

Regulation AB II

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Regulation AB II

- On August 27, 2014, the SEC adopted changes commonly referred to as Reg AB II
- This action involves changes to Regulation AB, new registration forms, amended reporting forms and changes related to various offering related rules
- We will discuss the history of Regulation AB and then discuss the changes adopted by the SEC, organized as follows:
 - Overview
 - The offering process and periodic reporting
 - Representations and warranties
 - Asset-level disclosure
 - CEO certifications
 - Transition and compliance
 - Impact on the market

History of Regulation AB

Regulation AB – Original Rule

- Originally adopted in December 2004
- Governs disclosure and reporting requirements for SEC-registered securitization transactions
- Proposed and adopted on the view that the securitization market had become so significant that special regulatory attention was warranted
- Issuance of both non-mortgage ABS and private-label RMBS has declined significantly since 2005, the first year Regulation AB was in effect
 - U.S. non-mortgage ABS issuance declined from \$289 billion in 2005 to \$188 billion in 2013*
 - U.S. non-agency RMBS issuance declined from \$726 billion in 2005 to \$16.8 billion in 2013*

* Source: SIFMA

Regulation AB II – History

- In April 2010, the SEC proposed substantial revisions in the wake of the financial crisis, attempting to provide greater investor protection and restore investor confidence
- The SEC re-proposed its revisions in July 2011 following enactment of Dodd-Frank Act provisions concerning asset-level disclosure, broker and originator compensation and risk retention
- Partial re-opening of comment period – February 2014
 - SEC re-opened comment period on certain aspects of asset-level disclosure to address privacy concerns
 - SEC staff memo proposed issuers be responsible for assuring borrower privacy, including possible use of secure websites
- Final rules adopted by SEC on August 27, 2014
- Note that revisions go beyond Reg AB itself—also include amendments to related 1933 and 1934 Act rules and new forms

Overview of Changes

Regulation AB II – Overview

- The most significant changes adopted by the SEC are:
 - a requirement to file a complete preliminary prospectus at least three business days prior to sales of any securities (this is referred to as the “speed bump” provision)
 - The preliminary prospectus must contain all of the required information other than pricing related information
 - Any material change requires the filing of a prospectus supplement at least 48 hours before the first sale of securities
 - a requirement to appoint an “asset representations reviewer” to review assets for compliance with representations and warranties and issue a report to the trustee
 - report periodically demands by the trustee to repurchase assets for breach of representations and warranties and any such assets not repurchased
 - dispute resolution – the transaction documents must contain provisions for repurchase claims unsatisfied after 180 days to be referred to mediation or arbitration
 - investor communications – the transaction documents must include a provision requiring the party responsible for distribution date Form 10-D filings to include a request from any investor to communicate with any other investor

Regulation AB II – Overview (cont'd)

- The most significant changes (cont.):
 - a requirement to provide in machine readable form asset-level information for securitizations involving residential mortgage loans, commercial mortgage loans, auto loans and leases, debt securities and resecuritizations of these assets
 - for each offering, a certification by the CEO
 - that the securitization as described in the prospectus is designed to produce cash flows from the assets in amounts sufficient to service expected payments on the securities, and
 - that the prospectus does not contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they are made, not misleading
 - fairly present in all material respects ... the risk of ownership of the ABS ...
 - Filing of final transaction agreements by the date of the filing of the final prospectus
 - new Forms SF-1 and SF-3 for the registration of asset-backed securities
 - new registrant and transaction eligibility requirements

Regulation AB II – Overview (cont'd)

- The following significant items from the 2010 proposal were not adopted by the SEC:
 - a requirement to file a computer program for the cash flow waterfall – in the 2011 re-proposal, the Commission stated that it would address this requirement separately
 - a requirement for the sponsor or an affiliate to retain an interest in the assets securitized – this is the subject of a separate multi-agency rulemaking as required by the Dodd-Frank Act
 - asset-level information for other assets, including student loans and equipment leases and loans.
 - the extension of the disclosure requirements of Forms SF-1 to private placements under Rule 506 or Rule 144A
 - filing of transaction agreements in substantially final form with the preliminary prospectus

Offering Process

ABS Offering Process – General

- Regulation AB II creates a new offering process for ABS
 - new Rule 424(h) preliminary prospectus for ABS and related delivery and filing requirements
 - new registration forms specifically for ABS
 - new eligibility requirements for shelf registration

ABS Offering – Rule 424(h) Preliminary Prospectus

- A complete preliminary prospectus must be filed at least 3 business days prior to first sale of ABS
 - If preliminary prospectus is used more than 3 business days before first sale of ABS, it must be filed on the earlier of (i) 3 business days before first sale, and (ii) the second business day after first use
 - This is a change from the original proposal, which would have required filing 5 business days prior to first sale
 - Prospectus must be a single document, not a base prospectus with prospectus supplement
- Preliminary prospectus must include all information required in final prospectus, with limited exceptions for pricing related information such as offering price, underwriting discounts and commissions, and final underwriting syndicate
- If any material change from information in the preliminary prospectus after filing, then a prospectus supplement must be filed at least 48 hours before date and time of first sale

SEC Registration – New ABS Forms

- Historically (and currently) ABS offerings have been registered on the same forms used for most corporate debt and equity offerings – Form S-1 (for stand-alone offerings) and Form S-3 (for shelf offerings)
- Regulation AB II adopts new forms specifically for ABS – Form SF-1 (for stand-alone offerings) and Form SF-3 (for shelf offerings)
- Issuer’s ability to use Form SF-3 for shelf offerings is subject to new transaction and registrant eligibility requirements
- Shelf prospectuses and preliminary prospectus can no longer use “base and supplement” format – prospectuses must be single, integrated documents
- Form SF-3 shelf registration statement must contain a “form of” prospectus and may cover only one asset class

SEC Registration – Shelf Eligibility Requirements

- New shelf eligibility requirements are intended to replace current requirement that securities be rated investment grade by at least one NRSRO
 - This implements a Dodd-Frank Act requirement that SEC remove references to NRSRO ratings from its rules
- Registrant eligibility requirements
 - Depositor and affiliates must have timely filed all 1934 Act periodic reports in 12 months prior to shelf filing
 - Depositor and affiliates must have timely filed all transaction agreements containing provisions for asset representations reviewer, dispute resolution and investor communications
 - A failure to meet the transaction agreement filing obligations results means ineligible to use an effective Form SF-3 until 90 days after all filings are up to date
 - Depositor and affiliates must have timely filed all periodic reports for ABS of the same asset class

SEC Registration – Shelf Eligibility Requirements (cont'd)

- Transaction Eligibility Requirements:
 - The ABS to be registered must satisfy the definition of “asset-backed security” in Reg AB and be offered for cash
 - CEO certification
 - Appointment of asset representations reviewer
 - Dispute resolution provisions
 - Investor communications provisions
 - Delinquent assets not 20% or more of the pool
 - For non-motor vehicle leases, residual value not 20% or more of the pool

Annual Evaluation of Shelf Eligibility

- Under current SEC rules, a shelf issuer needs to satisfy shelf eligibility requirements only at the time the registration statement is filed
- Under Regulation AB II, an ABS shelf issuer must evaluate annually, as of the 90th day after the end of the depositor's fiscal year:
 - Whether all 1934 Act reports required to be filed by the depositor (or any "affiliated" issuer backed by same asset class) were timely filed
 - If not, a new registration statement may not be filed until one year after the depositor or affiliated issuer becomes current
 - Whether the other filing requirements described above for ABS shelf eligibility (e.g., CEO certification, asset review, dispute resolution, investor communications) were satisfied
 - If not, failure will be cured 90 days after depositor files the required documents

SEC Registration – Other Changes

- 48-hour Rule
 - Current generally applicable SEC rules require brokers and dealers to deliver a preliminary prospectus to investors at least 48 hours prior to sending confirmation of sale, if the issuer is not subject to 1934 Act reporting requirements; there is an exception for ABS shelf offerings
 - Regulation AB II eliminates the exception for ABS shelf offerings, and makes 48-hour rule applicable to all ABS regardless of 1934 Act reporting status
- Definition of “Asset-Backed Security”
 - Current definition permits “pre-funding” – setting aside up to 50% of offering proceeds to purchase additional pool assets for a year following offering
 - Regulation AB II reduces the 50% pre-funding limit to 25%
 - SEC did not adopt proposals that would have further limited master trusts and revolving assets from current definition
- SEC Filing Fees
 - Final rules permit “pay-as-you-go” payment of SEC registration fees

SEC Registration – Other Changes (cont'd)

- Filing of Transaction Documents
 - Original proposal required transaction documents to be filed with filing of preliminary prospectus
 - Final rule requires filing of transaction documents not later than the date of the final prospectus
 - SEC says that original proposal to require filing of transaction documents with preliminary prospectus “remains outstanding”

1934 Act Reporting

- Form 10-D
 - Form 10-D is an existing report required to be filed in connection with distribution dates for ABS
 - Form 10-D will now include requests for investor communications, information regarding the asset representation reviewer's reviews, and information regarding any change in the asset representations reviewer
 - Form 10-D must include any material change in a sponsor's interest in an ABS transaction
 - Form 10-D will also include updated asset-level information (for applicable asset classes), which will be incorporated by reference to new Form ABS-EE filed on Edgar

1934 Act Reporting

- Form 10-K
 - Regulation AB II makes minor revisions to Form 10-K for ABS issuers, including increased disclosures regarding non-compliance with servicing criteria
- Form 8-K
 - It is expected that transaction documents for most offerings will be filed on Form 8-K and incorporated by reference into the prospectus
 - New Item 6.06 added to Form 8-K to permit filing and incorporation by reference into prospectus of static pool information

Representations and Warranties

Asset Representations Reviewer

- The transaction documents must designate an “asset representations reviewer” to review underlying assets for compliance with representations and warranties upon the occurrence of certain trigger events
 - This is essentially the same concept as the “credit risk manager” in the original proposal, but SEC has changed the term to more accurately reflect this party’s function
- The asset representations reviewer:
 - Must be designated at outset of the transaction, with its identity and details regarding its organization, experience, compensation and indemnification disclosed in the prospectus
 - May not be affiliated with the sponsor, depositor, servicer, trustee or and third-party pre-closing due diligence contractor

Asset Representations Reviewer (cont'd)

- Asset review triggers:
 - A threshold of delinquent pool assets set forth in transaction documents has been reached
 - Issuer may designate delinquency percentage and definition, but must explain in prospectus why reasonable and compare to delinquencies for prior pools
 - Investors vote to initiate the asset review
 - Issuer can establish minimum investor vote requirements in transaction documents, but (1) the minimum investor demand to initiate a vote cannot exceed 5% of total pool interests, and (2) the minimum percentage of investors needed to vote in favor of an asset review cannot exceed a simple majority of investors
- Scope of review
 - If triggered, asset review must include, at a minimum, all pool assets that are 60 or more days delinquent
 - Results to be reported to trustee and summarized in Form 10-D distribution date report

Dispute Resolution

- This requirement responds to widespread investor concerns regarding perceived difficulties in enforcing representations and warranties against issuers or originators
- Transaction documents must, under Regulation AB II, include specific dispute resolution procedures for disputed repurchase requests
- If a repurchase request is not honored within 180 days of request, the requesting party may demand either arbitration or mediation to resolve the request – repurchase obligor must agree to the method chosen by requesting party
- In an arbitration, arbitrator will determine party responsible for expenses of arbitration
- In a mediation, the parties must agree on allocation of expenses as part of the mediation
- Many post-crisis RMBS deals include some form of alternative dispute resolution, so this requirement has already been integrated into market to some extent

Investor Communications

- This requirement responds to perceived investor difficulties in identifying and communicating with other investors in the same transaction to coordinate on the enforcement of investor rights under transaction documents
- Transaction documents must require the party responsible for filing Form 10-D distribution date reports (generally the depositor or the servicer) to include in the Form 10-D any request from an investor to communicate with other investors
 - Investor request must specify a method for other investors to make contact
 - Beneficial owners may have to submit evidence of ownership

Asset-level Disclosure and other Disclosure

Asset-Level Disclosure – General

- Regulation AB II's asset-level disclosure requirement is probably the most far-reaching and controversial part of the rule
 - Included in original 2010 proposal
 - Dodd-Frank further mandated asset-level disclosure
- Final rule requires asset-level disclosure – both at time of offering and in ongoing reporting – for RMBS, CMBS, auto loans, auto leases, ABS backed by debt securities, and resecuritizations
 - SEC left open possibility of expanding asset-level disclosure to other asset classes
- Asset-level data must be provided in machine-readable XML language
- Specific data requirements are included on new Schedule AL
- Data to be filed on new Form ABS-EE and incorporated by reference into Form SF-1, SF-3 or Form 10-D, as applicable

Asset-Level Disclosure – General (cont'd)

- All fields must be disclosed – no issuer discretion for materiality
- Issuer may file separate “Asset Related Document” for any additional or clarifying information, including any additional, non-required data fields

Asset-Level Disclosure – RMBS

- RMBS has by far the most extensive asset-level disclosure requirements of any asset class
- For RMBS, there are 270 prescribed data points for each loan to be disclosed in the prospectus and in ongoing reporting
- Privacy concerns/Re-identification risk
 - 2-digit zip code (instead of MSA)
 - Some proposed fields removed, including income, sales price, origination date and borrower bankruptcy and foreclosure history
 - Exact credit score, LTV and DTI still required

Asset-Level Disclosure – CMBS

- 152 data points for both prospectus and ongoing reporting
- Based on CREFC Investor Reporting Package
 - Some variations from CREFC
 - SEC data points will not necessarily change with CREFC changes
 - Overall, current CMBS market is probably close to Regulation AB II requirements
- Examples of CMBS-specific data fields are property revenues and expenses, NOI and net cash flow, the identities of 3 largest tenants and lease expirations, and information regarding most recent appraisals or valuations
- Unlike RMBS, required fields include property address and 5-digit zip code

Asset-Level Disclosure – Auto ABS

- 72 data points for auto loans
- 66 data points for auto leases
- The auto-related asset-level disclosures may impose the largest new burden on issuers, as asset-level disclosure has not generally been required in the auto market even post-crisis
- Required disclosures include loan information, vehicle information (make, model, year and value), geographic information (by state), borrower information (credit score, income and employment verification level, payment-to-income ratio) and loan performance data
- Note that borrower income is not required, but credit score is required
- Fields for loans and leases are substantially the same

Asset-Level Disclosure – Other Asset Types

- Debt Securities
 - ABS backed by debt securities (a/k/a bond repackaging or “repacks”) require data regarding the underlying debt securities, including title of underlying security, origination date, payment currency, whether callable, payment frequency and interest rate
- Resecuritizations
 - ABS backed by other ABS, or resecuritizations, require the same data as is required for repacks
 - Moreover, if underlying ABS is of a type that requires asset-level disclosure, all asset-level disclosures are required for underlying assets
 - If underlying ABS were issued by a third party, resecuritization issuer may reference underlying issuer’s public filings
 - Asset-level data for underlying ABS not required if such ABS was issued prior to Regulation AB II compliance date for such ABS (i.e., 2 years after effective date)

Asset-Level Disclosure – Privacy Concerns

- From the initial 2010 proposal, borrower privacy has been a substantial concern of commenters
 - Issuers are concerned with liability to borrowers, customer relationships, and reputational damage
 - Privacy advocates are directly concerned with the privacy of borrowers
- From the outset, the SEC avoided requiring obvious privacy-related fields, like borrower name and address, but concerns remained that borrower identities could still be discovered from required fields
- The concern has been greatest with respect to RMBS, because of concern that identity thieves and marketers could correlate data to public property records to identify borrowers and their financial information – “re-identification”

Asset-Level Disclosure – Privacy Concerns (cont'd)

- In 2014 Re-Opening, the SEC floated the idea of making issuers responsible for privacy and allowing the use of web-protected websites to disseminate sensitive information
 - Re-Opening raised many new liability concerns among issuers, as well as concerns about equal access to information by investors and prospective investors
- Final rule rejected the Re-Opening approach, and reverted to original scheme of filing all asset-level data on Edgar, while carving back some fields of concern – most notably, requiring 2-digit zip code for RMBS rather than MSA or 5-digit zip code
- SEC conducted a study on the risk of re-identification in connection with certain data fields

Asset-Level Disclosure – Privacy Concerns (cont'd)

- With zip code for example, the study concluded that two-digit zip code disclosure for RMBS reduced the risk of re-identification to 20%
- So the SEC did not eliminate all risk, but balanced the risk of re-identification against the need for disclosure to investors
- Importantly, the SEC did not conclude that 5-digit zip code was not material; rather it concluded that it posed an unacceptable privacy risk
- The SEC obtained a letter from the CFPB that provides that filing the required information with the SEC will not constitute a violation of FCRA if the SEC determines that the information is necessary for investors to perform due diligence.
- Privacy concerns have not been entirely eliminated, and time will tell whether any significant privacy breaches occur

Other New Disclosure Requirements

- Originator disclosure
 - Under current rule, the prospectus is not required to identify any originator that originated less than 10% of pool assets
 - Under Regulation AB II, if amount of assets originated by parties other than the sponsor and its affiliates is 10% or more of the pool, prospectus must also identify originators originating less than 10% of pool assets
- Sponsor and originator repurchase capacity
 - Regulation AB II requires disclosure of financial condition of the sponsor or any 20% originator responsible for repurchasing or substituting assets for breach of representations and warranties, if there is a material risk that the effect on such party's ability to comply with repurchase/substitution provisions resulting from its financial condition could have a material impact on the performance of the pool assets or the ABS

Other New Disclosure Requirements (cont'd)

- Retained interests
 - Regulation AB II requires disclosure in the prospectus of the nature and amount of risk retained by sponsor, servicer, 20% originator or any affiliate of the foregoing
 - Separate disclosure required of nature and amount of risk retained to comply with law (e.g., the Dodd-Frank risk retention requirements when adopted)
 - Regulation AB II also requires disclosure of any hedge (specific security or portfolio) entered into by sponsor, servicer, 20% originator (or affiliate, if known) materially related to the credit risk of the ABS to offset the risk of the retained position
- Static pool data
 - Regulation AB II includes a number of changes to current static pool disclosure requirements to increase the consistency of disclosures, including the following:
 - A description of the static pool information presented, the methodology used in the calculations and any terms of abbreviations used, and a description of how the static pool assets differ from the assets included in the pool underlying the offered ABS

Other New Disclosure Requirements (cont'd)

- If applicable, an explanation of why an issuer has not provided static pool information and has provided alternative disclosure
- For amortizing pools, presentation of delinquencies and losses in accordance with Item 1100(b) of Regulation AB, requiring such information to be presented in 30-31 day increments through no less than 120 days
- Also for amortizing pools, a graphical presentation of delinquencies, losses and prepayments
- Static pool information may now be filed as an exhibit under new Item 6.06 of Form 8-K and incorporated by reference into the prospectus
- **Prospectus Summary**
 - Must be tailored to particular asset pool backing the ABS
- **Modification Provisions**
 - Prospectus must describe the ability of the servicer of the transaction agreements to modify loan terms, including how modifications will affect cash flows

CEO Certifications

CEO Certification

- In connection with each shelf offering, the depositor must file a certification by the depositor's CEO that:
 - The CEO has reviewed the prospectus and is familiar with, in all material respects, the characteristics of the securitized assets, the structure of the securitization, and all material transaction agreements as described in the prospectus
 - Based on the CEO's knowledge, the prospectus does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading
 - Based on the CEO's knowledge, the prospectus and other information included in the registration statement fairly present in all material respects the characteristics of the securitized assets and the risks of ownership of the offered ABS, including risks relating to the securitized assets that would affect the cash flows available to service payments or distributions on the ABS in accordance with their terms
 - Based on the CEO's knowledge, taking into account all material aspects of the characteristics of the securitized assets, the structure of the securitization, and the risks described in the prospectus, there is a reasonable basis to conclude that the securitization is structured (but not guaranteed) to produce expected cash flows at times and in amounts to service scheduled payments of interest and the ultimate repayment of principal (or other scheduled or required distributions, however denominated) in accordance with their terms as described in the prospectus
 - The foregoing certifications are subject to any and all defenses available to the CEO under the federal securities laws, including defenses available to an executive officer that signed the related registration statement

CEO Certification (cont'd)

- The SEC “moderated” a number of the above paragraphs from the initially proposed language by adding materiality qualifiers and making other adjustments in response to comments
- The final paragraph was added in the final rule to address concerns regarding personal liability of the CEO providing the certification
 - The SEC conceded that the new paragraph does not entirely eliminate the risk of personal liability

Transition and Compliance Dates

Regulation AB II – Compliance Dates

- Regulation AB as amended is effective 60 days after publication in the Federal Register, which was September 24 (November 23, 2014)
- Offerings of RMBS, CMBS, Auto ABS, ABS backed by debt securities and resecuritizations must comply with asset-level disclosure requirements not later than two years after the effective date (November 23, 2016)
- Any offering made more than one year after the effective date and any Form 10-D or 10-K filed after one year after the effective date (November 23, 2015) must comply with all requirements except asset-level disclosure

Impact on Market

Impact of New Rules on ABS Market

- Impact on Rule 144A market
 - Will issuers migrate to 144A market to avoid asset-level disclosures? Will investors accept this?
 - Will 144A market incorporate Regulation AB II standards? If so, to what extent?
- How will increased disclosures impact investors? Will asset managers have an increased responsibility to analyze continuing reporting? Will “disclosure overload” deter investors?
- Will investors and issuers make the investment in technology and people?
 - In particular, will the investment be made for RMBS when the market is essentially non-existent?
 - How will this impact restarting the private RMBS market?

Impact of New Rules on ABS Market

- What will be the impact of continuing uncertainty regarding “outstanding” proposals, such as waterfall computer program, asset-level disclosures for other asset classes, and possible extension of Regulation AB II disclosure requirements to Rule 144A and Regulation D transactions?
- In a 144A transaction, what if investors request 5-digit zip code, sale date and income, claiming such data are material to their investment decision?
- Will investors buy in the public market without the more detailed asset-level data?
- Will auto issuers continue to issue in public deals and disclose asset-level data?

Summary

Summary

- The offering process and disclosure requirements
 - New forms and new timing
- Representations and warranties
 - Asset review, dispute resolution, investor communication
- Asset-level disclosure
 - 270 data fields for RMBS
 - Asset-level data for auto securitizations
- CEO certifications
 - 10b-5 type certification and adequate cash flows
- Transition and compliance
 - 60 days, one year and two years
- Impact on the market
 - Is the asset-level disclosure going to work?

Thank You!