

Regulation **AB**

It has been two years in the implementation, and now, finally, Regulation AB is in effect. That makes this a good time to summarize what Regulation AB does, and how it has affected—and will affect—industry practices.

BY
ELLEN R.
MARSHALL

Before the adoption of Regulation AB, public offerings of mortgage- or asset-backed securities (ABS) were governed by an incredible hodgepodge of rulings, no-action letters and other interpretive material about what the securities laws required in the way of disclosure, filings and periodic reporting. The very fact that the operative rules derived from all of these different sources meant that counsel who had practiced in the area for many years possessed special knowledge that was difficult for newcomers to obtain. ■ With Regulation AB, the Securities and Exchange Commission (SEC) has consolidated these rules into a single regulation, easily accessed by all. ■ As of Jan. 1, 2006, this new regulation fully supplants prior rules and procedures for the registration, offering and ongoing reporting about public offerings of asset-backed securities. (There's a three-month delayed effectiveness for transactions that use shelf registrations that were on file with the SEC on or before Aug. 31, 2005.) ■ In addition to consolidating the existing rules, Regulation AB made some modifications in the operative principles. While these changes were not enormous, they do require attention, and in many cases revision of the substance of the disclosure documents and how they are filed with the SEC. ■ Regulation AB was adopted in 2004, and had a two-year phase-in period. During that time, those issuers that are regularly involved in the public issuance of mortgage-backed securities (MBS) and asset-backed securities have adapted their practices to the new requirements.

For infrequent issuers in the public market, however, the new rules may still come as a surprise. Moreover, as explained later, there are some aspects of Regulation AB that will require a greater degree of ongoing cooperation from parties other than the issuers themselves—such as servicers and private purchasers of mortgage pools. The impact of these changes is only now being fully recognized.

Summary of Regulation AB

APPLICATION OF REGULATION AB

Regulation AB applies to securitizations of all types of receivables. Although the term asset-backed securities (ABS) is used throughout the regulation, it is used in the broad sense that includes mortgage-backed securities, as well as securities backed by credit-card receivables, auto loans, debt securities, equipment-purchase receivables, home-equity loans and medical receivables. The term also includes securities that are backed by pools of leases, such as auto leases and equipment leases.

Regulation AB applies to securitizations of foreign receivables, as well as domestic receivables. Although some market participants were hoping that synthetic securities would be made eligible for Regulation AB and the other new provisions, this was not done. The SEC continues to view synthetic, credit-linked, index-linked and managed securities as outside the scope of ABS.

THINGS THAT HAVE STAYED THE SAME

Regulation AB mostly served to codify existing practices that were already accepted by the SEC through various rulings and interpretations. These include:

- Availability of shelf registration and Form S-3 for investment-grade securities.
- Required disclosures based on the principle of materiality, not a prescribed set of specifically listed details.
- Disclosures about asset pool's attributes and credit enhancers' financial condition, but not about the finances of the sponsoring entity or depositor.
- Scope and detailed disclosure of paydown scenarios.
- Use of computational materials, in addition to the prospectus.
- Filing of monthly distribution reports in lieu of quarterly reports on Form 10-Q.
- Permitted deregistration after one year if purchasers are not numerous.

The codification of these rules in one regulation is a great improvement. Moreover, the SEC's articulation, in its preamble to the final regulation, of the current practices contains many clarifications of the details of the SEC's position, even where not changed, and information about the

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bases upon which those practices are premised. All of these added elements are quite useful when applying the new regulation.

THINGS THAT HAVE CHANGED

There are, however, some respects in which Regulation AB makes substantial changes to prior practices. The following are some of the more significant changes.

Changes in the contents of the prospectus

■ **Sponsor:** More disclosure is required about the sponsor of the transaction, including a description of the sponsor's securitization program and historical information about other pools of assets of the same type securitized by that sponsor.

■ **Static pool data:** Static pool information must be disclosed for the five years preceding the issuance. This can be provided on a Web site rather than in the prospectus itself. But either way, it carries liability as if included in the prospectus. Required disclosures include prepayment as well as delinquency and loss information.

■ **Servicing functions:** There is new required disclosure about the allocation of servicing responsibilities among the parties.

■ **Servicing policies:** Expanded disclosure is required about servicing policies. These include the charge-off policy used for assets in the pool and any material changes in the servicer's servicing policies in the last three years. There is one standard for servicers of between 10 percent and 20 percent of the pool, more disclosures for servicers of 20 percent or more of the pool.

■ **Originator:** Expanded disclosure about originators is required. There is one standard for originators of between 10 percent and 20 percent of the pool, more disclosures for originators of 20 percent or more of the pool.

■ **Fees:** All fees to be imposed during the life of the issue must be disclosed in a new tabular format.

■ **Credit enhancements and derivatives:** Disclosures about credit enhancements and derivatives used as hedges are specified, based on the extent to which they affect cash flow. For credit enhancements, the amounts are measured on the basis of the maximum payout. Significantly (and different from the proposed regulations), where derivatives are used, the amounts are measured on the basis of the maximum probable exposure.

■ **Affiliation:** Any affiliation among parties to the transaction must be disclosed.

New limitations on asset pools

■ **Delinquency concentrations:** New limitations are added as to the portion of the asset pool that

may be contractually delinquent when the transaction begins.

■ *Leases:* For pools of leases, new limitations are added as to the percentage of cash flow that comes from residuals.

Other changes in registration process

■ *Foreign securities:* Foreign ABS may be registered using Form S-1 or S-3, in the same fashion as domestic issues are registered.

■ *Market-making transactions:* Prospectus delivery is no longer required for market-making transactions in ABS. This means that it is not necessary to update the prospectus or to avoid deregistering in order to have an active secondary market in a particular issue.

■ *Computational materials:* Computational materials must be filed electronically, not in paper form.

■ *Exhibits to registration statements:* All governing documents, including those between two third parties, must be filed with the SEC as exhibits.

Periodic reporting changes

■ *Distribution reports:* New Form 10-D is now to be used to report on periodic distributions (in place of Form 8-K, which had been used for this purpose). It must be filed within 15 days after the end of each period (monthly for securities that have monthly distributions), and must be signed by the depositor or the servicer.

■ *Signers:* Annual reports on Form 10-K and current reports on Form 8-K must also be signed by either the depositor or the servicer.

■ *Sarbanes-Oxley certification:* The form of certification under Section 302 of the Sarbanes-Oxley Act has been modified, and it, too, must now be signed by the appropriate senior officer of the depositor or servicer.

■ *Annual assessment and attestation:* Annual assessment and attestation reports are required for all parties that participate in any part of the servicing. This is not a significant change for the mortgage-backed issues, in which uniform single attestation program (USAP) attestations have been universally required as a contractual matter. For other types of asset-backed, the details of attestation reports are generally similar to the USAP standards that have been familiar in the mortgage servicing context.

There are some requirements, however, that go beyond the USAP standards. Moreover, the requirements apply not only to the servicer, but to any other party performing functions of collection, allocation, calculation or distribution. This may include trustees, subservicers and other participants in the process.

■ *Section 16 exemption:* ABSes are entirely exempt from Section 16 reporting and liability.

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Challenges so far

For mortgage-backed issuers, the transition to Regulation AB has been relatively smooth, though hardly without its challenges. Two areas of significant change are 1) the static pool data requirements and 2) reporting on third parties. In both cases, these are new requirements that demand new operational procedures and contractual arrangements in order to assure compliance over the long term.

STATIC POOL DATA

Regulation AB requires issuers to include—in both the prospectus or prospectus supplement at the time of issuance and in periodic reports—data about the performance of other pools of assets, on a pool-by-pool basis. The data include both delinquency and prepayment experience.

If the issuer has been in the business of securitizing other pools of similar loans, then the static pools can consist of the prior securitizations. If the issuer has not regularly securitized similar loans, then the issuer needs to disclose static pool information on the basis of the year of origination, treating each year's originations of that loan type as if it constituted a pool.

In order to meet this disclosure requirement, an ABS issuer must first determine which loans are similar. Loans of a different type (such as subprime vs. prime) or obtained through a different channel (such as bulk purchase vs. retail origination) may need to be considered separately. The establishment of these categories is a judgment call, to be made with reference to the investors' reasonable need for useful information.

If the relevant prior pools have all been securitized, it is likely that all of the delinquency and prepayment data will be readily available. It may even be fully disclosed on an existing Web site. Regulation AB permits the static pool data to be disclosed on a Web site, provided that the Web site is accessible without charge and without registration. In these situations, all that is required for compliance with Regulation AB is to disclose the Web site's address in the prospectus or prospectus supplement.

If the relevant prior pools have not been securitized, however—and especially where the loans of the relevant type have not even been considered a “pool” in the past—there is now a substantial chore of gathering information about the delinquency and prepayment patterns of those loans, on a year-by-year basis. This can be challenging, especially where the loans have been sold in the private market or are serviced by an unrelated entity.

Aside from the question of whether the static pool data exist or need to be reconstructed, there is an additional issue of liability. Because this information is now to be included in securities law disclosures and filings, there is a potential for greater

liability for errors or materially misleading reporting. The contracts by which servicers are required to report these data to issuers are now being rewritten to allocate the heightened level of liability that now derives from the use of these data for securities law compliance.

Moreover, there will be situations in which data reports are required from entities that never before had any reporting function at all. For example, a purchaser of a non-standard loan type (say, scratch-and-dent loans of some particular flavor) that purchases on a servicing-released basis previously would have had no obligation to report the performance of those loans to the entity that sold it the loans, or even to retain data on those loans as a separate group in its own records.

If the originator of those loans later finds a way to securitize that loan type, it will need static pool data. By hypothesis, this originator has not previously securitized loans of that type and so it cannot make its static pool disclosures on the basis of actual prior pools. Instead, it will need to make static pool disclosures on the basis of year-by-year originations of that loan type. Information about the loans that were sold on a servicing-released basis will be in the hands of the purchaser, not the originator.

Ideally, the originator will have anticipated this problem by including in its sale agreement an obligation to provide delinquency and prepayment information as and when needed, so that the originator can compile its static pool data. Adding this sort of obligation to an existing relationship may prove difficult or impossible, at least without considerable expense.

Aside from the challenge of obtaining this information, issuers will need to create systems to compile reports that may come in from several sources, to create the pool data for the origination year “pool,” which is not really a pool at all, but only a reporting convention.

THIRD-PARTY SERVICE PROVIDERS

Prior to Regulation AB, disclosure documents typically contained summary information about the servicer of the loans included in the pool, less disclosure about trustees and providers of credit enhancement, and little, if any, disclosure about other third parties involved with the pool assets. Regulation AB imposes greater uniformity on the scope of disclosure about entities that deal with pool assets.

Issuers are likely to find that more disclosure will be needed about subservicers and providers of services on an outsourcing basis, even if the master servicer has assumed legal liability for the performance by these third parties. For single-asset pools and pools with a small number of relatively large assets (typically commercial mortgage loans), more disclosure may be required about the obligors on

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those assets and about tenants whose rental obligations constitute the cash flow from which mortgage payments are funded.

Generally, Regulation AB draws distinctions based on the portion of the pool assets in which a third party has involvement. If an entity is involved with assets that form between 10 percent and 20 percent of the pool, a summary level of disclosure is required. If an entity is involved with assets that form 20 percent or more of the pool, a greater amount of disclosure is required.

These requirements mean that issuers now need to obtain and disclose information about entities with which they do not have direct contact or a contractual relationship. The best way to arrange for this is through the party with which they do have contact.

For example, a servicing agreement is amended to obligate the servicer to provide information about the subservicer. Ideally, from the issuer’s standpoint, the servicer will assume legal liability for the accuracy of that information. The servicer may then turn around and amend its contract with the subservicer to make the subservicer responsible and liable for the information it provides.

Even when the contractual arrangements can be modified in these ways, however, the disclosure of information about a subservicer or other third party by an issuer carries with it liability based on the federal securities laws. This is a high standard of liability. It is likely that, at least at the margins, some issuers may be reluctant to rely on providers that either are thought to have unreliable systems for reporting or are inadequately capitalized to stand behind their contractual obligations.

Both the static pool data requirements and the third-party information disclosures are occasioning new contracts among the entities that are involved in mortgage and asset securitization. As we have seen, even entities that are not themselves involved in securitization can be impacted by these changes.

The process of adapting existing contractual arrangements and operational procedures has begun, but certainly has not been completed, even as the new requirements have become fully applicable. Some vendors have been proffering tools to manage data and to develop Web-based disclosure tools. It’s anybody’s guess whether Regulation AB will, in the long run, result in substantially different business practices or will simply serve as a more accessible repository of essentially unchanged—though obviously evolving—practices. **MB**

Ellen R. Marshall is a partner with Manatt, Phelps & Phillips LLP in Costa Mesa, California. Marshall is adviser and legal counsel to many mortgage companies and other financial industry clients in regard to their secondary-market and securitization transactions. She can be reached at emarshall@manatt.com.