On August 27, 2014, the Securities and Exchange Commission (SEC) adopted long-awaited rules that impose new disclosure and reporting requirements, and modify the registration and offering process, for public offerings of asset-backed securities (ABS) by non-GSE issuers (so-called “private label” issuers)[i]. Among other things, these new rules (the “Final Rules”) require enhanced loan-level disclosure for ABS backed by residential mortgages, commercial mortgages and auto loans, call for additional reporting by ABS issuers, and revise the eligibility criteria for “shelf offerings” of ABS. The Final Rules represent the initial rollout of rules from a rulemaking process that began over four years ago.

While the Final Rules and accompanying SEC release are quite lengthy, they are perhaps equally notable for the items that they do not cover. Significantly, the SEC did not adopt its original proposal to apply the asset-level disclosure requirements of the Final Rules to Rule 144A offerings nor did it require issuers to file with it a “waterfall computer program” of the cashflow provisions of the transaction agreements governing the ABS. It is important to note, however, that the SEC explicitly noted that these proposals remain outstanding. Also, the Final Rules provide for a staggered implementation schedule. Generally, issuers will be required to comply with the new rules, forms and disclosure requirements (other than the asset-level disclosure requirements) no later than one year after publication of the Final Rules in the Federal Register, while compliance with the asset-level disclosure requirements will be required no later than two years after the date of such publication.

BACKGROUND

Regulation AB, adopted by the SEC in 2004, is a comprehensive regime regulating registration, disclosure, reporting and communications with respect to public offerings of ABS. Following the collapse of the ABS markets in 2008 and the ensuing financial crisis, the SEC proposed various amendments to Regulation AB, and additional rules relating to ABS, in April 2010. After passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, certain rule proposals were revised and re-proposed in July 2011 and again re-opened for comment in February 2014.[ii]

Public offerings of private label ABS are most frequently conducted via “shelf” registration statements, which allow issuers to access the capital markets more quickly than standalone registration statements. In a shelf registration, the issuer files a single registration statement for multiple, undefined future offerings. Once the shelf registration statement is declared effective by the SEC, the issuer may then make multiple offerings (or “takedowns”) of securities from the shelf from time to time thereafter without further SEC staff review or delay. In connection with each takedown, the issuer is required to file a prospectus supplement that describes the material terms of the securities then being offered.
THE FINAL RULES

The major changes implemented by the Final Rules include the following: (i) ABS of certain asset classes will be required to provide initial and ongoing asset-level disclosure and reporting in standardized, tagged data (XML) format via public filing on EDGAR [iii], (ii) ABS issuers that utilize shelf offerings will be required to provide transaction-specific information to investors via preliminary prospectus at least three business days prior the first sale of securities in the offering, (iii) an ABS issuer’s eligibility to use the shelf registration process will be dependent not on the ratings of the ABS to be issued but rather on satisfying specific transactional eligibility criteria, (iv) the prospectus disclosure requirements for ABS have been broadened to include additional information about transaction parties and agreements, and (v) certain amendments have been made to standardize certain static pool disclosure, specify disclosure on a aggregate basis of non-conforming assets and require explanatory disclosure regarding instances of noncompliance with Regulation AB servicing criteria. In adopting the asset-level disclosure requirements in particular, the SEC noted that it had taken into account, as much as possible, “pre-established industry codes, titles, and definitions” so as to preserve the comparability of offerings under the Final Rules with offerings under the pre-existing regulatory framework.

ASSET-LEVEL INFORMATION TO BE PROVIDED IN STANDARDIZED XML FORMAT

In adopting the Final Rules, the SEC emphasized the importance of providing investors and market participants with sufficient information to assess the credit quality of the assets underlying ABS at the time of the offering, as well as on an ongoing basis. To that end, the Final Rules require initial and ongoing disclosure and reporting of certain asset-level “data points” in a standardized format.[iv] This requirement will apply to public ABS backed by residential mortgages, commercial mortgages, auto loans, auto leases, and resecuritizations of such ABS or of debt securities[v], but not to ABS backed by other types of assets or ABS offered to qualified institutional buyers pursuant to Rule 144A. For ABS backed by residential mortgage loans and auto loans and leases, the SEC modified or eliminated certain of the data points that would otherwise be applicable in order to address the risk that the required data point disclosures could allow parties to “re-indentify” obligors, and reduce associated privacy concerns. Asset-level disclosures are required to be made according to standardized data definitions and in a machine-readable format (XML), so that the information can be downloaded directly into users’ spreadsheets and databases for analysis and modeling. The required data points include (i) basic data about the payment stream of the asset, such as the contractual terms, scheduled payment amounts, interest rate calculations and whether the payment terms change over time, (ii) data about the collateral supporting the asset, such as geographic location of the property, valuation of the property and loan-to-value ratio, (iii) performance data for the asset over time, such as delinquency, (iv) data about any loss mitigation efforts by the servicer and any losses that may pass through to investors, and (v) data about the extent to which income and employment status have been verified, mortgage insurance coverage and lien position. All of the required data points must be provided in the preliminary and final prospectuses for the ABS being offered, and must be updated in each Form 10-D that the ABS issuer is required to file with respect to the transaction (which currently is within 15 days after each required distribution date on the ABS).

PRELIMINARY PROSPECTUS TO BE DELIVERED AT LEAST THREE BUSINESS DAYS PRIOR TO FIRST SALE

The Final Rules require issuers conducting a takedown offering from an ABS shelf registration statement to file a preliminary prospectus containing transaction specific information at least three business days prior to first sale of any security issued in the offering. The SEC noted that while it has not generally built waiting periods into its shelf offering
process, and instead has believed that investors can take the time they believe is adequate to analyze an offering, investors have indicated that this not generally possible in the ABS market, particularly in a heated market. Therefore, the intent of this requirement is to provide investors with additional time to evaluate the assets underlying the offering, as well as the transaction structure and accompanying legal rights, before making a decision to invest. Any material change to the preliminary prospectus (other than certain pricing information) would need to be reflected in a prospectus supplement filed at least 48 hours prior to first sale.

SHELF OFFERING ELIGIBILITY NO LONGER DEPENDENT ON SECURITY RATINGS

Before adoption of the Final Rules, one of the eligibility criteria to use the shelf registration process for ABS was that the securities to be issued had to be rated investment-grade (i.e. rated in one of the four highest rating categories) by at least one nationally recognized statistical rating organization. In light of the Dodd-Frank Act’s directive for the SEC to review and eliminate the use of credit ratings as an assessment of creditworthiness in its rules, the Final Rules remove this investment grade ratings requirement and establish the following four new shelf eligibility criteria that are not ratings dependent: (i) the chief executive officer of the depositor (i.e. sponsor of the securitization) must file with the SEC at the time of each takedown a certification as to the disclosure in the prospectus and the structure of the securitization, (ii) the underlying transaction agreements must provide for a review of the assets for compliance with representations and warranties following a specified level of defaults and security holder action[vi], (iii) the underlying agreements must include a dispute resolution mechanism for asset repurchase requests and (iv) the underlying agreements must require ongoing distribution reports (on Form 10-D) to include any requests by an investor to communicate with other investors. According to the SEC, these new eligibility criteria will reduce investors reliance on credit ratings, eliminate the appearance of an imprimatur that such ratings references may create and help ensure that more diligence and care is exercised by the issuer to ensure that ABS are appropriate for issuance on an expedited basis via a shelf offering. To address commenters’ concerns about the potential liability of a certifying executive, the Final Rules do clarify that the certifier has any and all defenses available under the securities laws. In light of these new eligibility requirements and other changes made by the Final Rules, the SEC also created new Forms SF-1 and SF-3 for registration of ABS offerings, which are largely based on the existing Forms S-1 and S-3, in order to delineate between ABS filers and corporate filers and to tailor requirements for ABS offerings.

PROSPECTUS DISCLOSURE REQUIREMENTS HAVE BEEN EXPANDED AND MODIFIED

In addition to the asset-level disclosures described above, the Final Rules require ABS issuers to include additional or expanded disclosure on various items in each prospectus, including, but not limited to the following matters.

Non-affiliated originators. Under Regulation AB, an ABS issuer is required to identify, in addition to the sponsor and its affiliates, all originators of assets included in the collateral pool that have originated, or expect to originate, 10% or more of the pool assets. The Final Rules have expanded this requirement to provide that if the cumulative amount of assets originated by parties other than the sponsor and or its affiliates exceeds 10% of the total pool assets, then the prospectus must also identify each non-affiliated originator originating less than 10% of pool assets.

Financial information regarding parties obligated to repurchase assets. Under the Final Rules, the prospectus for each offering must disclose the financial condition of any originator that is required by the relevant transaction documents to
repurchase pool assets for breach of a representation or warranty related thereto, to the extent there is a material risk that the effect of such financial condition on its ability to comply with its repurchase obligations could have a material impact on pool performance or performance of the ABS.

Economic interests in transactions. Although, the Final Rules do not implement a risk retention requirement for ABS sponsors, servicers or originators (which is the subject of another rulemaking project), the Final Rules do require such parties to disclose the amount and nature of any continuing interest retained by them or their affiliates in the pool assets, as well as any materially related hedge to offset the credit risk.

Modification of underlying assets. The Final Rules require enhance disclosure of the provisions of the transaction agreements relating to modification of the terms of any assets underlying an ABS transaction.

Static pool disclosure. Under Regulation AB, the prospectus for each offering is required to include information for the sponsor’s prior securitized pools for the same asset class if that information is material to the transaction. The purpose of this requirement is to show how groups of assets (or “static pools”) – those originated at different points in time, for example – are performing over time. Because it presents comparisons between assets originated by the same originator at similar points in the assets’ lives, it is thought that static pool information can show trends or patterns that may not be readily apparent in overall performance numbers. In response to certain perceived shortcomings and inconsistencies in the static pool information currently being disclosed by ABS sponsors and issuers, the Final Rules amended the static pool disclosure provisions of Regulation AB to require (i) a narrative disclosure of certain introductory and explanatory information for the static pool information presented, (ii) a description of the methodology used in determining or calculating the static pool characteristics being disclosed and any abbreviations used, (iii) a description of how the assets in the static pool differ from the assets included in the pool underlying the ABS being offered, (iv) a graphic presentation of the static pool information if it would aid in understanding, (v) an explanation of why the issuer has not included certain static pool information (or any such information) or has included alternative static pool information. The Final Rules also contain provisions intended to further standardize static pool information for amortizing asset pools related to delinquencies, losses and prepayments.

Disclosure of nonconforming assets and servicing noncompliance. In addition to the asset-level disclosure requirements summarized above, the Final Rules also (i) call for disclosure on an aggregate basis of the type and amount of assets that do not conform to the underwriting criteria described in the prospectus and (ii) amend various periodic reporting Forms under the Securities Act of 1934, including Form 10-K, to require explanatory disclosure concerning any material instances of noncompliance with existing servicing criteria set forth in Regulation AB.

Inclusion of transaction summaries. Under the Final Rules, in addition to detailed statistical information elsewhere in the prospectus, issuers are required to include a prospectus summary in each prospectus that may include, among other things, summary statistical information concerning origination or underwriting programs, exceptions to underwriting or origination criteria and modifications to asset pools.

Filing procedures and forms related to shelf offerings. The Final Rules clarify that the material transaction agreements governing the ABS must be filed with the SEC by the date of the final prospectus for the transaction.[vii]
CONCLUSION

In light of the central role that investor over-reliance on credit ratings played in the 2008 financial crisis (and the ABS market meltdown in particular), the Final Rules are intended to create more transparency and encourage greater oversight and care by issuers in designing and preparing ABS offerings. The ultimate goal of the Final Rules is to facilitate ABS investors’ review and analysis of asset-level information so as to permit investors to make independent, informed investment decisions instead of relying primarily (if not solely) on credit ratings, while also providing additional recourse for investors when and if issues arise. Although the disclosure and reporting requirements of the Final Rules are quite extensive, as noted above, and granular in detail, they apply only to a limited number of asset classes and do not extend to Rule 144A offerings. Therefore, while the SEC indicated that it believes these Final Rules will work to improve investors’ willingness to invest in ABS and lead to recovery of the ABS market, it is difficult to predict whether the Final Rules will in fact have a significant impact on how the ABS markets function.

For more information regarding this Client Alert, please contact Neil Casey (212.631.4414 / caseyn@whiteandwilliams.com) or Lori S. Smith (212.714.3075 / smithl@whiteandwilliams.com) in our New York office.


[ii] This package of revisions to Regulation AB has come to be known as “Regulation AB II”.

[iii] EDGAR is the SEC’s Electronic Data Gathering And Retrieval system.

[iv] All of the asset-level data points required to be provided under the Final Rules at securitization and on an ongoing basis are enumerated in a new Schedule AL to be filed with the SEC via EDGAR.

[v] In its Adopting Release, the SEC noted that it was deferring action on other asset classes and would continue to evaluate whether such asset classes should be subject to similar standardized asset-level data point disclosure requirements.

[vi] The Final Rules did not adopt a proposal to require the appointment of a “credit risk manager” with respect to each ABS offering, but do require the prospectus for each offering to identify the party that will be performing any such required asset reviews, as well as disclose the reviewing party’s qualifications and the scope of its duties under the relevant transaction agreements.

[vii] In its proposed version of the rules, the SEC had expressed concern that certain issuers were delaying the filing of material transaction agreements with the SEC via EDGAR for days or even weeks following the related ABS offering, and had therefore proposed that substantially final versions of transaction agreements would also be required to be filed via EDGAR at the time of filing of the preliminary prospectus. While the Final Rules did not adopt this proposed additional filing requirement, the SEC noted in its adopting release that the proposal remains under consideration.

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult a lawyer concerning your own situation and legal
SEC Adopts Regulation AB II: New Disclosure, Reporting and Shelf Eligibility Requirements for Asset-Backed Securities | Continued

questions.