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U.S. Person Restrictions in the U.S. Risk Retention Regulation Foreign Transaction Safe Harbor raise practical problems for non-U.S. securitizations

With effect from December 24, 2016, the sponsor of a securitization transaction is required to comply with the U.S. credit risk retention requirements set out in Section 15G of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and the related implementing regulations[1] (the "**Regulations**") unless an exemption applies. The Regulations contain a safe-harbor for foreign transactions[2] that meet specific conditions. One of those conditions is a limit on the offer and sale of the securitization securities to U.S. Persons. Unfortunately, the definition of U.S. Person in the Regulations is different from the familiar Regulation S definition. Sponsors and issuers should take care to ensure that their offering complies with the Regulations.

Background and scope

The Regulations require that the sponsor of any securitization transaction must retain an economic interest in the credit exposure to the securitized assets. The "sponsor" in this case is the entity that organizes and initiates a securitization transaction by selling or transferring assets, directly or indirectly, including through an affiliate, to the issuing entity. The sponsor can retain its credit exposure by acquiring and holding a liability of the issuer (or a cash deposit) representing a five per cent. first loss exposure to the securitized assets, or a vertical exposure representing five per cent. of each tranche of liabilities issued by the issuer, or a combination of the two. The Regulations contain specific provisions for alternative modes of retention for certain asset types, such as revolving pool securitizations, asset-backed commercial paper and commercial mortgage-backed securitizations.

A "securitization transaction" is any transaction involving the offer and sale of asset-backed securities. An asset-backed security is defined in the Exchange Act (in relevant part) as a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset. Importantly, for those familiar with the European understanding of a securitization that looks, in most cases, for an issuance of tranched debt, the structure of the securities and the existence of a "capital stack" is not a concept that is found in the U.S. definition. While there are distinctions between

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1 *Credit Risk Retention; Rule* 79 FR 77602, December 24, 2014
2 17 CFR 246.20

securitizations and other types of fund investments, the definition is complex and issuers and sponsors should take legal advice to determine whether their transaction falls within the scope of the definition and, consequently, the Regulations.

Foreign Transaction Safe Harbor

The Regulations contain an exclusion for transactions that do not feature a significant U.S. nexus. However, in order to qualify for the foreign transaction safe harbor, a securitization transaction must satisfy all of the four conditions:

1. The securitization transaction is not required to be and is not registered under the Securities Act of 1933;
2. No more than 10 percent of the dollar value[3] (or equivalent amount in the currency in which the ABS interests[4] are issued, as applicable) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons;
3. Neither the sponsor of the securitization transaction nor the issuing entity is:
   (a) Chartered, incorporated, or organized under the laws of the United States or any State;
   (b) An unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of the United States or any State; or
   (c) An unincorporated branch or office located in the United States or any State of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State; and
4. If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State, no more than 25 percent (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from:
   (a) A majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the United States or any State; or
   (b) An unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any State.[5]

While three of the conditions are relatively self-explanatory and should be straight-forward for issuers and sponsors to verify, the restriction on the offer and sale of the issuer's liabilities to U.S. Persons is likely to cause significant issues.

The Risk Retention U.S. Person definition

The problem is that the definition of U.S. Person used in the Regulations is different from the relatively familiar definition set out in the Regulation S safe harbor from registration under the Securities Act. The relevant parts of the two definitions are set out below for comparison

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[3] Value in this case means fair value on the date of sale determined in accordance with U.S. GAAP. That can present practical difficulties where there is a significant period between the pricing date (when ABS interests are allocated) and the closing date (when they are sold)

[4] The term ABS interests covers any liability of the issuer that is supported by the cashflows on the underlying assets, other than its common stock or other evidence of ownership

[5] 17 CFR 246.20(b)

Regulation S[6]	Risk Retention Regulations[7]
[A U.S. Person includes] any partnership or corporation if: (A) Organized or incorporated under the laws of any foreign jurisdiction; and (B) Formed by a U.S. person principally for the purpose of investing in securities not registered under the [Securities] Act, *unless it is organized or incorporated, and owned, by accredited investors (as defined in [Regulation D]) who are not natural persons, estates or trusts*. [emphasis added]	[A U.S. Person includes] any partnership, corporation, limited liability corporation or other organization or entity if: *(1)* Organized and incorporated under the laws of any foreign jurisdiction; and *(2)* Formed by a U.S. person (as defined under any other clause of this definition) principally for the purpose of investing in securities not registered under the [Securities] Act

The institutional accredited investor exclusion from the Regulation S definition of U.S. Person has historically been a very important means for U.S. investors and investment managers to participate in non-U.S. securities markets. By establishing offshore investment entities, investors that met the relatively objective test for accredited investor status could participate in offshore transactions involving the offer and sale of securities, outside the scope of U.S. federal securities laws. The use of a different definition in the Regulation means that the foreign transactions safe harbor will not be available where more than 10% of the obligations issued by the issuer are acquired by offshore investment vehicles established by U.S. investors, notwithstanding that the securities may be exempt from registration under Regulation S.

Practically, this is likely to have two significant effects:

- First, issuers and sponsors who are seeking to rely on the foreign transactions safe harbor will need to take additional steps to form a reasonable belief that the offer and sale of the issuer's liabilities complied with the 10% limit; and
- Secondly, it could reduce the viability of some types of non-U.S. securitization asset-classes that have historically relied on offshore funds to make up a significant part of the investor demand for specific tranches of securities. The limit on sales to such buyers could make those types of non-U.S. transaction more expensive, or deter originators and sponsors from issuing at all. That in turn could affect the availability of non-bank credit to the related non-U.S. financial sector.

Under the Regulations as they stand, there is no way to avoid the second consequence except by complying with the US risk retention requirements.

With respect to the first consequence, we expect that procedures will develop to allow sponsors of non-U.S. securitization transactions to reach a reasonable conclusion that the offer and sale of the issuer's liabilities complied with the safe harbor. In

6 17 CFR 230.902(k)
7 17 CFR 246.20(a)(1)(H)

that respect, it is important to note that this restriction applies only to the initial offer and sale of ABS interests, not to *bona fide* secondary market transfers after the completion of initial distribution. [8]

Procedures

Issuers and sponsors must form their own conclusion as to the compliance of their offer and sale with the foreign transaction exemption. There is presently no consensus in the market as to what combination of factors will be decisive in the context of a particular offering or asset class, but we expect that the following elements will each play a role:

1. **Disclosure**: since the U.S. Person definition under the Regulations is relatively new and unfamiliar, we expect that issuers and sponsors would want the offering document to contain clear and prominent statements that the issuer is relying on the foreign transaction safe harbor and that consequently the offer and sale is restricted with respect to investors who are U.S. Persons within the meaning of the U.S. Risk Retention Regulations. We expect that that disclosure would highlight the distinction between the Regulation S definition and the risk retention definition, and specify whether the issuer intends to limit sales to risk retention U.S. Persons to less than 10% of the primary offering, or to prevent sales to U.S. Persons entirely;
2. **Investor Representation:** since compliance with the foreign transaction safe harbor will depend on the identification of investors as U.S. Persons under the Regulations, we would expect the practice to develop of either including deemed representations that each purchaser of the issuer's liabilities is not a U.S. Person within the scope of the Regulations, or where the issuer permits limited distribution to U.S. Persons, that each investor that is a U.S. Person under the Regulations has identified itself to the issuer or its agents.

We would also expect that representation (or related disclosure) to set out the relevant part of the definition in detail, so that investors are aware that it is not the same as the Regulation S definition. Finally, issuers and sponsors may develop the practice of including language to the effect that any transfer to a U.S. Person is null and void (this may be qualified where the issuer has permitted limited distribution to U.S. Persons).

Issuers or sponsors that choose to permit limited distribution to U.S. Persons may elect to put in place similar procedures to those used for limited distribution of equity interests to ERISA Plans under the 25% rule. Those procedures would generally include written undertakings from Plan investors accompanied by absolute representations from other investors that they are not Plan investors. A similar approach could be adopted with respect to complying with 10% restriction under the risk retention rules.

3. **Distributor Assistance**: the final element of the verification procedure is likely to involve the underwriters or placement agents for the securitization assisting the issuer and sponsor to understand the allocation of the issuer's liabilities and the status of the investors as U.S. Persons or otherwise under the Regulations. It is presently unclear whether dealers' investor on-boarding procedures will be modified to require investors (or at least those investors for which the answer is not immediately clear) to confirm their status under the U.S. Person definition, or whether dealers will require investors to give some form of confirmation as to their status at the time of placing an order for ABS interests. However, we expect that issuers and sponsors will, at a minimum, require underwriters and placement agents to provide practical assistance to identify investors and to notify the issuer and sponsor if the underwriter or placement agent is unconfident of the U.S. Person status of any such investor.

These steps are not exclusive, and sponsors and issuers may conclude that other procedures are appropriate in the context of a particular offering.

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[8] See 79 FR 77668: "The agencies wish to make clear that, in general, the rule is intended to include in the calculation of the 10 percent limit only ABS interests sold in the initial distribution of ABS interests. Secondary sales to U.S. persons would not normally be included in the calculation. However, secondary sales into the U.S. under circumstances that indicate that such sales were contemplated at the time of the issuance (and not included for purposes of calculating the 10 percent limit) might be viewed as part of a plan or scheme to evade the requirements of the rule."

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