Asset-Backed Securities Disclosure and Regulation

SEC Adopts Revisions to Regulation AB and Other Rules Governing the Offering Process, Disclosure and Reporting for Asset-Backed Securities

SUMMARY

On August 27, 2014, the Securities and Exchange Commission adopted significant revisions to Regulation AB and other rules relating to the disclosure, reporting and offering process for asset-backed securities ("ABS"). The rules adopted reflect substantial changes to many of the rules originally proposed by the Commission in April 2010 and re-proposed in July 2011 in response to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that directed the Commission and other federal agencies to issue or prescribe several ABS-related rules. Earlier this year, the Commission reopened the comment period on the 2010 ABS Proposal and 2011 ABS Re-Proposal to solicit comments on an approach to disseminating asset-level data outlined in a memorandum prepared by the Division of Corporation Finance intended to address privacy concerns by requiring disclosure on a website that is not part of EDGAR.

The Commission intends for the final rules “to provide investors with timely and sufficient information, reduce the likelihood of undue reliance on credit ratings, and provide mechanisms to help enforce the representations and warranties made about the underlying assets.” The rules impose new requirements for asset-level disclosures for residential and commercial mortgage-backed securities, auto loan and lease securitizations and securitizations of debt securities, as well as resecuritizations of ABS that include these asset types. The final rules revise the eligibility criteria for shelf registration of ABS, make a number
of changes to the shelf offering process and prospectus delivery requirements applicable to ABS, and revise the periodic and current reporting requirements applicable to ABS.

The Commission did not adopt several rules proposed in the 2010 ABS Proposal or 2011 ABS Re-Proposal, including:

- a requirement that issuers provide the same disclosure for Rule 144A offerings as required for registered offerings;
- asset-level or grouped-account disclosures for other classes of securitized assets;
- filing of a waterfall computer program;
- filing of substantially final transaction documents by the date the preliminary prospectus is required to be filed;
- exempting ABS issuers from current requirements that the depositor’s principal accounting officer or controller sign the registration statement and instead requiring an executive officer in charge of the securitization to sign; and
- revising when pool disclosure must be updated on Form 8-K.

According to the Adopting Release, these proposals remain outstanding.

Since the Commission has adopted extensive asset-level disclosure requirements for registered offerings of several major asset classes without requiring that issuers provide the same disclosure for Rule 144A offerings, the considerable burden placed on issuers may create an incentive to conduct more offerings pursuant to that exemption from registration.

The asset-level disclosure requirements, including those applicable to distribution reports on Form 10-D and annual reports by ABS issuers on Form 10-K, will apply beginning two years after the effective date of the rules, which will be 60 days following their publication in the Federal Register. All other new requirements will apply beginning one year after the effective date of the rules.

I. ASSET-LEVEL DISCLOSURE

The final rules include asset-level disclosure requirements for ABS where the underlying assets consist of residential mortgages, commercial mortgages, auto loans, auto leases and debt securities, as well as resecuritizations of ABS that include these asset types. The disclosures must be provided in standardized XML format and must include the asset-level data points required by newly-adopted Schedule AL at the time of the offering and on an ongoing basis. The asset-level data points generally cover the payment stream related to the relevant asset, the collateral, the performance of the asset over time and loss mitigation efforts by the servicer, as well as the extent to which income and employment status have been verified, mortgage insurance coverage and lien position. The Commission did not adopt the approach presented by the Division of Corporation Finance in its memorandum, but noted in
the Adopting Release that the newly mandated disclosures are intended to balance investors’ need for information and consumers’ privacy concerns.

The Commission has acknowledged that these requirements will impose costs on issuers and other market participants, including costs to modify information systems to capture, store and report the mandated data, but believes that ongoing costs are likely to be less significant than start-up costs. The Adopting Release includes an extensive discussion of the specific data points that the Commission has decided to require, with particular emphasis on the risk of “re-identification” of the obligors of securitized consumer financial assets.

II. SECURITIES ACT REGISTRATION AND FILING REQUIREMENTS

Prior to these amendments, ABS issuers have filed registration statements on Form S-3 (for shelf offerings) and Form S-1 (for non-shelf offerings) of their securities, and the instructions to those forms included specific requirements for ABS offerings. The final rules create two new forms for registration of ABS — Form SF-3 (for shelf offerings) and Form SF-1 (for non-shelf offerings) — and use of Forms S-3 and S-1 by ABS issuers will no longer be permitted. New Form SF-3 creates four transaction requirements for ABS shelf eligibility in lieu of the investment grade ratings requirement, which has applied to asset-backed securities qualifying for registration on Form S-3 since 1992:

- a certification by the chief executive officer of the depositor at the time of each takedown;
- an asset review provision requiring review of the assets for compliance with the representations and warranties upon the occurrence of a specified percentage of delinquencies in the asset pool and a direction of investors holding not more than a level specified in the transaction documents (which may not be more than 5%) of the total investors’ interest in the asset pool and a simple majority of the interests casting a vote;
- a dispute resolution provision enabling the party submitting a repurchase request to require mediation or arbitration if the relevant asset is not repurchased within 180 days (whether or not the asset review provision has been used); and
- disclosure in the ongoing distribution reports filed on Form 10-D of investors’ requests to communicate with other investors regarding the exercise of their rights under the transaction documents.

The Adopting Release stresses the significance of the asset-related disclosures that are included in the prospectus only at the time of each takedown and the importance of senior level review of this information by the depositor, and notes as well that the Sarbanes-Oxley Act mandated certifications for ABS issuers apply only to past transactions and are not tied to future offerings off the same shelf. The CEO certification must include statements that:

- the CEO has reviewed the prospectus and is familiar in all material respects with the characteristics of the securitized assets, the structure of the transaction and all material transaction agreements;
based on his or her 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 they were made, not misleading;

the prospectus, together with the other information included in the registration statement, fairly presents, in all material respects, the characteristics of the securitized assets, the structure of the securitization and the risks of ownership of the securities; and

based on his or her knowledge, there is a reasonable basis to conclude that the securitization is structured to produce, but is not guaranteed by the certification to produce, expected cash flows at times and in amounts sufficient to service scheduled payments of interest and ultimate repayment of principal on the securities in accordance with their terms as described in the prospectus.

The Adopting Release explains that the term “fairly presents” as used in the certification “will require the CEO to consider whether the disclosure is tailored to the risks of the particular offering and presented in a clear, non-misleading fashion.” The Commission also noted its view that the statutory safe harbor for forward-looking statements is not available for the CEO certification because the depositor for the issuing entity of an ABS is a different “issuer” from that same person acting as a depositor for any other issuing entity or for purposes of that person’s own securities, and thus (other than in the case of master trusts) is not subject to the reporting requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act at the time the certification is made. The CEO certification will state that it is given subject to any and all defenses available under the federal securities laws, including those available to an executive officer who signed the registration statement.

The asset reviewer must be named in a transaction document filed with the Commission and must, at a minimum, review all assets that are 60 or more days delinquent. A report of the asset reviewer’s findings and conclusions for the reviewed assets must be provided to the trustee so it can determine whether a repurchase request would be appropriate, and a summary of the asset reviewer’s report must be included in the Form 10-D for the distribution period during which the review was required.

The final rules limit registration of continuous ABS shelf offerings to “all or none offerings”, and allow “pay-as-you-go” registration fees for ABS. The final rules also include a new Rule 430D setting forth the terms on which a prospectus filed as part of a shelf registration of ABS may omit information unknown or not reasonably available pursuant to Rule 409. Paragraph (d)(2) of Rule 430D clarifies that information that adds a new structural feature or credit enhancement must be included in a form of prospectus that is filed as part of a post-effective amendment. Existing Rule 430B will no longer be available for ABS.

ABS issuers using shelf registration procedures under the final rules will be required under new Rule 424(h) to file a preliminary prospectus containing transaction-specific information at least three business days prior to the first sale of securities in the offering and to file material changes in a prospectus supplement that provides a clear description of how the information has changed at least 48
hours before the first sale. The Commission supported setting the waiting period at three business days with a detailed quantitative analysis of historical volatility in ABS index returns. Under General Instruction IV of Form SF-3, only one form of prospectus for the asset class that may be securitized in a takedown of ABS may be included in the registration statement. Accordingly, the currently widespread practice of using a base prospectus and a separate prospectus supplement describing the pool assets and the terms of the ABS determined at the time of the takedown will be discontinued.

The final rules also clarify the requirement in the current rules for the filing of transaction documents by the date of the final prospectus. As noted above, the Commission continues to consider its proposal to require filing of transaction documents in substantially final form by the date the preliminary prospectus is required to be filed. The Commission did not adopt its earlier proposal to require registrants to file blacklines showing how their representations and warranties differ from industry standards.

III. EXCHANGE ACT REPORTING

Under the new rules, distribution reports on Form 10-D will include three new items:

- Item 1A calls for the information required by Items 1111 (Pool Assets) and 1125 (Schedule AL – Asset-level information) of Regulation AB.

- Item 1B, applicable to shelf registrations only, calls for the information required by Item 1121(d) of Regulation AB regarding events triggering review of assets for compliance with representations and warranties and a summary of the associated report and Item 1121(e) regarding investor communication requests.

- Item 7 calls for the information required by Item 1124 of Regulation AB regarding changes in the interest of sponsors and their affiliates in the ABS resulting from any purchase, sale or other acquisition or disposition of the ABS by the sponsor or its affiliates during the period covered by the report. The 2010 ABS Proposal had contemplated requiring this information to be reported currently on Form 8-K.

Form 10-D currently requires issuers to report only material changes to the delinquency and loss information required in the prospectus pursuant to Item 1100(b)(5) of Regulation AB, which is provided in 30- or 31-day increments. The 2010 ABS Proposal contemplated requiring updated delinquency and loss disclosure in each Form 10-D in similar increments. In response to commenters’ concerns about providing this information in these increments through charge-off, this information will be required through no less than 120 days.

The final rules will require the assessment of compliance with servicing criteria in an ABS issuer’s annual report on Form 10-K to include disclosure of whether any material instance of non-compliance involved the ABS covered by the report and any steps taken to remedy any previously reported material instance of non-compliance with respect to ABS transactions taken as a whole and with respect to ABS transactions backed by the same asset type as the ABS covered by the report.
IV. MISCELLANEOUS

The current definition of ABS in Regulation AB requires that the security be primarily serviced by the cash flows of a discrete pool of financial assets, subject to certain exceptions for master trusts, prefunding accounts and revolving periods. The 2010 ABS Proposal contemplated (i) limiting the exception for master trusts to ABS backed by financial assets that arise under revolving accounts, (ii) reducing the prefunding limits from 50% to 10% of the principal balance of the total pool for master trusts or of the offering proceeds for other ABS, and (iii) shortening the revolving period to one year. The revised ABS definition decreases the prefunding limits to 25% instead of 10%, but does not adopt the two other proposed modifications to these exceptions.

Other amendments to prospectus disclosure requirements include a new instruction suggesting various types of statistical information about the asset pool for inclusion in the prospectus summary, a description of provisions in transaction agreements concerning modifications of underlying assets, more explanatory language about static pool disclosures and standardized delinquency presentation, identification of originators originating less than 10% of the pool assets if the cumulative amount originated by parties other than the sponsor or its affiliates is more than 10% of the pool assets, and expanded disclosure about transaction parties.

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ENDNOTES

1 Release No. 33-9638, 34-72982 (the “Adopting Release”).


3 See Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities, Release No. 33-9244, 34-64968 (July 26, 2011) [76 FR 47948] (the “2011 ABS Re-Proposal”). This release is discussed in detail in our September 1, 2011 memorandum entitled “ABS Shelf Eligibility Criteria.” The 2011 ABS Re-Proposal proposed new shelf eligibility criteria in part because two of the criteria originally proposed to replace the investment grade ratings requirement, risk retention and continued reporting under the Securities Exchange Act, were addressed by Sections 941(b) and 942(a) of the Dodd-Frank Act.

4 See Dodd-Frank Act Section 621 (rules implementing restrictions on certain conflicts of interest), Section 941(b) (joint regulations of the Commission and the Federal banking agencies with respect to credit-risk retention), Section 942(b) (disclosure of asset-level information), Section 943 (disclosure of representations and warranties in credit rating reports and disclosure of repurchase requests) and Section 945 (review of assets underlying publicly offered ABS). Prior to the adoption of the rules discussed in this memorandum, which address in part the requirements of Section 942(b), final rules have been adopted only pursuant to Sections 943 and 945. These rules are discussed in our January 31, 2011 memorandum entitled “Disclosure of Repurchase Requests and Issuer Review of Assets in ABS Offerings.”


6 The final rules respond in part to the requirement in Section 939A(b) of the Dodd-Frank Act to eliminate reliance on credit ratings by substituting alternative standards for the use of shelf registration by ABS issuers.

7 Forms SF-1 and SF-3 generally require registrants to disclose the same information (apart from information relating to eligibility to use Form SF-3) but Form SF-1 limits incorporation by reference to the asset-level data file and static pool information, which must be filed prior to effectiveness.

8 The Commission observed that no ABS issuer has filed a registration statement on Form S-1 that went effective since 2008. See Adopting Release at note 875.

9 See Release No. 33-6964 (Oct. 22, 1992) [57 FR 32461]. The final rules replace Rule 415(a)(1)(vii), which has provided automatic shelf eligibility to mortgage-related securities since 1984 (See Release No. 33-6499 (November 17, 1983) [48 FR 52889]), with a new Rule 415(a)(1)(vii) allowing shelf registration of ABS that are to be offered and sold on an immediate or delayed basis and registered on Form SF-3 if they satisfy the requirements specified in the instructions to that form. No changes were proposed or adopted with respect to the registrant requirements or the transaction requirements that delinquent assets not constitute 20% or more of the asset pool and that, with respect to securities that are backed by leases other than motor vehicle leases, the portion of the securitized pool balance attributable to the residual value of the physical property underlying the leases does not constitute 20% or more of the securitized pool balance.

10 See new paragraph (36) of Item 601(b) of Regulation S-K.

11 New Item 1113(a)(7)(i) of Regulation AB requires a description of how the delinquency threshold was determined to be appropriate, including a comparison of the threshold against delinquencies.
disclosed for prior securitized pools of the sponsor for that asset type. The delinquency based trigger replaces the proposed trigger tied to credit enhancements.

12 See new Item 1121(e) of Regulation AB. Note that the Instruction to General Instruction I.B.1(d) of Form SF-3 limits the extent of verification that may be required for beneficial holders of the ABS.

13 Note 1017 of the Adopting Release.

14 See new Rule 415(a)(1)(xii). The new limitation is intended to avoid situations where the specific assets to be included in the pool cannot be determined prior to the offering because the size of the offering would be unknown.

15 See new Rules 456(c) and 457(s). Under existing Rule 456(b), “pay-as-you-go” registration fees are available only to well-known seasoned issuers. Issuers of asset-backed securities as defined in Regulation AB are excluded from Rule 405’s definition of “well-known seasoned issuer” under clause (1)(iv) thereof.

16 See Adopting Release at notes 881 and 883. Existing Rule 424(b) requires that a form of prospectus or prospectus supplement relating to the delayed offering of mortgage-backed securities or an offering of asset-backed securities be filed no later than the second business day following the date it is first used after effectiveness in connection with a public offering or sales. The 2010 ABS Proposal contemplated a five business day waiting period both for the filing of the preliminary prospectus and for any material change in the information provided, other than the offering price. The final rules also eliminate the exemption in Rule 15c2-8(b) for asset-backed securities that qualify for shelf registration from the requirement that a broker-dealer deliver a preliminary prospectus at least 48 hours prior to sending a confirmation.

17 See the new sentence in Item 1100(f).

18 This new requirement anticipates the adoption of the joint credit risk retention regulations required under Section 941(b) of the Dodd-Frank Act in an instruction that the disclosure must separately state the resulting amount and nature of any interest or asset retained in compliance with law.

19 See Item 1122(c) of Regulation AB.

20 See Instruction to Item 1103(a)(2) of Regulation AB.

21 See Item 1111(e) of Regulation AB.

22 See Item 1105 of Regulation AB.

23 See Item 1110(a) of Regulation AB.

24 For example, new Items 1110(b)(3) and (c) and Items 1104(f) and (g) of Regulation AB require information regarding an originator’s or sponsor’s financial condition if it is required to repurchase or replace any asset for breach of a representation and warranty to the extent there is a material risk that the effect of its financial condition on its ability to satisfy those obligations could have a material impact on performance of the asset pool or the ABS, and information regarding any interest retained by it or its affiliates and any hedge materially related to the credit risk of the securities. New Item 1108(e) of Regulation AB requires information regarding any interest retained by the servicer or its affiliates and any hedge materially related to the credit risk of the securities.
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