CO-PUBLISHED FEATURE

REGULATORY DEVELOPMENTS IN THE US AND THE POTENTIAL IMPACT ON AUSTRALIAN TRANSACTIONS INTO AMERICA

While the US economy and capital markets have generally rebounded from the recession of 2008, many of the regulations put in place in response to the economic downtown are now beginning to take effect. ***Mayer Brown*** *believes these regulations will have a direct impact on both the content of disclosure documents as well as the structure of transactions.*

Most notably, the Dodd-Frank Wall Street Consumer Protection Act of 2010 (Dodd-Frank Act), which was the US Congress's response to the credit crisis, has been the driving force behind many of the new and proposed regulations affecting the securitisation market. While many of the problems in the securitisation market arose in the US residential mortgage-backed securities (RMBS) and collateralised loan obligation spaces, the Dodd-Frank Act was aimed at the securitisation market as a whole – including both domestic participants and international securitisers that issue into the US.

Many of the rules that have been promulgated pursuant to the Dodd-Frank Act by the various regulatory bodies charged with adopting these reforms have been drafted with the US securitisation market and its structured products in mind. This is even though the rules apply to numerous asset classes in the asset- and mortgage-backed securities markets – including commercial mortgage-backed securities – and for any securitiser issuing into the US.

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Three rules which have either recently come into effect or that will come into effect in the coming months will likely have the largest impact on Australian market participants. These are, in order of effective date:

- The credit-rating-agency reform and third-party due-diligence rules adopted by the Securities and Exchange Commission (SEC) on August 27 2014.
- Amendments to Regulation AB II disclosure rules adopted by the SEC on August 27 2014.
- The credit-risk-retention rules adopted by the SEC, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation and, with respect to the rules relating to residential mortgages, the Federal Housing Finance Agency and the Department of Housing and Urban Development (Agencies) on October 20 2014.

In this article, we will explore these changes in more detail – including explaining why Australian securitisers with any degree of interest in the US market should be aware of their consequences.

CREDIT-RATING-AGENCY REFORM AND THIRD-PARTY DUE-DILIGENCE RULES

The credit-rating-agency reform and third-party due-diligence rules adopted by the SEC set forth three major things. One is amendments to existing rules and new rules that apply to credit rating agencies registered with the SEC as nationally recognised statistical rating organisations (NRSROs). The second is new rules and forms for providers of third-party due-diligence services. The third is amendments to existing and new rules that require issuers and underwriters of asset-backed securities (ABS) to make publicly available the findings and conclusions of third-party due-diligence providers.

The rules are intended to improve the quality and transparency of credit ratings and increase the accountability of the NRSROs that provide such ratings. While the rules set forth many requirements for NRSROs, certain new

requirements have had a direct impact on securitisation transactions – which would also include any Australian-sponsored securitisations issued into the US.

Specifically, Rule 15Ga-2 and Rule 17g-10 relate to the disclosure of third-party due-diligence findings and reports in securitisation transactions, which include disclosure of the services performed by accountants in certain agreed-upon procedure (AUP) engagements and Rule 193 reviews, among other third-party due-diligence reports that are often produced in Australian RMBS transactions.

Initially, the rules were problematic for accounting firms, as they ran counter to the AUP engagements and professional standards of the American Institute of Certified Public Accountants (AICPA). The AICPA, however, granted interpretative relief to allow issuers and underwriters to continue to obtain Rule 193 AUPs and also to disclose such AUPs, as required by the new due-diligence rules.

Rule 15Ga-2 and Rule 17g-10, which came into effect on June 15 2015, require the disclosure of due-diligence services performed by a third party for any rated ABS transaction regardless of whether the securities are offered in publicly registered or otherwise exempted transactions – known as "Exchange Act ABS".

The rules have prompted parties to a securitisation to satisfy two different delivery requirements – one pursuant to Rule 15Ga-2 and the other pursuant to Rule 17g-10. Pursuant to Rule 15Ga-2, the issuer or underwriter of any Exchange Act ABS must make the findings and conclusions of any third-party diligence report obtained by it publicly available via a form ABS-15G on the SEC's Edgar system five business days prior to the first sale of the Exchange Act ABS.

Pursuant to Rule 17g-10, in any case in which third-party due-diligence services are employed by an NRSRO, an issuer or an underwriter, the third-party due-diligence provider must provide, to any NRSRO that produces a rating to which the services relate, a certification on form 15-ABS Due Diligence-15E – known as a "form 15E".

Accordingly, the third-party diligence provider must deliver the form 15E promptly after completion of its services to any NRSRO that has requested it. The third-party diligence provider must also provide the form 15E to the party maintaining the 17g-5 website related to that transaction for posting so that any NRSRO that accesses the site may obtain it.

While the new rules are relatively straightforward on their face, some interpretative issues exist – particularly for mortgage-backed securitisations – and should be discussed at the beginning of any transaction.

The threshold question is whether a third-party service is considered a due-diligence service, and thereby subject to the third-party due-diligence rules. However, once this threshold question has been answered, the market has generally adapted to the handling of this material in light of the new diligence rules.

Nonetheless, the extended time periods in the marketing process for ABS transactions have caused some timing issues. While investors should always have enough time to review disclosure and make informed decisions, this has led to timing disruptions in some transactions – though the market appears to be digesting these changes as well.

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REGULATION AB II

After more than three years since the original proposal and several additional requests for comment, the SEC adopted final rules amending Regulation AB on August 27 2014. The latest iteration, Regulation AB II, unlike the credit-rating-agency reform and third-party diligence rules, will only relate to securitisations publicly registered in the US with the SEC. Macquarie Bank's SMART programme is one such.

The SEC adopted new rules, forms and disclosures for registered ABS transactions with two separate compliance dates. The compliance date for new forms and disclosures is November 23 2015 and the compliance date for asset-level disclosures is November 23 2016.

The five most significant requirements set forth in Regulation AB II relate to the following:

- Changes to the definition of an ABS.
- New eligibility conditions for shelf registration.
- Changes to the shelf-offering process, including changes related to the timing of required filings.
- Asset-level data disclosure for selected asset classes and related privacy issues.
- A range of various other new prospectus disclosure requirements.

Regulation AB II includes many changes that will affect the marketing process, deal terms, disclosure requirements, registration processes and periodic reporting requirements for registered transactions, but it does not govern ABS offered for sale pursuant to an exemption from registration – ie Rule 144A or Regulation S offerings.

The SEC amended the definition of ABS by decreasing the prefunding limit to qualify as an ABS, to 25 per cent from 50 per cent of the offering proceeds. In the case of master trusts, the equivalent figure is the principal balance of the total asset pool. The intent of this change was to address the concern that pools of assets are not sufficiently developed at the time of an offering. The SEC sought to ensure that the asset pool in a transaction is in fact a discrete pool of assets that, by the regulator's terms, convert to cash.

The SEC also made revisions to the shelf-registration process, which include a certification by the chief executive officer of the depositor, inclusion of new transaction document provisions and requirements for the timely filing of Exchange Act reports. The SEC now requires the chief executive officer of the depositor to complete a certification as to, among other things, the disclosure in the prospectus and the structure of the securitisation at the time of the filing of the final prospectus and for each takedown off the shelf.

The transaction documents must be revised to include provisions that:

- Require an asset representation reviewer to review delinquent assets for compliance with representation and warranties if a delinquency test has been triggered and investors vote to direct a review.
- Establish dispute resolution procedures for repurchase requests unresolved after 180 days.
- Set forth mechanics to facilitate communications among investors.

Finally, the SEC is imposing stricter requirements for Exchange Act filings. Under Regulation AB II, there are new shelf-eligibility requirements tied to the timely filing of Exchange Act reports and compliance with the transaction requirements for shelf registration. Additionally, Regulation AB II requires securitisers to conduct an annual evaluation with respect to the same Exchange Act filing requirements and transaction requirements for shelf registration in order to complete takedowns from an existing shelf-registration statement.

Regulation AB II also significantly changes the timeline for filing and delivery of the preliminary prospectus in a shelf takedown. For registered offerings, the sponsor must file a preliminary prospectus at least three business days in advance of the first sale of the ABS. Any material changes to the preliminary prospectus must be filed at least 48 hours prior to the first sale and the final preliminary prospectus must be delivered to investors at least 48 hours prior to the investor receiving its confirmation of sale.

These rules will slow the offering process for many programmatic securisations, which tend to happen on a more compressed timeline. The SEC has stated that its goal in protracting the offering timeline is to give investors more time to review and digest offering documents.

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Additionally, the SEC has adopted rules requiring asset-level disclosure. Residential and commercial mortgages, automotive loans and leases, debt securities and resecuritisations will be the asset classes subject to asset-level disclosure requirements. The SEC has not yet adopted asset-level disclosure requirements for any other asset classes. For the relevant asset classes, issuers must provide disclosure in standardised XML machine-readable format, filed and made publicly available through the SEC's Edgar system on form ABS-EE.

Regulation AB II provides for new disclosure schedules that set forth the asset-level disclosure requirements. For residential mortgages, the SEC stated that it modeled the scope of its disclosure requirements around the information that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation require for each loan.

Finally, the SEC made various other changes to publicly registered transactions. Among these changes, the base prospectus and prospectus supplement must now be combined into one document. The SEC also limited each registration statement to a single asset class, which eliminates the so-called "rent-a-shelf" filings by investment banks to be offered to clients.

Additionally, the SEC established a "pay-as-you-go" system for filing fees for shelf-registration statements, meaning that registration fees may be paid at the time of filing a preliminary prospectus for each takedown rather than before the shelf is declared effective. The SEC also made other changes regarding disclosures on transaction parties, prospectus summaries, modifications of the underlying assets and how static pool data is presented.

Although Regulation AB II is not yet effective, there has been a flurry of activity in the market around the preparation of new Regulation AB II-compliant shelf-registration statements. Since the review process with the SEC can generally take a few months without even taking into account new regulations, the majority of active market participants

have submitted shelf-registration statements for review with the SEC with the hope of being declared effective prior to the November 23 compliance date.

In terms of asset-level disclosures, market participants are now beginning to work through the requirements and are undertaking examinations of their origination and underwriting platforms to ensure that they can gather the data required.

While Regulation AB II will have an impact on the market, many are hopeful that it will not prove to be overly onerous. It is also likely that, once the market digests the rules and investors become accustomed to some of the new timelines and disclosures, these timelines and disclosures may appear in the 144A and Regulation S markets in the US as well. This would include any Australian securitisation transactions issued into the US.

"Due to certain technical differences between the US and Australian mortgage regulations as well as differences between the mortgage products in each country, Australian RMBS sponsors will not benefit from the "qualified residential mortgages" exemption."

RISK RETENTION

The Agencies responsible have adopted final risk-retention rules, implementing the credit-risk requirements of Section 15G of the Securities Exchange Act of 1934, as amended.

Section 15G generally requires the Agencies to prescribe regulations to require any securitiser to retain at least 5 per cent of the credit risk of the assets supporting its securities. Additionally, under Section 15G the sponsor may not eliminate or reduce its credit exposure by hedging or otherwise transferring its retained credit risk.

Generally, the sponsor of a securitisation must retain 5 per cent of the credit risk of the securitised assets – determined as of the closing date of the transaction – in accordance with one of the standard risk-retention options described in the final rule or one of the specialised risk-retention options available for specific classes of assets.

The standardised risk-retention options include eligible horizontal residual interest (EHRI), eligible vertical interest or a combination of both. In lieu of retaining an EHRI, the sponsor may cause an eligible horizontal cash-reserve account to be established in an amount equal to the fair value of all or a portion of such EHRI. This is discussed in more detail below. The risk-retention rules for RMBS will be effective from December 24 2015, and for securitisations backed by other asset types from December 24 2016.

The final risk-retention rules provide exemption from the risk-retention requirements for certain ABS backed entirely by qualifying assets. Many of the exemptions provided, however, are not workable for the applicable asset classes.

Perhaps most relevant to Australian securitisers is the exemption for RMBS backed by "qualified residential mortgages" (QRM). While this exemption will be helpful for domestic securitisers in the US, due to certain technical differences between the US and Australian mortgage regulations as well as differences between the mortgage products in each country, Australian RMBS sponsors will not benefit from the QRM exemption.

The Australian Securitisation Forum (ASF) is currently working to lobby the responsible agencies for relief from the risk-retention rules, particularly given the solid performance history of Australian RMBS. While the ASF's efforts are still in process and the general impact of the risk-retention rules on the US capital markets is not yet known, many in the Australian market are concerned as to what impact it will have on Australian issuance into the US if Australian securitisers cannot get the benefit of the QRM exemption or otherwise obtain some relief from the Agencies. The approach that will be taken on this important issue is still developing.

The US market is undergoing and will continue to undergo many changes in terms of the disclosures, practices and processes for securitisation transactions as a result of the Dodd-Frank Act.

There are many rules for market participants to digest. While the full impact of these regulations is not yet known, many are hopeful that things will return to business as usual shortly after implementation of the new regulations – which will mean business as usual for market participants based in both the US and Australia. ■

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