

# ABS/MBS Disclosure Update #6: 24 Steps to Tighter ABS – Regulation AB

## I. Introduction

27 December 2004

On 15 December 2004, the SEC unanimously approved the release of its long-awaited rules on ABS and MBS disclosure.<sup>1</sup> Now, for the first time, securitizations have their own, tailor made regulatory regime. The text of the new rules became available on the SEC's website last Wednesday. The heart of the new rules is "Regulation AB," which consists of 24 items, numbered 1110 through 1123. Following are highlights from each item, as well as highlights from some important new rules outside of Regulation AB.

## II. Highlights of Regulation AB

**Item 1100 (General):** Item 1100 includes "general provisions" that apply to the rest of Regulation AB. It contains detailed instructions on how to present historical static pool data on losses and delinquencies. For example, it specifies the use of 30- or 31-day increments for presenting loss and delinquency data and requires explanations of how an issuer defines relevant terms such as "charge-offs, charge-off rate, gross losses, recoveries and net losses." In addition, Item 1100 contains the instructions on how to present financial information about third parties such as credit enhancement providers and significant obligors. Item 1100 itself does not require disclosure of static loss and delinquency data or third party information, rather it specifies how the information should be presented if disclosure is required by other items in Regulation AB.

**Item 1101 (Definitions):** Item 1101 contains the definitions of terms used in the rest of Regulation AB. The most important definition is the one for "asset-backed security." That term defines the whole scope of Regulation AB. Securities that fall within the definition are covered by Regulation AB, but any security that falls outside the definition is not. The term "asset-backed security" includes most of today's ABS and MBS. The heart of the definition is the requirement that an asset-backed security "is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets." The definition permits up to 50% prefunding and, in the case of deals backed by automobile leases, up to 65% of a deal can be backed by vehicle residual values. The definition *does not include* so-called "synthetic ABS," which rely primarily on derivative contracts (such as total return swaps) rather than raw financial assets.

Item 1101 also contains definitions for the following key terms:

- sponsor – an entity that organizes and initiates an asset-backed securities transaction,

<sup>1</sup> Securities and Exchange Commission, Asset-Backed Securities, Release Nos. 33-8518, 34-50905 (22 Dec 2004) (available at <http://www.sec.gov/rules/final/33-8518.pdf>).

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**Contacts:**

Mark Adelson  
(212) 667-2337  
[madelson@us.nomura.com](mailto:madelson@us.nomura.com)

Nomura Securities International, Inc.  
Two World Financial Center  
Building B  
New York, NY 10281-1198  
Fax: (212) 667-1046

[www.nomura.com/research/s16](http://www.nomura.com/research/s16)

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- issuing entity – the (special purpose) entity created by a sponsor to hold pool assets and to issue asset-backed securities,
- depositor – the (special purpose) entity that transfers pool assets to the issuing entity in a deal; usually an intermediate entity positioned between the sponsor and the issuing entity,
- significant obligor – an obligor that, together with its affiliates, accounts for 10% or more of the pool assets backing an asset-backed security, and
- ABS informational and computational materials – written materials such as term sheets and yield tables that meet specified criteria for use during the offering of an asset-backed security.

**Item 1102 (Prospectus Cover):** Item 1102 enumerates the types of information that must be included on the front cover of a prospectus for asset-backed securities.

**Item 1103 (Prospectus Summary):** Item 1103 enumerates the types of information that must be included in the "summary" and "risk factors" sections of a prospectus for asset-backed securities.

**Item 1104 (Sponsors):** Item 1104 specifies the required disclosure about a transaction's sponsor. The disclosure must include a discussion of the sponsor's securitization experience, with particular focus on the types of assets included in the subject deal. In addition, the disclosure must address the roles of the sponsors and its affiliates in the sponsor's securitization program.

**Item 1105 (Static Pool Information):** Item 1105 specifies the requirements for disclosing static pool data. Item 1105 focuses on static pool data from a transaction's sponsor.

Item 1105 specifies different disclosure requirements for amortizing asset pools and for revolving pools. For amortizing asset pools, Item 1105 calls for up to five years of static pool data covering cumulative losses, delinquencies, and prepayments. If available, Item 1105 calls for static pool data about past deals. Otherwise, Item 1105 calls for static pool data about vintage originations.

For revolving pools, Item 1105 calls for data covering delinquencies, cumulative losses, prepayments, payment rate, yield, and standardized credit scores. Performance measures should be organized based on the date of origination of the pool assets (i.e. vintages).

Item 1105 directs an issuer to disclose alternative performance data if it would be material and if the specified disclosure items would not be material.

Item 1105 provides that static pool data about pools securitized before 2006 does not "count" as part of a registration statement or prospectus. That means that issuers (and others) have reduced liability for potential inaccuracies or omissions in that data. However, as time passes, the liability limitation will expire and investors eventually will have full protection with respect to all static pool information provided under Item 1105.

Item 1105 also permits an issuer to omit static pool data about pools securitized before 2006 if it does not have the relevant information and cannot obtain it without unreasonable effort or expense.

**Item 1106 (Depositors):** Item 1106 requires specific disclosures about the depositor for a transaction, if the depositor is different from the sponsor.

**Item 1107 (Issuing Entities):** Item 1107 enumerates the required disclosures about an issuing entity for asset-backed securities. As originally proposed, the item would have required disclosure of the amount that an issuing entity pays for the pool assets. However, the final version instead requires disclosure of the market price of the assets only if the assets are themselves securities.

**Item 1108 (Servicers):** Item 1108 contains the required disclosures about servicers. The item requires a discussion of the servicer's servicing experience, with particular focus on the its experience servicing assets of the type included in the subject deal. In addition, the disclosure should address any significant changes to the servicer's policies or procedures over the past three years. In cases

where a deal has multiple servicers, Item 1108 requires full disclosures for (1) each master servicer, (2) each affiliated servicer, (3) each special servicer, (4) each bond administrator, and (5) each unaffiliated servicer that services 20% or more of the pool assets.

Item 1108 requires merely disclosing the identity of an unaffiliated servicer that services between 10% and 20% of a deal's assets. No disclosure is required (not even identity) with respect to a servicer that services less than 10% of the deal's assets.

**Item 1109 (Trustees):** Item 1109 enumerates the required disclosures about a trustee for asset-backed securities. This item contains the requirement to disclose the percentage of a class or classes of asset-backed securities that is needed to compel a trustee to take certain actions. If a deal has multiple trustees (e.g., an "owner trustee" and an "indenture trustee"), item 1109 requires a description of the roles and responsibilities of each one.

**Item 1110 (Originators):** Item 1110 requires disclosing the identity of any originator, other than the sponsor and its affiliates, that originated 10% or more of a deal's pool assets. If such an originator originated 20% or more of the pool assets, then expanded disclosure is required. The expanded disclosure includes "information material to an analysis of the performance of the pool assets, such as the originator's credit-granting or underwriting criteria for the asset types being securitized." Item 1110 does not require static pool data about originators.

**Item 1111 (Pool Assets):** Item 1111 covers the specific assets included in a deal. It requires a general discussion of the assets as well as familiar stratifications of pool assets along various dimensions such as loan size, interest rate, amortization period, and loan-to-value ratio. Item 1111 specifies different subjects that would apply to different asset classes. For example, the relevant subjects for commercial real estate are different from the ones for automobile or equipment leases.

Item 1111 provides for disclosure of certain material that generally has not been disclosed in the past. For example, required disclosures cover changes in an originator's underwriting criteria and its policies regarding exceptions ("[a] description of the solicitation, credit-granting or underwriting criteria used to originate or purchase the pool assets, including, to the extent known, any changes in such criteria and the extent to which such policies and criteria are or could be overridden"). Likewise, Item 1111 requires disclosure of "ranges of standardized credit scores," which generally has not been provided in disclosure for credit card deals.

**Item 1112 (Significant Obligors):** Item 1112 requires disclosure of financial information about each "significant obligor" in a deal. Recall from the definitions that a significant obligor is one that, together with its affiliates, accounts for 10% or more of the deal's pool assets.

If a significant obligor accounts for less than 20% of a deal's pool assets, then the required disclosure includes only "selected financial data." If a significant obligor accounts for 20% or more of the pool assets, then Item 1112 requires full financial disclosure including financial statements.

**Item 1113 (Transaction Structure):** Item 1113 requires disclosure of a transaction's structure. That includes the terms of the securities, distributions, cash-flows within the transaction's structure, credit enhancement mechanisms, and other features. The item requires disclosure of about the allocation of voting rights among different classes and the required vote to amend the transactions. Item 1113 also requires specific disclosure about the ownership of a deal's residual interest if the residual interest is owned by a party to the deal (e.g., the sponsor, depositor, credit enhancement provider, servicer, originator, etc.).

**Item 1114 (Credit Enhancement):** Item 1114 requires disclosure about both *internal* and *external* credit enhancement arrangements for an asset-backed security. Examples of internal credit enhancement include subordination, overcollateralization, and excess spread. Examples of external credit enhancement include bond insurance, guarantees, liquidity facilities, and certain derivative contracts. Item 1114 requires disclosure of selected financial data about each provider of external credit enhancement that supplies enhancement amounting to 10% or more of the whole deal. If a

credit enhancement provider supplies enhancement amounting to 20% or more of the deal, then Item 1114 requires full financial disclosure including financial statements.

**Item 1115 (Derivatives):** Item 1115 requires disclosure about derivatives, such as interest rate swaps and currency swaps, whose primary purpose is not to provide credit enhancement. Like Item 1114, Item 1115 requires disclosure of selected financial data about each derivative counterparty with a "maximum probable exposure" amounting to 10% or more of the deal (or the specific classes covered by the derivative contract). If the maximum probable exposure to a derivative counterparty amounts to 20% or more, then Item 1115 requires full financial disclosure including financial statements.

Item 1115 directs a transaction's sponsor to estimate the "maximum probable exposure" to each derivative counterparty, using the same approach that it uses for internal risk management in respect of similar derivative instruments.

**Item 1116 (Tax Matters):** Item 1116 requires disclosure about the tax treatment of an asset-backed security.

**Item 1117 (Legal Proceedings):** Item 1117 requires disclosure of material legal proceedings against the sponsor, depositor, trustee, issuing entity, servicer, or originator.

**Item 1118 (Reports and Additional Information):** Item 1118 requires a description of the monthly reports to investors. The content of the reports is not specified in Item 1118, but rather in the instructions to forms 10-D, 10-K, and 8-K. Those forms, in turn, refer back to other Items of Regulation AB.

**Item 1119 (Affiliations and Non-Arm's Length Transactions):** Item 1119 requires disclosure about affiliations among parties to an asset-backed securities transaction (e.g., among the sponsor, a servicer, and an enhancement provider). In addition, Item 1119 requires disclosure of non-arm's length transactions among transaction parties during the past two years.

**Item 1120 (Ratings):** Item 1120 requires disclosure of credit ratings on an asset-backed security. Item 1120 requires disclosure of whether a rating will be monitored over a security's lifetime. Item 1120 does not require disclosure of whether the sponsor for an asset-backed security presented the deal any rating agencies that ultimately did not issue ratings.

**Item 1121 (Distribution and Pool Performance Info):** Item 1121 enumerates the types of information that should be included in monthly distribution reports on asset-backed securities. In contrast to current practice, Item 1121 requires disclosure of "[a]ny material modifications, extensions or waivers to pool asset terms, fees, penalties or payments." In addition, Item 1121 requires disclosure of "[m]aterial breaches of pool asset representations or warranties or transaction covenants." For deals backed by revolving asset pools, Item 1121 requires disclosure of "any material changes in the solicitation, credit-granting, underwriting, origination, acquisition or pool selection criteria or procedures, as applicable, used to originate, acquire or select the new pool assets."

**Item 1122 (Servicing Compliance):** Item 1122 describes the requirement for servicers of an asset-backed security to supply a report on whether they have complied with the servicing criteria enumerated in Item 1122. For a deal with multiple servicers, each one whose activities related to more than 5% of the pool assets must supply the report specified in Item 1122. The report must include disclosure of any non-compliance with the servicing criteria enumerated in Item 1122. In addition, the report must include an accountant's attestation covering the report.

The final form of Item 1122 is quite different from what the SEC had originally proposed. Under the proposal, a single party would have been responsible for assessing servicing compliance of all parties involved in a deal. Under the actual rule, each party involved in servicing a deal is responsible for supplying a report on its own compliance.

**Item 1123 (Statement of Servicing Compliance):** Item 1123 describes the requirement for an authorized officer of each servicer that services 10% or more of a deal's assets to certify that he has reviewed his company's servicing performance and that his company has fulfilled its servicing obligations during the year. If a company has not fulfilled its servicing obligations, the statement must enumerate each failure and specify its nature and status.

### III. Beyond Regulation AB

Here are some highlights from new and amended rules that accompanied the release of Regulation AB:

**Rule 167:** Rule 167 authorizes the use of "ABS informational and computational materials," as defined in Regulation AB.

**Rule 426:** Rule 426 requires filing of all ABS informational and computational materials. Filing makes the materials become part of the registration statement for the deal to which they relate.

**Regulation S-T, Rule 312 (15 C.F.R. § 232.312):** Rule 312 of Regulation S-T allows an issuer to use its web site for delivering static pool information. More precisely, if an issuer includes static pool information in a prospectus, it can do so through "incorporation by reference" to its web site. Static pool information that an issuer incorporates by reference will count fully as part of its registration statement. However, as noted above in the discussion of Item 1105 of Regulation AB, static pool data about deals issued before 2006 will not count as part of a registration statement.

Rule 312 of Regulation S-T expires on 12/31/09. After that date, incorporation by reference to issuer web sites will no longer be permitted. Issuers will need to file their static pool data with the SEC.

**Form 10-D:** Form 10-D is a new form for filing monthly distribution reports (Item 1121 of Regulation AB). The form must be filed within 15 days after each required distribution date on the subject asset-backed securities. Form 10-D can be signed either by the depositor or on behalf of the issuing entity by an authorized representative of the servicer. Form 10-D references Items 1112, 1114, 1115, and 1117 of Regulation AB.

**Form 8-K:** Form 8-K has been amended to cover special and unusual reportable events with respect to asset-backed securities. It will no longer be used for filing monthly distribution reports. Form 8-K is the form for filing ABS informational and computational materials. It is also the form for updating a filed prospectus if the characteristics of a deal's final asset pool vary by more than 5% from the description in the prospectus. The types of special events that trigger a reporting requirement under Form 8-K include the following:

- termination of a material agreement (e.g. servicing agreement),
- entry into a new material agreement,
- bankruptcy of a sponsor, depositor, trustee, credit enhancement provider, significant obligor, or other party,
- breach of performance triggers,
- amendment to governing documents of issuing entity,
- change of servicer or trustee,
- change of credit enhancement or other external support, and
- failure to make a required distribution.

Form 8-K references Items 1108, 1109, 1110, 1111, 1112, 1114, and 1115 of Regulation AB. Form 8-K can be signed by either the depositor or on behalf of the issuing entity by a duly authorized representative of the servicer.

**Form 10-K:** Form 10-K remains the form for filing annual reports about asset-backed securities. Form 10-K references Items 1112, 1114, 1117, 1119, 1122, and 1123 of Regulation AB. Form 10-K must be signed either by a senior officer of the depositor or on behalf of the issuing entity by the senior officer in charge of the servicing function of the servicer (or the master servicer if there are multiple servicers).

**Securities Act Reform:** Although the ink is still drying on Regulation AB, market participants can look forward to even more changes on the regulatory landscape. In early November, the SEC released a lengthy proposal to reform the securities offering process in general.<sup>2</sup> The proposal would not change the general content of ABS/MBS registration statements. However, the proposal could somewhat change use of structural and collateral term sheets. Contrary to new Rule 426, under the November proposal, structural and collateral term sheets would be considered "free writing prospectuses," which would not automatically be incorporated into registration statements. A free writing prospectus would still be subject to liability under section 12(a)(2) of the 1993 Act,<sup>3</sup> but investors arguably would receive greater protection if the proposal provided for liability under section 11 as well.

#### IV. Conclusion

New Regulation AB and the other new rules that accompany it represent historic steps in the evolution of financial regulation in the U.S. Under the new rules, investors will receive static pool data similar to what the rating agencies have received for years.

Although the new rules go into effect in 2006, the market should not feel their full impact until several years later, when static pool data will count as part of registration statements for liability purposes. By that time, the SEC intends to have augmented its electronic filing system to replace incorporation by reference to issuer web sites as the vehicle for disclosure of static pool performance data.

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<sup>2</sup> Securities and Exchange Commission, Securities Offering Reform, Release Nos. 33-8501, 34-50624, 69 Fed. Reg. 67392 (17 Nov 2004) (available at <http://www.sec.gov/rules/proposed/33-8501.htm> and <http://www.sec.gov/rules/proposed/33-8501.pdf>).

<sup>3</sup> *Id.*, 69 Fed. Reg. at 67443-44.

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## NEW YORK

Nomura Securities International  
2 World Financial Center, Building B  
New York, NY 10281  
(212) 667-9300

## TOKYO

Nomura Securities Company  
2-2-2, Otemachi, Chiyoda-Ku  
Tokyo, Japan 100-8130  
81 3 3211 1811

## LONDON

Nomura International PLC  
Nomura House  
1 St Martin's-le-grand  
London EC1A 4NP  
44 207 521 2000

David P. Jacob 212.667.2255 International Head of Research

Nomura U.S. Fixed Income Research

David Resler	212.667.2415	Head of U.S. Economic Research	James Manzi	212.667.2231	CMBS Research/Strategy
Mark Adelson	212.667.2337	Securitization/ABS Research	Elizabeth Bartlett	212.667.2339	Analyst
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