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# An Overview of the SEC's Proposed Revisions to Regulation AB and Their Effect on Mortgage-Backed Securities

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On January 7, 2005, the Securities and Exchange Commission (SEC or the Commission) issued Regulation AB, a final regulation intended to clarify the requirements for the registration, disclosure, and periodic reporting for asset-backed securities (ABS), including all public deals in residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).[1] Prior to Regulation AB, public offerings of mortgage- or asset-backed securities were governed by a mix of SEC no-action letters and other interpretive guidance with respect to what the securities laws required. The regulatory framework for corporate debt issuance did not neatly gel with the needs of ABS market participants and the SEC took the position that ABS market practices were lacking in efficiency and transparency. Securitization reporting also did not neatly fit into the financial reporting framework.

Regulation AB was intended, among other things, to clarify the Securities Act of 1933 (Securities Act) registration requirements for ABS offerings; set forth Securities Exchange Act of 1934 (Exchange Act) reporting rules more relevant to ABS; and provide disclosure guidance and requirements for ABS Securities Act and Exchange Act filings. Securities meeting the definition of "Asset-Backed Security" issued through the SEC registration process are covered by Regulation AB. Privately issued securities are not presently subject to Regulation AB. Asset classes covered by Regulation AB include, but are not limited to, residential mortgages, home equity lines of credit, commercial mortgages, and manufactured housing. Regulation AB requirements pertain to originators, sponsors, issuers, depositors, servicers, sub-servicers, trustees, significant obligors, and credit enhancement and derivatives providers. As of January 1, 2006, all new S-1 and S-3 registrations had to be Regulation AB compliant.

In light of the recent credit crisis, the SEC took a fresh look at existing practices, and on April 7, 2010, the SEC released proposed rules and forms to make significant revisions to Regulation AB (the Release or Proposed Rules) and other rules regarding the offering process, disclosure, and reporting for ABS,[2] with the goal of improving investor protection and promoting more efficient ABS markets by improving the quality of assets being securitized, improving the quality of information presented to investors, and reducing reliance on ratings agencies.

Major trade organizations representing members across various disciplines within the real estate finance markets, including the CRE Finance Council, Mortgage Bankers Association, and the American Securitization Forum, have authored significant comment letters to the Commission in response to the Release (Comments).[3] Members of these trade organizations include RMBS and CMBS investors, issuers, real estate portfolio lenders, multifamily lenders, servicers, financial intermediaries, ratings agencies, financial guarantors, and other professional organizations involved in securitization transactions. The comment period ended on August 2, 2010.

RMBS and CMBS industry participants strongly support the Commission's intention to strengthen the alignment of interest between issuers and sponsors on the one hand and the investor community on the other. Comments by RMBS and CMBS industry participants state that it is critical that this alignment is tailored to account for the unique nature of various types of ABS. In addition to the SEC regulations described herein, in the midst of the Regulation AB comment period, Congress also legislated certain additional requirements that the SEC and banking regulators will impose on securitizers. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[4] passed on July 15, 2010, includes references to rulemaking and to studies that may affect the content of the Proposed Rules. RMBS and CMBS trade organizations plan to continue to work closely with policymakers in Congress, the Obama Administration, and financial regulators, providing advice on regulatory guidance designed to restore liquidity and facilitate lending in the RMBS and CMBS markets, and have urged the Commission to formally continue the period for which comments may be provided on the Proposed Rules until all such rulemaking and study activity under the Dodd-Frank Act has been completed. Industry participants strongly believe that any action taken by the Commission should be undertaken on a coordinated basis, in accordance with the legislative mandate that such regulations be developed on an interagency basis, as informed by the findings and recommendations presented to Congress.

While the devil will certainly be in the details to be established by regulation, the Dodd-Frank Act does provide a clear enough indication that securitizers and originators must be prepared to retain some sort of interest in the credit risk of the assets they channel into securitization transactions. Likewise, issuers and ratings agencies must be prepared to provide disclosure relating to the individual assets being securitized and the performance history of a sponsor's platform. These complementary requirements have been designed to move the interests of originators, issuers, and investors into closer alignment, to have a favorable impact on the credit quality of securitized assets and to give investors better tools to make an assessment of this credit quality. Compliance with these requirements will certainly impose burdens on the RMBS and CMBS markets and may have negative impacts on market participation and credit availability (both for issuers and consumers).

Two primary areas of concern for investors and issuers include the new rules pertaining to shelf eligibility and private securities offerings. This article describes the changes being proposed and discusses some of the key concerns raised by members of the real estate finance industry.

## SHELF ELIGIBILITY

The current rules regarding shelf offering have certain eligibility criteria including the requirement that offered ABS be investment grade securities rated BBB or higher. A security is considered "investment grade" for the purpose of determining shelf eligibility when at least one nationally recognized statistical organization has rated the security as investment grade. As part of its ongoing effort to eliminate reliance on such ratings in connection with ABS offerings, the Commission proposes to replace the investment grade shelf eligibility requirement with four shelf eligibility criteria, including: (1) requirements related to risk retention, (2) third party review of repurchase obligations, (3) certification of the chief executive officer (CEO) of the depositor, and (4) an undertaking to file ongoing reports. Each of these four shelf eligibility criteria is identified below followed by a discussion of proposed shelf registration procedures.

### Risk Retention

The first proposed criterion for shelf eligibility—risk retention—would require that a sponsor of any securitization retain, at issuance and on an ongoing basis, a portion of the economic risk in each tranche of a deal (*i.e.*, a "vertical slice" of the deal) equal to a minimum of 5 percent of the nominal amount of each of the tranches sold to investors pursuant to registration. Proposed Form SF-3 also would require disclosure relating to the interest that is retained by the sponsor or its affiliate.

The Dodd-Frank Act charges the Commission and "Federal banking agencies" (defined as the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency) with jointly promulgating regulations to establish the nature, duration, and other details of risk retention, and affords such agencies broad flexibility in so doing. The Dodd-Frank Act does, however, set forth general guidelines for such regulations. For instance, the Dodd-Frank Act establishes a default risk retention level of 5 percent, but gives the regulators discretion to require levels of greater than 5 percent and, within certain limitations, also allows for levels of less than 5 percent. The Dodd-Frank Act also requires that the regulations prohibit a securitizer from directly or indirectly hedging away or otherwise transferring the retained credit risk. Final risk retention requirements must be issued by April 17, 2011, and must go into effect two years after publication of final rules (one year for RMBS).

A number of industry participants support the Dodd-Frank Act "menu" of options approach to risk retention. Issuers point out that any blanket or one-size-fits-all retention requirement would be arbitrary to its application to any particular asset type, and would not account for important differences in the expected credit and performance characteristics of that asset type versus other types of assets. Issuers strongly believe that, in addition to the qualified residential mortgage exemption mandated under the Dodd-Frank Act, the Commission should utilize the authority conferred upon it to provide exemptions from any risk retention requirement for issuances of ABS supported by other high quality assets, relying, in part, on the underwriting standards to be established by the Federal banking agencies under the Dodd-Frank Act that specify the terms, conditions and characteristics of a loan within each of the various asset classes that indicate a low credit risk with respect to the loan.

There remains a concern with respect to the relationship between risk retention requirements and the Financial Accounting Standards Board's adoption of Financial Accounting Statements 166 and 167. Specifically, accounting firms are considering what level of risk retention constitutes a "significant economic interest" and results in balance sheet consolidation by a sponsor when that entity also is the servicer of the asset pool. The concern raised is that mandated risk retention in the form of a substantial vertical slice may cause such accounting firms to more readily conclude that such risk retention is a "significant economic interest," thereby triggering balance sheet consolidation, even when such accounting firms would have concluded, in the absence of such mandate, that consolidation would not be the result.

Comments also stated that greater clarification is needed regarding the impact of mergers, consolidations, and other reorganizations and recourse financing on satisfaction of risk retention requirements, as reorganizations are of particular importance in the context of restructurings that have occurred as result of the recent financial crisis.

## Third Party Opinion Regarding Repurchase Obligations

The Commission's second proposed criterion for shelf eligibility—third party review of repurchase obligations—would require that the pooling and servicing agreement contain a provision requiring a third party to furnish, upon the trustee's assertion of a breach of any representation or warranty with respect to a loan not repurchased or replaced, an opinion in support of the obligated third party's assertion that the related asset satisfies the representations and warranties in the pooling and servicing agreement. The proposed third party opinion would be required to be provided by a party not affiliated with the obligated party and be furnished to the trustee at least quarterly.

Industry participants understand that the Commission's impetus for this criterion is to compensate for the perceived lack of ABS investor access to asset and servicing data file information. However, many industry participants questioned whether this concern was well-founded. For example, most CMBS transactions already provide investors with access to asset and servicing data files through each transaction's trustee and include mechanisms for addressing breaches of representations and warranties. The servicer or special servicer investigates potential breaches of representations and warranties on behalf of the trust, and actions may be commenced to remedy the breach in accordance with the related transaction documents, which generally include a "put back" right.

Industry participants believe that a robust third party mechanism for investigating and resolving breaches better serves the interests of investors than a post-mortem opinion or certificate unaccompanied by an adequate and ultimately binding repurchase mechanism.

It also has been noted that the notion of a third party opinion provider is impractical, as it is highly unlikely that any one unrelated party would have the combination of expertise and access to information needed to assess representation and warranty breaches, and also that assessing whether a breach in fact exists would require legal and accounting skills, knowledge of underwriting and valuation, and access to local market knowledge, and market practices and procedures. An approach proposed as more productive in the Comments is a streamlined dispute resolution mechanism.

## Certification of the Depositor's Chief Executive Officer

The third proposed criterion for shelf eligibility—certification of the depositor's CEO—would require that the issuer provide a certification signed by the CEO of the depositor stating that he or she has reviewed the prospectus and the necessary documents for the certification, and that to his or her knowledge the assets have characteristics that provide a reasonable basis to believe they will produce, taking into account internal credit enhancements, cash flows at times and in amounts necessary to service payments on the related securities as described in the prospectus.

As proposed, the depositor's CEO must certify that the payments from the assets would be sufficient to maintain a particular stream of cash flows to investors or repay the total principal balance of each of the related securities in full by the maturity date. Comments noted the implication is that the CEO is acting as a guarantor of the payments on the ABS but that the CEO cannot predict factors such as economic conditions, movements in market interest rates, declines in real estate or other values related to the assets and legislative or regulatory changes, or the precise impacts such events may have on cash flows. Comments further noted that requiring such an implicit guaranty by the depositor's CEO would be contrary to the very concept of securitizations, which are based upon a discrete pool of assets and whereby holders of securities receive uncertain payments and may absorb losses based on the uncertain performance of the underlying assets. Consequently, investors purchase securities based on their appetite for risk, the price of the securities and their view of how the assets may perform.

Industry participants believe it is inappropriate to compare the proposed certification to those under Sarbanes Oxley, as the meaning and intent of the certifications fundamentally are different. In a Sarbanes Oxley certification, an executive will certify to the procedures done to ensure that information was disclosed, the material accuracy of the disclosure and the obligations of certain parties. The proposed CEO certification looks to the future performance of the assets by requiring the CEO to have a "reasonable basis to believe" that the assets will produce timely and sufficient cash flows. Industry participants have significant concerns with the proposed certification language and believe that it is not an appropriate condition to registration of ABS on a shelf basis and does not effectively implement the Commission's intent to replace a ratings-based condition to shelf eligibility with other measures of ABS quality. Comments note the acknowledgment by the Commission in its Release that ABS transactions already contain issuer liability as a result of the CEO's signature on the registration statement for which liability is brought down in each takedown from a shelf, including disclosures included in the prospectus. A compromise proposed by certain members of the industry is to have a CEO certification focusing on the sufficiency of the disclosure in the offering documents rather than on the future performance of the assets.

## Undertaking to File Ongoing Reports

The fourth proposed criterion for shelf eligibility—an undertaking to file ongoing reports—would require the issuer to undertake to file reports with the SEC to provide disclosure as would be required pursuant to Exchange Act Section 15(d) and the related rules, if the issuer were required to report under that section. The issuer's reporting obligation would extend as long as non-affiliates of the depositor hold any of the issuer's securities that were sold in registered transactions. This proposal was prompted by the operation of Exchange Act Section 15(d), which automatically suspended the duty to file ongoing reports after the first year if the securities of each relevant class were held by fewer than three hundred persons. As a result, the reporting obligations of most ABS issuers suspended after they filed one annual report on Form 10-K. The Dodd-Frank Act, however, amends Section 15(d) to exclude ABS from the automatic suspension provisions and, in its place, authorizes the Commission to suspend or terminate Section 15(d) reporting requirements for any class of ABS on such terms and conditions and for such periods as the Commission deems appropriate.

CMBS industry participants believe that, although full and transparent disclosure on an ongoing basis is desirable, the proposed ongoing SEC filings do not add much value in the CMBS context. CMBS market participants noted in their Comments that the CMBS market in particular has been a market leader in ongoing reporting as is evidenced by the CRE Finance Council Investor Reporting Package™ (IRP) that is either distributed directly to investors or made easily accessible to investors electronically much sooner than proposed filings, thereby making the proposed filing requirement not necessary and of little value to investors. They note that the IRP is a widely used data reporting methodology for disclosing loan-level and property-level information on a pool-specific basis that has evolved over the course of the past 14 years based on feedback from industry stakeholders, which have included servicers, trustees, commercial and investment banks, ratings agencies, insurance companies, traders, and investors.

Industry participants recognize that pursuant to Section 942 of the Dodd-Frank Act, Congress has put in the hands of the Commission the authority to determine when and under what conditions an issuer is able to suspend filing. They noted in their Comments that the Commission is authorized to permit different filing requirements for each class of issuers of ABS. Industry participants believe that the CMBS industry, in large part because of the history of the IRP, warrants a shorter period of Exchange Act filings and urged the Commission to permit the CMBS industry to continue its longstanding approach for post-securitization reporting by adopting rules that require CMBS transactions to comply with current practices, which allow for the suspension of Exchange Act filing pursuant to Section 15(d), to the extent that the pooling and servicing agreement requires that investors have access to the IRP that is available closer in time to the related payment date than a corresponding Exchange Act filing.

ABS participants noted in their Comments that for the vast majority of outstanding issuances, the issuer has not filed periodic reports for as many years (other than the initial year) as the ABS have been outstanding, and the related transaction documents do not contain provisions necessary to support an ongoing reporting obligation or provide for the funds to cover the costs of such reporting, because it was never contemplated that such a reporting obligation might arise, and that ABS issuances completed under Section 15(d) in its pre-amended form and before any amendments to Rule 15d-22 occur, should be grandfathered.

In the event the Commission does amend Rule 15d-22, industry participants requested that the Commission also confirm that: (1) ABS issuers can suspend ongoing reporting for so long as all of the issuer's securities that were sold in registered transactions are held by affiliates of the depositor and (2) ABS issuers can cease ongoing reporting at such time as all of the issuer's securities that were sold in registered transactions are no longer outstanding.

## SHELF REGISTRATION PROCEDURES

Under the Proposed Rules, ABS issuers would be required to file a preliminary prospectus (a 424(h) filing) at least five business days in advance of the first sale of securities in the offering, or if used earlier, then within two days of first use. Material changes to the disclosure other than to pricing information would require a new 424(h) filing with the updated information and a new five business day period for review.

Industry participants generally agree that the five business day waiting period triggered by a 424(h) filing in the case of material changes to disclosure is a source of concern. As currently proposed, the rules would require a new 424(h) filing every time a change occurs that materially alters the transaction, even if that change does not, as a practical matter, require such a lengthy period for investors to review and understand. Comments reflect the concern that market inefficiencies from a mechanistic application of a five day filing rule will create a material incentive to avoid the public market altogether with a result that would be inconsistent with the public policy behind the Proposed Rules to increase the efficiency of public markets.

Industry participants have requested that the Commission adopt a revised rule that would provide that the waiting period after a revised 424(h) filing or the filing of a supplement to a 424(h) filing be a period *up to* five business days based on the nature of the change and the length of time that would be needed for the market to digest that change in accordance with past experience and limited review criteria. They also have requested that the Commission permit the filing of a supplement as a free writing prospectus that would highlight (*e.g.*, through the use of a "blacklining" function) the affected section(s) of the 424(h) filing in lieu of a requirement of an entirely new 424(h) filing.

## PRIVATELY-ISSUED STRUCTURED FINANCE TRANSACTIONS

The Proposed Rules require that in order for a "structured finance product" to be eligible for resale in reliance on Rule 144A, or for sale in reliance on Rule 506 of Regulation D, the underlying transaction agreement for the securities must grant to holders of the securities or prospective purchasers designated by the holder the right to obtain from the issuer of such securities the same information (upon request and including ongoing information) as would be required if the transaction were publicly registered. The proposal also adds a new Securities Act rule that would require a structured finance product issuer that had represented and covenanted to provide the information proposed to be required by Rule 144, Rule 144A, and Rule 506 of Regulation D to provide such information, upon request. Lastly, the proposal would require a notice of the offering to be filed with the SEC for the initial placement of structured finance products that are presented as eligible for resale under Rule 144A. In submitting the notice, the issuer would be undertaking to furnish the offering materials relating to the securities to the SEC upon written request. Conforming revisions would be made for filing requirements of securities issued under Regulation D.

Industry participants voiced concern that the Proposed Rules have the effect of eliminating the distinctions between public and private offerings, and, accordingly, eliminating the benefits to issuers and sophisticated investors of having a less rigid presentation of information that is tailored to particular investors' needs, and concern with a resultant negative effect on the availability of credit.

It was noted in the Comments that the Commission's proposed information requirements fail to recognize that an array of structured finance products offered and sold in the private placement market operate in that market because the disclosure framework for registered transactions is too rigid and not well suited to the structure and terms of certain products and transactions. Comments note that issuers also operate in the private placement market for a number of other valid and important reasons, such as:

- An issuer may not have access to all of the information required for a registered transaction.
- The underlying assets or transaction structure may not lend themselves to the delivery of the information required for registered transactions.
- The issuer's issuances may not be on a sufficient scale.
- The market for a particular product may be sufficiently limited that the costs and difficulties of compliance with the disclosure standards for a registered transaction make the private placement market the only viable alternative.

Industry participants also voiced their belief that the application of the disclosure requirements to private transactions will effectively extinguish the market for certain types of products and will severely constrain the development of new, innovative financing techniques.

Industry participants urged the Commission to consider that certain assets customarily financed in the private market may not be able to comply with rules that extend full public market disclosures to the private market. For example, many commercial mortgage loan borrowers who represent more than 20 percent of the pool assets of a CMBS transaction may not have audited financial statements available in the form necessary to satisfy Regulation AB's requirements related to significant obligors.

Currently, loans made to those borrowers routinely are securitized in privately-placed CMBS transactions. They note that the proposed rule change will prohibit loans to such borrowers from being securitized and that the ultimate effect will be to decrease the availability of credit to those borrowers. To the extent credit is extended to those borrowers, industry participants note in the Comments that it will be at higher interest rates because the loan will be ineligible for securitization and therefore less marketable.

Industry participants urged the Commission to refrain from adopting rules that would impose detailed information delivery requirements on private placements. They noted that the Commission has not felt it necessary to mandate that sophisticated institutional investors be given the same information as public investors with respect to non-ABS offerings and that sophisticated institutional investors can demand (and have demanded and received) the information they need to make their investment decisions and thus do not need additional protection. Additionally, to the extent the Commission imposes disclosure requirements on private placements, industry participants urged the Commission to refrain from adopting final rules that require notice filings to be made for Rule 144A transactions in order to avoid public dissemination of private transaction information.

To the extent the Commission now has concerns that institutional investors lack the sophistication to appropriately consider and understand the risks of an investment in structured finance products, there are industry participants who believe that the appropriate course of action is to identify a class of institutional investors that possess a level of knowledge and experience in the purchase and surveillance of structured finance products who are able to make investment decisions relating to those products without the protections mandated by the registration provisions of the Securities Act. Industry participants submitted to the Commission, along with corresponding investor concerns relating thereto, recommended changes to the definition of "qualified institutional buyer" and related provisions for purposes of the purchase of structured finance products.

A "qualified institutional buyer of structured finance products" would be required to satisfy certain qualitative and quantitative standards enumerated in the Comments and it was suggested that Rule 144A be amended to permit resales of any structured finance products of any issuer to "qualified institutional buyers of structured finance products" (SQIBs), or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is an SQIB. In defining an SQIB, industry participants have attempted to establish a level at which they (and the Commission) can be confident that participating investors have extensive experience in the resale market for structured finance products and believe they have identified a class of investors that can be assumed to be sophisticated and without need of the protection afforded by the Securities Act's registration provisions.

Generally, if the securities offered or sold are structured finance products that, by their terms, may be offered or sold only to SQIBs, or to an offeree, or purchaser that the seller and any person acting on behalf of the seller reasonably believe is an SQIB, an issuer undertaking comparable to that required today—to provide, upon request, only basic, material information—would continue to be required, on the basis that SQIBs are sophisticated investors that are able to adequately assess their need for information and to determine when to proceed with an investment. If, on the other hand, the securities offered or sold are structured finance products that, by their terms, may be offered or sold to both SQIBs and QIBs, then an issuer undertaking comparable to that proposed by the Commission—to provide, upon request, substantially the same information as would be required in a registered transaction—would be required.

## CONCLUSION

Although we cannot predict what will be the exact requirements stemming from Regulation AB and the Dodd-Frank Act, it is clear today that the pendulum has swung far in favor of increased regulatory oversight of the securitization market. Risk retention in some form will be required. Investors will be presented with more information. Private deals will look much more like public deals. It remains to be seen how much this increased oversight will improve underwriting standards and ABS investor protection and to what extent, if any, it will diminish the availability of consumer credit.

## NOTES

1. Release Nos. 33-8518; 34-50905; File No. S7-21-04 available at *http://www.sec.gov/rules/final/33-8518.htm*.
2. Release Nos. 33-9117; 34-61858; File No. S7-08-10 available at *http://www.sec.gov/rules/proposed/2010/33-9117fr.pdf*.
3. The CRE Finance Council comment letter is available at *http://www.sec.gov/comments/s7-08-10/s70810-94.pdf*, the Mortgage Bankers Association comment letter is available at *http://www.sec.gov/comments/s7-08-10/s70810-122.pdf* and the American Securitization Forum comment letter is available at *http://www.sec.gov/comments/s7-08-10/s70810-70.pdf*.
4. The Dodd-Frank Act is available at *http://www.financialreformwatch.com/uploads/file/Dodd-Frank-Final-Enrolled(1).pdf*.