REGULATION AB II: SECOND TIME'S THE CHARM?

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Securitization and Structured Finance Alert

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On August 27, 2014, following years of preparation, speculation and comment, the Securities and Exchange Commission (SEC) adopted Regulation AB II (Reg AB II). Reg AB II represents a response to requirements of Sections 939A and 942(b) of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). It effects significant revisions to Regulation AB with respect to disclosure, reporting and shelf registration of mortgage- and asset-backed securities (ABS). Reg AB II is intended to provide investors with timely and sufficient information, reduce the likelihood of undue reliance on credit ratings and enhance enforcement of asset-level representations and warranties.

To the relief of many, Reg AB II was adopted in a more manageable form than initially proposed and re-proposed. Notably, the final rule does not enact public disclosure requirements on private securitizations under Rule 144A, which originally was a key component of the proposed rules. While the final rule formalizes new reporting requirements, those tend to be based on industry standards that issuers are already familiar with. Also left out of the final rule were the proposed requirement that final transaction documents be filed at the time that the preliminary prospectus is filed, the proposed inclusion of a computer “waterfall” model, credit risk retention for issuers and originators and asset-level disclosures for equipment loans and leases, student loans and floorplan financings. Some of these topics are subjects of separate rulemaking proposals.

Some of the more notable provisions of Reg AB II change the current standards in the following ways:

- New asset-level data disclosure and reporting requirements affecting certain asset classes;
- New shelf registration eligibility requirements that seek to reduce the likelihood of undue reliance on credit ratings and provide mechanisms to help to enforce the representations and warranties made about the underlying assets;
- A requirement that a complete preliminary prospectus be filed under new Rule 424(h) at least three business days prior to the date of the first sale in the offering; and
- Creation of new registration forms SF-1 and SF-3 for registration of ABS, streamlining of the form of prospectus for shelf-registered offerings of ABS and a new provision for paying registration fees on a “pay-as-you-go” basis.

Reg AB II will become effective 60 days after publication in the *Federal Register*. Issuers must comply with Reg AB II (except for the asset-level data disclosure requirements) with respect to all publicly offered ABS commencing with an initial public offering one year following the effective date. Compliance with the asset-level data disclosure standard will be required for ABS with an initial public offering two years or more following the effective date.

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SCOPE

- Reg AB II does not change the basic definition of "asset-backed security," but it limits the exceptions to the requirement that the ABS be backed by a discrete pool of financial assets in significant ways that will limit flexibility. Specifically:
- Securities that are backed by assets that arise in non-revolving accounts are no longer ABS because they are now excluded from the master trust exception to the discrete pool requirement;
- The revolving period for securities backed by non-revolving assets is reduced to one year from three years; and
- For securities backed by a pool with a prefunding period, the prefunding account cannot exceed 25% (reduced from 50%) of the offering proceeds (or of the principal balance of the total asset pool in the case of master trusts).

TRANSPARENCY: NEW ASSET-LEVEL DISCLOSURE

Reg AB II does not require asset-level disclosure for all ABS asset classes that were covered in the original proposal; however, the SEC is still considering requirements for ABS asset classes for which Reg AB II mandated disclosure. The following table shows which asset classes and transaction types are covered by the asset-level disclosure requirements of Reg AB II.

Regulation AB II asset-level disclosures will apply to:	**Reg AB II asset-level disclosures *will not* apply to:**
Residential mortgages/RMBS	Managed pools, such as CLOs
Commercial mortgages/CMBS	Synthetic transactions
Auto loans/auto leases	Equipment loan/lease ABS
Resecuritizations of RMBS, CMBS and auto ABS	Student loans
Debt securities	Floorplan financings

Perhaps the most significant revision of the rule is the suite of heightened reporting requirements for asset-level data. The required asset-level disclosures must be made in EDGAR in XML format on new Form ABS-EE both at the time of offering and with each Form 10-D report. Importantly, the rules require reporting of certain data fields regardless of whether the field is material, unless Rule 409 can be used to omit information that is unknown and cannot be obtained without unreasonable effort or expense. The specific data reporting requirements differ from asset class to asset class, as outlined below:

	RMBS	**CMBS**	**Auto ABS**	**Debt Securities**	**Resecuritizations**

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Further information may be found in:	Item 1 of Schedule AL	Item 2 of Schedule AL	Items 3 (auto loans) and 4 (auto leases) of Schedule AL	Item 5 of Schedule AL	Item 6 of Schedule AL
Data points required in prospectus and reporting:	270 data points in a single schedule	152 data points in a single schedule	72 data points (auto loans) and 66 data points (auto leases) in a single schedule	60 data points for each pooled security	Item 6(a) indicates that Item 5 data be provided for each underlying ABS included in the resecuritization
Selected reporting fields include:	Mortgage terms, property, information about the obligor, mortgage insurance, loan activity	Property name, address, five-digit ZIP code	State as a geographic indicator; loan terms including origination date, original loan amount, first payment date, make, model, year and value of vehicle; borrower information including credit score, income and employment verification level; payment-to-income ratio; loan performance	CUSIP and other unique identifiers, issuer, trustee, servicer, other key parties; key terms of the security, security performance information	CUSIP and other unique identifiers, issuer, trustee, servicer, other key parties; key terms of the security, security performance information
Industry model:	Borrows in part from Project RESTART	Strongly correlates with current SREFC protocols, with some differences	n/a	n/a	n/a

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SHELF REGISTRATION: ELIGIBILITY REQUIREMENTS

In addition to creating a new Form SF-3 for shelf registrations of ABS offerings, Reg AB II radically changes the rules governing the eligibility of ABS issuers to use the new shelf registration statement. These shelf registration requirements will now apply to all ABS, including mortgage-related securities as defined in Section 3(a)(41) of the Securities Exchange Act.

Shelf Registration Eligibility: Consistent with the mandate of the Dodd-Frank Act to eliminate the mandatory use of ratings for securities offerings, Reg AB II eliminates the requirement that ABS be rated "investment grade" to be eligible for shelf registration. That requirement has been replaced by four new criteria that are designed to foster issuer due diligence and empower investors.

1. **CEO certification:** The CEO of the depositor must certify in writing that as of the date of the final prospectus, the CEO has (i) reviewed the prospectus; (ii) is familiar with the securitized asset, the structure and the material transaction documents; and (iii) believes that such information is accurately described. Additionally, the CEO must certify that, based on his knowledge, there is no untrue statement of material fact included or omitted from the prospectus and there is a reasonable basis to conclude that it the issuance is structured to produce (but not guaranteed to produce) expected cash flows at times and in amounts necessary to make timely payments of principal and interest, taking into account the risks disclosed in the prospectus.
2. **Asset review:** The transaction documents must provide for the selection and appointment of an independent asset representations reviewer, who must be engaged at the time of issuance and identified in the prospectus. The reviewer's responsibility will be to review the pool assets for compliance with the representations and warranties following specific trigger events, which must include (i) a threshold percentage of delinquent assets being reached on a pool-wide basis and (ii) an investor vote to direct a review.
3. **Dispute resolution:** The transaction documents must permit a party making repurchase demands that are not resolved after 180 days to refer the disputed put-back to mediation or third-party arbitration.
4. **Investor communications:** The transaction documents must contain provisions requiring the party responsible for filing Form 10-D to include in that report any request from an investor to communicate with other investors.

Registrant Eligibility to Use Form SF-3. A depositor, issuing entity or affiliate filing a registration statement on Form SF-3 must meet certain registrant requirements at the time the shelf registration statement is filed and for the prior 12 months. These include the timely filing of all reports required under the Exchange Act as well as the filing of all required certifications and transaction agreements (a depositor must disclose its compliance with the registrant requirements). Reg AB II provides for a 90-day cure period for late filings. An effective shelf on Form SF-3 will become ineffective if the requirements above, as well as certain other requirements stated in Form SF-3, are not met after 90 days following the depositor's fiscal year-end prior to the offering.

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SHELF REGISTRATION: TIMING CONSIDERATIONS

Shelf offerings of ABS on Form S-3 are, prior to the effective date of Reg AB II, subject to relaxed rules governing when a preliminary prospectus must be filed under Securities Act Rule 424 and delivered to prospective investors under Exchange Act Rule 15c2-8.

Securities Act. Under Reg AB II, an issuer of ABS registered on Form SF-3 must file a complete preliminary prospectus under Rule 424(h)(1) no later than three business days prior to the date of the first sale of an ABS offering issued under a shelf registration statement (or within two business days after first use if it is used earlier). The preliminary prospectus must contain all information required to be included in the final prospectus, other than pricing information. If there is any material change from the information set forth in the preliminary prospectus, the registrant must file a supplemental preliminary prospectus at least 48 hours before the date and time of the first sale in the offering and such supplemental preliminary prospectus must clearly delineate changes made from the initial preliminary prospectus. Additionally, final transaction documents must be filed in connection with shelf takedowns no later than the date the final prospectus is required to be filed.

Exchange Act. Reg AB II eliminates the exception in Exchange Act Rule 15c2-8(b) for shelf-eligible ABS from the requirement that a broker or dealer provide an investor with a preliminary prospectus at least 48 hours before sending a confirmation of sale. ABS had previously been exempt from this 48-hour preliminary prospectus delivery requirement on the basis of unique features of ABS offerings, including the use of computational and collateral term sheets as described below. Under Reg AB II, the 48-hour preliminary prospectus delivery requirement in Rule 15c2-8(b) will apply to all offerings of ABS, including those involving master trusts. The SEC has stated that it considers an ABS offering to be similar to an initial public offering because each pool of assets in an ABS offering is unique, and that, even with subsequent offerings of a master trust, the offerings are more similar to an initial public offering, given that the precise mix of assets is different for each offering.

Practical Implications: The 48-hour requirement for delivering a preliminary prospectus (including a supplemental preliminary prospectus) will potentially limit the flexibility of shelf offerings. Currently, relatively small changes in the composition of the asset pool can be material and require updated disclosure (commonly referred to as a “sticker”). This stickering often occurs on a very short turnaround with a quick confirmation of the previously accepted offering terms. The new requirement will require sponsors to make a judgment about any potential change to their pricing due to a required 48-hour waiting period following any stickering.

The requirement that transaction documents be filed no later than the date of filing of the final prospectus represents a marked departure from existing requirements; however, it is unlikely to have a significant effect on market practice, because issuers of ABS have gravitated towards this timing in anticipation of the adoption of Reg AB II. Filing transaction documents with the final prospectus is more realistic than filing with the preliminary prospectus, as originally proposed. It is worth noting that the SEC has stated that it may reconsider whether to require filing of transaction documents with the preliminary prospectus.

The ABS market adapted to the unique prospectus filing and delivery requirements by means of ABS term sheets describing collateral and structure of deals as permitted by SEC no-action letters. The new preliminary prospectus filing requirements will make those practices unnecessary as a means to satisfy disclosure obligations. They may still be used for pre-marketing, subject to applicable selective disclosure restrictions (understanding that ABS

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offerings are generally exempt from Regulation FD). It is an open question how those term sheets will evolve in light of the changes wrought by Reg AB II or whether they will simply become obsolete.

EXCHANGE ACT REPORTING

Reg AB II changes a number of items in Exchange Act reports for ABS as summarized in the following table.

Form 10-D	**Form 10-K**
Pool-level delinquency reporting in the periodic distribution report on Form 10-D must be presented according to the requirements for delinquency reporting in item 1100(b). This information is required in 30-day increments for a minimum of 120 days.	The annual report on Form 10-K required for every publicly offered ABS transaction has been changed.
Material changes in the sponsor's (or an affiliate's) interest in the ABS transaction due to purchase or sale or other transfer of the securities are required to be reported.	Disclosure is required if it has been determined that, for any material instance of noncompliance identified in a platform-level assessment, the noncompliance involved is in the servicing of the assets in the pool.
	Disclosure of any steps taken to remedy any material instance of noncompliance at the platform level is now required.

OR WILL THE THIRD TIME BE THE CHARM?

While Reg AB II makes steps towards increased industry transparency, reduced reliance on ratings and slowing down the offering and sale process in public securitizations, it is important to note that the SEC continues to consider additional measures to bolster these aims as a result of the Dodd-Frank Act. Some of the more problematic issues have been left open to discussion: specifically, the SEC has left the door open for disclosure requirements for Rule 144A transactions, as well as reporting for additional asset-classes. Therefore, while the current Reg AB II changes may not affect a specific asset class or transaction types, the possibility has been left open for industry reform in the future.

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