Client Alert

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Privacy Concerns and the Proposed Reg AB II Revisions Relating to Asset Level Data

In February 2014, the Securities and Exchange Commission (SEC) once again re-opened the comment period with respect to proposed revisions to Regulation AB relating to the disclosure of asset-level data after receiving many public comments relating to privacy law compliance issues. On the same date, the SEC released a memorandum (the "Memo") outlining an alternative means for disseminating asset-level data in an attempt to address such concerns. Regulation AB governs the offering, disclosure and reporting process for asset-backed securities ("ABS"). In 2010, as a result of the financial crisis and the perceived role that securitization played in it, the SEC released a series of proposed revisions to Regulation AB ("Reg AB II"). In 2011, the SEC re-proposed portions of its Reg AB II proposal to take into account the passage of the Dodd-Frank Act and other developments since the date of the initial proposal. This most recent comment period closed on April 28 with many commenters feeling that the memorandum falls short of resolving the myriad of privacy concerns expressed by industry participants and consumer protection advocates.

In an effort to provide greater transparency to ABS investors, and subsequently to comply with Section 942 of the Dodd-Frank Act that requires asset-level disclosure "necessary for investors to independently perform due diligence," the SEC Reg AB II proposal and re-proposal contain a schedule of asset-level data points that issuers would be required to disclose to both investors and potential investors. Although the few data examples set forth in the Dodd-Frank Act relate to originator data, the Reg AB II proposals require issuers to provide an extensive amount of borrower data via the SEC's EDGAR website. Despite an outpouring of comments relating to such data disclosure after the Reg AB II proposal was released, the re-proposal did not revise the data requirements. Rather, it included a number of questions relating to the privacy concerns raised by industry groups, market participants, and consumer protection groups. Similarly, the Memo does not revise the borrower information required or address concerns raised about privacy law compliance; instead it offers an alternative approach for disseminating the most sensitive borrower information: a website established and maintained by the issuer. The Memo sets forth a two-step approach for providing information to investors and potential investors. Issuers would be required to file non-sensitive information with the SEC via EDGAR and to make available all required information on a secure website maintained by the issuer (with a copy of such information provided to the SEC on a confidential basis).

The Memo highlights the SEC's difficulty trying to balance investor demands for more asset information with concerns over privacy law compliance. Throughout the Memo, the SEC cites numerous comments and concerns from both sides of the debate and notes that little feedback was received that offered alternative solutions for providing such data. Ultimately, the SEC concludes in the Memo that the issuers are in the best position to determine compliance requirements and disseminate sensitive data accordingly. However, the Memo does not provide a proposed final list of data points that will be required for each asset class, any guidance to issuers on how to comply with the myriad of existing privacy laws, any proposed safe harbors for issuers who establish data websites, or any interpretative guidance with respect to the applicability of certain federal privacy laws or materiality under federal securities laws. It also does not address consumer advocate concerns over borrower

identity theft resulting from dissemination of such sensitive data. As a result, the comment letters submitted to the SEC in response to the Memo suggest that much more discussion is needed before a workable final rule can be issued and failure to adequately address these concerns will hinder the return of the securitization markets as issuers decide to either turn to alternative funding sources or spend additional time and money examining potential legal and regulatory costs and liabilities associated with meeting their obligations under the new disclosure regime.

Based on the general nature of the Memo and the comments submitted in response to it, the following points will need further attention prior to implementing a final rule:

Materiality: Does the SEC view all of the asset-level data that has been proposed to be provided under Reg AB II to be "material" information for investors, or necessary for purposes of section 942 of the Dodd-Frank Act?

- If no, are there certain data points that the SEC is willing to eliminate, or will the SEC permit issuers to provide the most sensitive data in an aggregated format or by some other means to alleviate privacy law compliance concerns?

- If yes, will an issuer have securities law liability for not disclosing such information to an investor or potential investor that refuses to agree to the terms of access posted on the website?

Although the SEC's approach seems to suggest that investors' need for this data outweighs the costs and compliance issues that issuers will face when providing such data, the Memo does not address the materiality of the information. Nor does the Memo state that the asset-level information that the SEC is proposing be disclosed is necessary to meet the requirements of section 942 of the Dodd-Frank Act.

Privacy Laws – Applicability and Compliance: Will the SEC collaborate with other federal agencies to provide issuers with interpretative guidance with respect to the applicability of, and compliance with, existing federal privacy laws and the potential liability associated with non-compliance?

- If the asset-level data is "personally identifiable information" ("PII") under the Fair Credit Reporting Act, Gramm-Leach-Bliley Act, the FTC Act, and state privacy and information security laws, will issuers be expected to comply with consumer notices or opt-out requirements? Will the issuer have to comply with all requirements under such laws?

- By disclosing information, issuers may be deemed "consumer reporting agencies" ("CRAs") under the Fair Credit Reporting Act. If issuers are deemed CRAs, how will issuers comply with all CRA requirements, such as the requirements to allow consumers to inspect and dispute information that is on file with the issuer? And, how will investors comply with the duties of "users" of consumer reports?

- For issuers or servicers that may be deemed "debt collectors" under the Fair Debt Collections Practices Act, will the issuer's disclosure of such information be in violation of the prohibition on communicating with unauthorized third parties "in connection with the collection of any debt"?

- Will issuers be liable under existing privacy laws for dissemination of information if done in compliance with Reg AB II? Will issuers be liable for improper use or dissemination by investors or potential investors who access the issuer website?

- Even if the SEC was inclined to issue interpretations or make rules for issuers and investors under the Fair Credit Reporting Act and other relevant privacy laws, would it have the authority to do so?

Although large financial institutions may have experience with federal privacy laws and related compliance, many issuers will find this new requirement greatly increases the costs and risks of structuring an ABS deal. Legal and regulatory research and compliance costs up-front and on an ongoing basis could be cost-prohibitive, especially with the uncertain additional legal liabilities and reputational risk if the issuer fails to consider or comply with each applicable law.

Privacy Laws – Non-U.S. Issuers: Has the SEC compared the myriad of U.S. privacy laws against international privacy laws, such as the E.U. Data Protective Directive?

- If no, will the SEC conduct a review of such privacy laws? And how will the SEC address conflicts with such laws?

- Will non-U.S. issuers who are unable to comply with Reg AB II disclosure requirements due to home jurisdiction laws be closed out of the U.S. market? Or will non-U.S. issuers have different disclosure requirements? Is the SEC concerned that such differences could create an un-level playing field for issuers?

- If a U.S. issuer issues securities in both the U.S. and in Europe, the U.S. issuer will have to provide two different setoff disclosures. A non-U.S. issuer may have to provide U.S. investors with both Reg AB II required disclosures and those required in their home jurisdiction. Is the SEC concerned that investors in different jurisdictions may receive different data?

In a global financial market, issuers need certainty when structuring deals in other jurisdictions. If there are differences between privacy law requirements or prohibitions across jurisdictions, which jurisdiction will govern?

Issuer Safe Harbors: Will the SEC include any compliance safe harbors in Reg AB II?

- Website access restrictions: If an issuer maintains a website but certain investors or potential investors do not gain access to the website, will the issuer be protected from federal securities law liability?

- Privacy law compliance: If the issuer has certain policies, controls and restrictions in place to comply with existing privacy laws, and as a result determines that certain Reg AB II disclosures cannot be made, will the issuer have liability for non-compliance with Reg AB II?

Ultimately, the Reg AB II privacy debate from the SEC's standpoint is a debate over disclosure versus privacy. While investors will always want the most complete information available when analyzing investment decisions, a balance must be struck that adequately addresses the concerns of all involved. In light of the concerns above, the SEC needs to determine if the incremental value of requiring issuers to provide all data at the borrower level is worth the additional issuer costs and risk exposures (legal, regulatory, reputational and otherwise) and the additional borrower risks relating to privacy rights and identity theft. Although not discussed in detail in the Reg AB II proposals, the Memo, or even in the comment letters, the SEC and industry groups may want to consider if other alternative solutions would resolve the privacy concerns while still providing needed disclosure. Such alternatives that have been mentioned include further de-identification of sensitive data, aggregation of sensitive data, creation of a centralized depository where independent, licensed and regulated analysts could run scenarios for investors (rather than provide them with the data) or where investors could run such scenarios themselves, or limit data distribution to investors based on risk of investment and require those investors receiving the most sensitive data to first sign a non-disclosure agreement. Although none of these alternatives may address the concerns of all parties involved, one thing is certain: failure to address such risks puts millions of borrowers at potential risk for identity theft and violations of privacy, and will further hinder the return of a robust securitization market in the U.S.

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