclose whether any significant party is retaining a portion or a tranche of the economic interest in a transaction, the amount retained and whether the retained exposure has been hedged.

▪ Conflicts of Interest

Under the CSA's securitization proposals, those who are or have been in the past engaged in a transaction that would involve a conflict of interest with investors are not prohibited from participating as underwriters in a securitization. Rather, this becomes a prospectus disclosure issue.

▪ Ratings Agencies

Credit ratings will remain an eligibility criterion for accessing the Canadian shelf prospectus system for issuers of asset-backed securities. No one seems to have come up with more meaningful criteria yet — including the drafters of RegAB II — so the CSA are sticking with the poison that they know.

Also, credit rating agencies continue to be exempt from expert liability when issuing their ratings. As a result, it will not be necessary to obtain rating agency consent to disclose ratings. In fact, disclosure of certain credit rating information in a prospectus is required and, unlike the current situation under RegAB, it is expected that Issuers will be able to comply with these requirements because consent of the rating agencies will not be required.

▪ Level of Disclosure

The type and level of disclosure required by the Canadian securitization proposals is similar to, and is based upon, that required under the current RegAB. Major departures, such as asset- or loan-level disclosure and the provision of a computer waterfall payout program, have been rejected in the current proposals.

▪ Static Pool Data

Notwithstanding the general move towards RegAB-level disclosure, an issuer need not include static pool data if it would not be material, provided that the prospectus discloses why such information was omitted. A recent decision of the Supreme Court of Canada (Sharbern Holding Inc. vs Vancouver Airport Centre Ltd., et al., 2011 SCC 23) could provide support under certain circumstances for issuers wanting to take the position that static pool data may not be material.

▪ Review of Pool Assets

Under the CSA's securitization proposals, there is no mandatory review of pool assets underlying ABS. However, if the pool assets are reviewed, the result of this review must be disclosed in the prospectus and, as with U.S. securitization initiatives, if the review is conducted by a third party, that third party must be named in the prospectus and must consent to being named as an expert.

▪ Fulfilled and Unfulfilled Purchase Requests

The differences here are subtle. The Canadian securitization proposals require a prospectus to provide historical demand, repurchase and replacement information with respect to other securitizations by the sponsor for the same class of assets when ABS is distributed by prospectus. Subsequent demand, repurchase and replacement information must be provided as part of the continuous disclosure package. However, it is not necessary for issuers to disclose this information regarding different asset classes or in connection with privately placed securities.

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