WHITE PAPER

APPLICABILITY OF U.S. RISK RETENTION RULES TO STRUCTURED MARINE CONTAINER PORTFOLIO TRANSACTIONS

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The purpose of this White Paper is to provide general guidance to transaction participants and practitioners in their consideration of the application of the provisions of Section 15G of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the federal interagency credit risk retention rules promulgated thereunder, codified at 17 C.F.R. Part 246 (the "CRR Rules"), to a typical issuance of securities by a newly formed special purpose vehicle that owns or will own, among other things, a portfolio of marine containers and related leases which may be entered into directly or indirectly by way of one or more management agreements (a "Structured MCP Transaction"). This White Paper was prepared by Watson Farley & Williams LLP ("WFW") but does not reflect the view of WFW in the context of any particular transaction. The guidance set forth in this White Paper is for informational purposes only and is subject to change in light of future federal interagency decisions interpreting the CRR Rules or applicable legislative or judicial action. Neither this publication nor the law firm that authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship.

1 INTRODUCTION

The CRR Rules require each securitizer of "asset-backed securities" (as such term is defined in Section 3(a)(79) of the Exchange Act, an "Exchange Act ABS") to retain an economic interest in a portion of the credit risk for all assets transferred, sold or otherwise conveyed to a third party by such securitizer through the issuance of asset-backed securities. The CRR Rules came into effect on December 24, 2016 for all classes of asset-backed securities (except for those collateralized by residential mortgages, which took effect from December 2015). As the CRR Rules only apply to Exchange Act ABS, the key consideration is whether a typical Structured MCP Transaction constitutes an issuance of:

> "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,…".[1] (emphasis added)

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[1] *Exchange Act ABS "(A) means 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, including—*

(i) a collateralized mortgage obligation;

(ii) a collateralized debt obligation;

(iii) a collateralized bond obligation;

(iv) a collateralized debt obligation of asset-backed securities;

(v) a collateralized debt obligation of collateralized debt obligations; and

Notwithstanding the voluntary compliance with the CRR Rules in some prior Structured MCP Transactions, when considering securities issued in a typical Structured MCP Transaction, we are of the belief that, subject to the Finance Lease Proviso (see section IV below), the CRR Rules will not apply to such issuances and thus will not constitute an Exchange Act ABS. We have detailed the reasons for this conclusion below.

2 ANATOMY OF A TYPICAL STRUCTURED MCP TRANSACTION

The sponsor of a Structured MCP Transaction (the "Sponsor") is typically either (a) a container leasing company whose primary business is to own, lease and manage a portfolio of containers for itself (as well as manage portfolios of containers owned by other unaffiliated third parties (a "*Lease Manager*") or (b) an entity that services a portfolio of containers owned by other group affiliates (a "Servicer") that are leased to different lessees through one or more Lease Managers. The relevant portfolio(s) of containers, alongside any associated leases and the associated management agreements with the Lease Managers (the "Lease Management Agreements"), are then sold by the Sponsor to a newly formed special purpose vehicle (the "Issuer"). The Issuer itself is normally either a wholly owned subsidiary of the Sponsor or an orphan special purpose vehicle owned entirely by a charitable or purpose trust.

In order to acquire the portfolio of containers, the Issuer will obtain finance by issuing one or more classes of debt securities and, in some recent cases, selling some or all of its residual (or equity) interests to a third-party purchaser, in the form of ordinary shares in the Issuer or a profit participating note (e.g., an E note). The inclusion of the sale of equity interests (or an E note) to a third-party means that the purchaser will often, akin to the due diligence a buyer would perform in connection with the acquisition of a target company, perform due diligence on the Sponsor, the seller (if different), the Lease Manager(s) and their respective relevant affiliates, as well as on the containers which are owned or to be purchased by the Issuer and any associated Lease Management Agreement(s) pursuant to which lease proceeds are collected.

The Issuer is generally managed by a Board of Directors (the "Board") which engages third parties to manage its business and provide additional administrative services to the Issuer and its Board. The Lease Manager(s) typically manage the leasing of the containers on behalf of the Issuer pursuant to one or more Lease Management Agreements and are responsible for, among other things, collecting lease rentals, sale proceeds and total loss proceeds, enforcing the terms of the lease agreements and remarketing the containers for sale and/or re-lease following the expiry or termination of the lease. In a Servicer-sponsored transaction, the Servicer will enter into a servicing agreement with the Issuer under which the Servicer will monitor the performance of the Lease Managers on behalf of the Issuer. The Sponsor will also be required to engage one or more replacement Lease Managers upon the resignation or termination of an existing Lease Manager. The Sponsor is also responsible for preparing (or procuring that the Lease Managers prepare) financial reporting with respect to the container portfolio and will also provide other financial management and cash management services. The Board of the Issuer retains rights in respect of certain specific actions, including the winding up of the Issuer.

Once acquired, the containers are used to generate income for the Issuer to pay operating costs and expenses, service its debt securities and make equity distributions. The income stems from (a) rent and related payments under leases of the containers to various lessees (which are remitted to the

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(vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company".

Issuer from the Lease Manager(s) pursuant to the Lease Management Agreement(s)) and (b) the proceeds of the sale or other final disposition of the containers themselves.

Structured MCP Transactions are structured such that the expected income from the initial container leases will be inadequate to repay the debt securities and that the estimated present value of such cash flows is comfortably less than the acquisition cost of the portfolio by the Issuer (subject to the Finance Lease Proviso discussed below). In order to generate sufficient income to fully repay the debt securities, each container will need to be sold, re-leased several times over the life of a Structured MCP Transaction or scrapped. Therefore, it is essential to the performance of a Structured MCP Transaction that the Issuer (through the relevant Sponsor, Lease Manager, the Issuer's Board and other service providers) remarket off-lease containers for sale or lease as appropriate, as well as manage storage costs, maintenance expenses, repositioning costs and transition costs.

3 DEFINITION OF ASSET-BACKED SECURITY

(a) SEC Guidance.

The Securities and Exchange Commission (the "SEC") has not expressly interpreted the definition of Exchange Act ABS. It has, however, in Regulation AB that was codified in 2005[2], defined certain 'key principles' that it considers are inherent in any "asset-backed security" (in such generic form, an "ABS"); such principles included "a general absence of active pool management" and an emphasis on "the self-liquidating nature of pool assets that by their own terms convert into cash."[3].

Before the implementation of Regulation AB, securities backed by assets which required positive action to generate income (for example, the sale of non-performing assets and physical property) were generally thought not to constitute an ABS under the then existing regimes related to registration, disclosure and reporting for "asset backed securities". As part of the amendments being made to Form S-3 in 1992, the SEC originally adopted a definition of "asset-backed security" (the "pre-2005 ABS definition") covering securities that were "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders".

Then, in 2005, the SEC codified the pre-2005 regime in respect of "asset-backed securities" in Regulation AB and expressed that its pre-2005 ABS definition would need to be amended if it was intended to capture lease-backed ABS where it was anticipated that part of the cash flows to repay the securities would come from the disposal of the physical asset underlying the lease (as these did not fall within the SEC's then existing 'core principles'). The outcome of this codification was that the 'core principles' from the pre-2005 ABS definition remained in place with expansions being made to capture lease-backed securities within the registration, disclosure and reporting requirements for asset-backed securities under the Securities Act and the Exchange Act (the "Regulation AB definition").[4] It is important to note that the SEC's Regulation AB definition was not adopted in Section 15G of the

[2] 17 C.F.R. § 229.1100

[3] Asset-Backed Securities; Final Rule, SEC Release No. 33-8518, 34-50905, 70 Fed. Reg. 1506, 15 t3 (Jan. 7, 2005) (the "2005 ABS Adopting Release").

[4] *The Regulation AB definition means "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders;* ***provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases****…" (emphasis added)*

Exchange Act and the CRR Rules, which instead uses a definition which adheres much more closely to the pre-2005 ABS definition (this is discussed further below).

When expanding upon the definition of "asset-backed securities" in 2005, the SEC clarified that such expansion was a special accommodation to the pre-2005 ABS definition which was specifically designed to capture such lease-backed ABS within the remit of the Regulation AB regime.[5] Importantly, the SEC was also clear in that the change did not represent a shift in its fundamental belief as to what types of securities should constitute an "asset-backed security". Rather, by expanding the definition for the purposes of Regulation AB, the SEC recognized that the inclusion of any significant amount of residual value in a securitization represented a deviation in one of the core principles of the meaning of an asset-backed security, explaining at the time:

> "However, as we explained in the Proposing Release, even though we are recognizing the growth in lease-backed ABS that include securitizations of residual value, such securitizations are subject to additional factors that are not present in securitizations backed solely by financial assets that convert into cash. Residual value is often determined at the inception of a lease contract and represents an estimate of the leased property's resale value at the end of the lease. Assumptions and modelling are necessary to determine the amount of the residual value. In addition, the transaction is not simply dependent on the servicing and amortization of the pool assets, but also on the capability and performance of the party that will be used to convert the physical property into cash and thus realize the residual values.
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> The higher the percentage of cash flows that are to come from residual values, the more important these other factors become and the less the transaction resembles a traditional securitization of financial assets for which our regime for asset-backed securities is designed. Although some commenters did not believe we should have any limits on residual values, we continue to believe, as discussed above, that the core principle that an asset-backed security should be primarily serviced by financial assets that by their terms convert into cash should be retained. At the same time, we believe a defined limited exception to this general principle is appropriate and consistent for access to the alternate regulatory regime for certain lease-backed ABS." (2005 ABS Adopting Release)

Further to this, the SEC sought to mitigate any adverse effects of this deviation from this core principle:

> "As we explained in the Proposing Release, we are addressing concerns with the deviation from the core principle in two principal ways. First, we are adopting disclosures… on how residual values are estimated and derived, statistical information on historical realization rates and disclosure of the manner and process in which residual values will be realized, including disclosure about the entity that will convert the residual values into cash. Second, we are establishing limits on the percentage of the securitized pool balance attributable to residual values in order to be considered an "asset-backed security." We believe these changes will expand eligibility of lease-backed transactions for shelf registration and appropriately permit

[5] *As stated in the 2005 ABS Adopting Release: "[t]he one change we proposed making to the basic definition of "asset-backed security" is to expand the definition to include securitizations backed by leases where part of the cash flows backing the securities is to come from the disposal of the residual asset underlying the lease (e.g., selling an automobile at the end of an automobile lease). In that instance, the asset-backed securities are not backed solely by financial assets that "by their terms convert into cash," because the transaction also involves a physical asset that must be sold in order to obtain cash. As a result, securitizations where a portion of the cash flow to repay the securities is anticipated to come from the residual value of the physical property do not fall within the current definition of "asset-backed security" in Form S-3 and thus are often registered on a non-shelf basis on Form S-1."*

> lease-backed transactions under our new rules while continuing to apply the core principles underlying the definition of "asset- backed security." (2005 ABS Adopting Release)

The SEC has also considered the meaning of an "asset-backed security" in contexts outside of Regulation AB definition and the pre-2005 ABS definition. The SEC also defines "eligible assets"[6] within the meaning of Rule 3a-7 of the Investment Company Act of 1940, as amended (the "40 Act definition"), which is generally considered as 'functionally equivalent' to the pre-2005 ABS definition.[7]

Although Dodd-Frank did not adopt the pre-2005 definition or the '40 Act definition,[8] it is nonetheless analogous to the definition of Exchange Act ABS. In all cases (a) the primary assets collateralizing the applicable securities must be "self-liquidating" (often referred to by the SEC as "convert[ing] into cash within a finite time period"[9]) and (b) these definitions do not expressly include securities backed by non-self-liquidating leases (contrary to the Regulation AB definition).

Notably, the '40 Act definition has not been amended in line with the Regulation AB definition. As such, asset-backed securities that predominantly depend on the residual value of the leased assets for repayment typically fall outside of the '40 Act definition. This further reflects the intention to exclude certain asset-backed securities that demonstrate characteristics that do not accord with the core principles from the definition of Exchange Act ABS. As stated by the American Bar Association in its November 2011 response to the SEC's notice of proposed rulemaking regarding Rule 3a-7:

> "The current definition of "eligible assets" in Rule 3a-7 limits the ability to execute certain lease securitizations. This definition covers only financial assets that "by their terms convert into cash within a finite time period." Virtually all auto leases, and a significant portion of equipment leases, permit the lessee to return the vehicle or leased equipment upon lease termination in lieu of purchasing that property. The residual value of the auto or equipment that is realized upon liquidation of the returned auto or equipment is an important part of the securitization value of the leasing arrangement.
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> This residual value, however, does not currently fall within the definition of "eligible asset," because such residual value is not itself a financial asset that "convert[s] into cash within a finite time period."

Accordingly, we believe that securities which have a material dependence on active management of the underlying physical asset to generate income and make payments (including the re-leasing, sale or other disposition of such assets) fall outside of the scope of Exchange Act ABS, and therefore the CRR Rules do not apply to such securitizations. This aligns with the treatment of most securities backed by leased assets, which were excluded from the scope of the pre-2005 ABS definition and continue to be excluded from the '40 Act definition today.

(b) Legislative History

The legislative history further illustrates the intentional differences between (i) the Exchange Act ABS definition and the '40 Act definition and (ii) the Regulation AB definition. The final House Bill (H.R. 4173) (Dodd Frank) originally proposed using the Regulation AB definition, which would have

[6] *"Eligible assets" means financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.*

[7] *SEC Release No. 33-6964 (Oct. 22, 1992) [57 FR 48970].*

[8] *See discussion of the legislative history below.*

[9] *Id at 6.*

established a “bright line” test of greater (or less) than 50% of residual value,[10] and undoubtedly captured lease-backed ABS within the scope of an "asset-backed security". This was, however, rejected by the Senate in favour of the definition of Exchange Act ABS, which does not include language that would expressly expand its meaning to include lease-backed ABS to the extent dependent on the sale (or other disposition) of the leased asset for repayment. This, taken in conjunction with the then prevailing interpretation of the pre-2005 definition, the Regulation AB definition and the '40 Act definition and the SEC's statements on the characteristics of an asset-backed security in those contexts, leads us to believe that the CRR Rules were drafted to purposefully exclude from the definition of Exchange Act ABS any transaction involving a non-self-liquidating lease-backed ABS.

4 APPLICATION OF DEFINITION TO STRUCTURED MCP TRANSACTION

(a) Are Assets in a Structured MCP Transaction Self-Liquidating Financial Assets?

When considering what constitutes a "financial asset", the SEC offers no interpretation or guidance which would indicate that a container, or another similar physical asset, constitutes a financial asset. On a plain reading of the words, a conclusion can be drawn that a container is not a financial asset. On this basis, it follows that the presence of container leases would have to evidence, in accordance with the requirements of the Exchange Act ABS, that the "assets" consist of self-liquidating financial assets "that allow[s] the holder of the security to receive payments that depend primarily on cash flow from the asset".

Subject to the Finance Lease Proviso (discussed below), we do not believe that this applies to Structured MCP Transactions, for the reasons set out in the following paragraphs.

Although neither Section 15G of the Exchange Act nor the associated CRR Rules define the terms "self-liquidating" and "primarily", the term "self-liquidating" has been (a) used by the SEC to describe an asset that "converts into cash payments within a finite time period"[11] and (b) defined by the courts since 1937:

> "The mechanism is called a self-liquidating loan because when the banks purchase the notes, they also purchase the right to receive interest payments before the notes mature. Thus, the money expended to buy a note will be repaid by the interim interest payments and the final principal payment." United States v. Esogbue, 1996 U.S. App.
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> LEXIS 45265, No. 94-20615 (5th Cir. Feb. 12, 1996).
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> "A self-liquidating project may be defined as one wherein the revenues received are sufficient to pay the bonded debt and interest charges over a period of time." Kelley v. Earle, 325 Pa. 337, 345 (Pa. 1937).

Based on the foregoing, the generally accepted legal meaning of "self-liquidating" refers to an asset that will independently generate income sufficient to pay back its original cost.

To determine whether or not a Structured MCP Transaction falls within the meaning of "self-liquidating", it is necessary to analyse the contracted cash flows from the initial leases and the breakdown of the container portfolio by lease type.

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[10] *We note that many recent Structured MCP Transactions would also fall outside of the scope of the Regulation AB definition for this reason.*

[11] *"[T]he basic definition [of asset backed security] is sufficiently broad to encompass any self-liquidating asset which by its terms converts into cash payments within a finite time period." Id at 6.*

In the marine container leasing market, container leasing companies typically lease their containers under three different lease types: (i) a long-term operating lease under which the lessee is required to return the container to the lessor at the expiry of the lease term, with a term that ranges between three to seven years (a "Long-Term Lease"); (ii) a short-term operating lease, with a term that ranges between 12 months to three years (a "Short-Term Lease"); and (iii) a finance lease under which the lessee is granted a purchase option for less than the market value of the asset and/or is otherwise economically incentivised to acquire title to the container at the expiry of the lease (a "Finance Lease").

Assuming that a lessee under a Finance Lease exercises its purchase option, a Finance Lease will fall within the generally accepted legal meaning of "self-liquidating". Therefore, we believe that a portfolio consisting primarily of containers that are subject to Finance Leases would likely be subject to the CRR Rules (the "Finance Lease Proviso").

However, a typical container portfolio for a Structured MCP Transaction will comprise only a small and insignificant portion of containers subject to Finance Leases and instead will principally comprise Long-Term Leases and Short-Term Leases. The net present value of the rentals under such Long-Term Leases and Short-Term Leases will be significantly lower than the acquisition cost of the corresponding containers. Our view is that Structured MCP Transactions comprising such portfolios would not be subject to the CRR Rules because the majority of the container leases in such a portfolio (i.e. those not subject to a finance lease) cannot be considered to be "self-liquidating". Firstly, the original cost of the containers (and initial leases) cannot be repaid by the cash flows generated solely from the initial container leases. Secondly, neither a container Long-Term Lease nor a container Short Term Lease "convert into cash" because the Issuer expects to retake possession of the container upon the expiry of such lease. As such, the level of active management required for these types of portfolios exemplifies their dependence on additional cash flows that are contingent on successful business activities in the future, which does not accord with the meaning of "self-liquidating".

(b) Does Repayment Depend Primarily on Cash Flow from Self-Liquidating Financial Assets?

As described in greater detail above, in the case of a typical Structured MCP Transaction (and for the purposes of this section, ignoring the Finance Lease Proviso), repayment of the Issuer's debt via the generation of income from the securitized "financial assets" (a defining characteristic of ABS) depends on the active management of such "financial assets" and the ability to generate sufficient operating income as a result of the successful operation of its business.

As noted above, a defining feature of ABS is the ability of the "financial assets" subject to the securitization to generate sufficient cashflow to repay the Issuer's debt. However, in a typical Structured MCP Transaction, the original acquisition cost of the containers (and initial leases) cannot be repaid by the insufficient cash flows from the initial leases. Additionally, such cash flows from the initial leases are significantly less than the amount required to repay the Issuer's securities. The Issuer must also have sufficient financial resources available to pay out-of-pocket expenses incurred in relation to the redelivery, refurbishing and repositioning any container for a new lease or sale as this requires the Lease Manager and/or Servicer, as applicable, to engage in remarketing, maintenance and other container management expertise. Regardless as to whether the container is on- or off-lease, the costs, resources and time involved here are incongruous with the principal condition of Exchange Act ABS in that the repayment of the securities does not rely *primarily* on cash flows generated from a pool of *self-liquidating* financial assets.

Let us suppose that container leases were characterized separately from the value of the physical container as "self-liquidating financial assets" in a typical Structured MCP Transaction. In that case, it would nonetheless be inaccurate to describe repayment of the securities as depending *primarily* on the cash flows from the initial leases. Instead, the ultimate repayment of the securities still depends on the re-leasing and disposal of the physical containers, which requires active management from the Lease Manager or the Servicer.

5 CONCLUSION

Despite the lack of an interpretation of the definition of Exchange Act ABS from the SEC and other relevant federal agencies, the principles discussed by the SEC in the context of the pre-2005 ABS definition, the Regulation AB definition and the '40 Act definition should equally apply to an analysis of the securities in a Structured MCP Transaction. Further, the "assets" in a typical Structured MCP Transaction (subject to the Finance Lease Proviso) should not be considered *self-liquidating* financial assets. For this reason (and those discussed further above), we believe that, if properly interpreted and applied, the definition of Exchange Act ABS would not (subject to the Finance Lease Proviso) include a Structured MCP Transaction and therefore such a Structured MCP Transaction would not be subject to the CRR Rules.

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