

# Chapman Client Alert

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Current Issues Relevant to Our Clients

## The Next Compliance Hurdle under Regulation AB II: Annual Compliance Checks to Determine Continued Shelf Eligibility

In 2014, the Securities and Exchange Commission (SEC) adopted “Regulation AB II” — final regulations that substantially revise the offering process, disclosure and reporting requirements for registered offerings of asset-backed securities (ABS).

- Registered offerings of ABS became subject to the new rule, form and disclosure requirements, except for the asset-level disclosure and reporting requirements, on November 23, 2015.
- Registered offerings of ABS backed by residential mortgages, commercial mortgages, auto loans, auto leases, or debt securities (including securitizations)<sup>1</sup> will become subject to the asset-level disclosure and reporting requirements on and after November 23, 2016.
- Any Form 10-D or Form 10-K report filed after November 23, 2015, including those relating to legacy transactions, must comply with the new reporting requirements, except for asset-level reporting.

In this Client Alert, we provide a brief overview of the key reforms under Regulation AB II, followed by a more focused review of the next compliance hurdle that ABS issuers will face — annual compliance checks to determine continued shelf eligibility.

### Overview of Reforms

#### Offering Process Reforms

**New Forms for Registered ABS Offerings:** Forms S-1 and S-3 have been replaced with new forms — Forms SF-1 and SF-3 — for registered ABS offerings. ABS offerings that qualify for shelf registration must be registered on Form SF-3 and all other ABS offerings must be registered on Form SF-1.

**New Standards for Shelf Eligibility:** The prior investment grade rating requirement for ABS shelf eligibility has been replaced with four new transaction requirements, intended to encourage issuers to design and prepare ABS offerings with greater oversight and care, and to provide investors with effective tools to address the enforceability of repurchase obligations and help overcome collective action problems.

The new transaction requirements involve the filing of a CEO certification and the filing of transaction agreements that contain prescribed asset review, dispute resolution, and

investor communication provisions in connection with each ABS offering.

A new registrant requirement has also been added regarding compliance with these new transaction requirements by the depositor and its affiliates during a 12-month look-back period immediately preceding the filing of the registration statement.

We have included an At-a-Glance Summary of these revised ABS shelf eligibility criteria as [Attachment A](#) to this Client Alert.

**Ongoing Access to Effective Shelf:** ABS issuers are now required to conduct an annual compliance check to determine whether the registrant requirements have been satisfied during a 12-month look-back period immediately preceding the date of the compliance check and, therefore, whether the issuer remains eligible to conduct takedowns off its effective shelf registration statement. The compliance check must be conducted as of 90 days after the end of the depositor’s fiscal year end. For a depositor with a calendar year end fiscal year end and that already has an effective SF-3 shelf registration statement, its first annual compliance check will be next month, on March 30, 2016.<sup>2</sup>

**Integrated Prospectus:** ABS issuers must include an integrated “form of” prospectus in their shelf registration statements and must prepare an integrated prospectus at the time of each takedown, thereby eliminating the practice of preparing a base prospectus and a prospectus supplement.

**Investor Review Period:** ABS issuers using shelf registration must file a complete preliminary prospectus at least three (3) business days prior to the first sale of securities in the offering, and must file a supplement to the preliminary prospectus highlighting any material changes at least 48 hours prior to first sale.

**48-Hour Rule:** Under amended Exchange Act Rule 15c2-8 — the “48-hour rule” — broker-dealers must deliver a preliminary prospectus at least 48 hours before the sending of confirmations of sale. This requirement applies to both shelf and non-shelf ABS offerings.

**Pay-as-You-Go (PAYG) Registration Fees:** The final rules permit, but do not require, ABS issuers to pay registration fees as securities are offered off of their shelf registration statements, as opposed to paying all fees upfront at the time their shelf registration statements are filed. PAYG fees are due at the time the preliminary prospectus is filed.

**Accelerated Filing Deadlines for Transaction Agreements:** The final rules accelerate the filing deadline for final transaction agreements in connection with shelf takedowns — to no later than the date the final prospectus is required to be filed.

## Disclosure Reforms

**Asset-Level Information for Certain Asset Classes:** The final rules require asset-level information in the prospectus and in ongoing reports in a standardized, tagged format for ABS backed by residential mortgages, commercial mortgages, auto loans, auto leases, and debt securities (including resecuritizations).

**Other Disclosure Reforms:** The SEC adopted a series of other discrete but important disclosure reforms, including:

- In cases where the sponsor or its affiliates have originated less than 90% of an asset pool, identification of each other asset originator.
- Disclosure of financial information relating to any party with a repurchase obligation if there is a material risk that the party’s financial condition could

affect its ability to repurchase and thereby adversely impact the asset pool or the ABS.

- Disclosure of information about the economic interest in the transaction retained by a sponsor, a servicer, a 20% originator, or any of their affiliates.
- Disclosure of statistical information regarding whether pool assets were originated in conformity with (or as exceptions to) disclosed underwriting/origination criteria, or modified after origination.
- Disclosure intended to increase the clarity, transparency, and comparability of static pool information, some of which applies to all issuers and others of which apply only to amortizing asset pools.

## Ongoing Reporting Reforms

### Annual Reports on Form 10-K:

- Codification of an existing SEC staff interpretation relating to servicing participants’ reports on assessment under Item 1122 of Regulation AB. The staff interpretation, codified in new servicing criterion 1122(d)(1)(v), applies in cases where information obtained in the course of performing the servicing participant’s duties is required by another transaction party in order to complete its duties under the transaction agreements — the so-called “link-in-the-chain” scenario. In those cases, the new servicing criterion requires an assessment that the information conveyed is accurate and, if applicable, that the aggregation of the information is mathematically accurate.
- Where a material instance of non-compliance (MINC) with one or more servicing criteria has been identified in a servicing participant’s Item 1122 report, the ABS issuer must disclose in the body of its Form 10-K report (i) whether it has been determined that the MINC involved servicing of the pool assets that are the subject of the Form 10-K report and (ii) whether steps have been taken to remedy the MINC.

### Distribution Reports on Form 10-D:

- Requiring disclosure in Form 10-D reports regarding material changes in the sponsor’s or an affiliate’s interest in the ABS transaction during the related

reporting period, whether due to purchase, sale, or other transfer of the ABS (but not pledges).

- Requiring pool-level delinquency reporting in Form 10-D reports to be presented in 30-day increments for not less than 120 days.

## The Next Compliance Hurdle

### Annual Compliance Checks to Determine Eligibility to Conduct Further Shelf Takedowns

Prior to Regulation AB II, once a shelf registration statement was declared effective, an ABS issuer was not required to reassess its shelf eligibility until such time as it filed a new registration statement. As a result, under the previous regulations, an ABS issuer could continue to conduct takedowns off an effective shelf registration statement even if the issuer would not satisfy the eligibility criteria to file a new shelf registration statement at that time.

Under Regulation AB II, an ABS issuer must conduct an annual compliance check to determine whether the registrant requirements specified in Form SF-3<sup>3</sup> have been satisfied during a 12-month look-back period immediately preceding the date of the compliance check and, therefore, whether the issuer remains eligible to conduct takedowns off its effective shelf registration statement. The annual compliance check must be conducted as of 90 days after the end of the depositor's fiscal year end.

The final rules allow a depositor or an issuing entity to cure a deficiency in compliance with the new registrant requirement by subsequently filing the required information and waiting for 90 days, after which the depositor/issuing entity would be permitted to resume takedowns off its effective shelf registration statement. Notably, however, no corresponding mechanism is available to cure deficiencies in compliance with the legacy Exchange Act reporting registrant requirement.<sup>4</sup> In the absence of a cure mechanism, the Regulation AB II adopting release indicates that the related registration statement could not be used for further takedowns for at least one year from the date the depositor or the affiliated issuing entity that had failed to file Exchange Act reports then became current in its Exchange Act reports (assuming all other requirements had also been met).<sup>5</sup>

As has been the case in the past, in the event of a compliance deficiency affecting shelf eligibility, a depositor or an issuing entity could appeal to the SEC staff in writing to request that the staff confirm that it would raise "no objection" if the

depositor/issuing entity were to proceed to file a shelf registration statement, or were to resume takedowns off an effective shelf registration statement, sooner than it would otherwise qualify to do so. The staff's willingness to confirm "no objection" would, of course, depend on the totality of the surrounding facts and circumstances.

The Regulation AB II adopting release includes narrative illustrations of the impact of a deficiency in compliance with the new registrant requirement on shelf eligibility. Specifically, the SEC describes two hypothetical scenarios — one where the ABS issuer does not cure the compliance deficiency and the other where the issuer does cure the deficiency — and the differing impacts of the two scenarios on shelf eligibility.<sup>6</sup>

We have included graphical illustrations of the SEC's "no cure" and "cure" scenarios in [Attachment B](#) to this Client Alert.

The SEC's new rule achieves its intended results in cases where the ABS issuer is able to accurately determine whether any compliance deficiencies exist as of the compliance check date. The more challenging question arises in cases where the issuer undertakes its annual compliance check in good faith, has a reasonable basis to believe that it passed the compliance check, proceeds to conduct one or more additional shelf takedowns, but facts subsequently surface that lead the issuer to conclude that, despite its earlier diligence and beliefs, the issuer actually failed the compliance check.<sup>7</sup>

The SEC's new rule does not squarely address the situation outlined immediately above. Instead, the new rule simply indicates that "... requirements as to proper form ... will have been violated for any offering of securities where the [ABS issuer fails its annual compliance check] as of 90 days after the end of the depositor's fiscal year end prior to such offering."<sup>8</sup> If the same situation were to arise in connection with the *initial filing* of a shelf registration statement, long-standing SEC rules direct that, so long as the registrant signed the registration statement (and, in so doing, certified that it had reasonable grounds to believe that it met all of the requirements for filing on that registration form), the registration statement "... is deemed filed on the proper registration form unless the [SEC] objects to the registration form before the effective date."<sup>9</sup> In effect, therefore, the SEC applies a more stringent standard for shelf eligibility at the time of each annual compliance check than it does at the time the shelf registration statement is initially filed.

Absent more and favorable guidance on this topic from the SEC, questions regarding satisfaction of requirements as to

proper form will in many cases depend on whether the ABS issuer is able to accurately determine whether any compliance deficiencies exist as of the compliance check date. This, in turn, leaves open the possibility that, in cases where the issuer has been diligent and has a reasonable basis to believe that it passed its annual compliance check, but facts subsequently surface that call that conclusion into question, requirements as to proper form may also be called into question for any takedowns conducted in the intervening period of time.

## For More Information

If you would like further information concerning the matters discussed in this article, please contact Michael H. Mitchell or the Chapman attorney with whom you regularly work:

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- 1 Resecuritized ABS that were issued prior to the compliance date for the asset-level disclosure and reporting requirements are exempted from these requirements.
- 2 Note that, because this annual compliance check must be conducted as of 90 days after the end of the depositor's fiscal year end, the precise date for the compliance check may vary slightly from one year to the next. 2016 is a leap year, which will impact this 90-day computation for a depositor with a calendar-year-end fiscal year end.
- 3 We have included an At-a-Glance Summary of these registrant requirements in [Attachment A](#) to this Client Alert.
- 4 This legacy Exchange Act reporting registrant requirement requires that the depositor and the issuing entities previously established by the depositor or its affiliates be current and timely in their Exchange Act reporting. As a general matter, an entity will be treated as current and timely in its Exchange Act reporting unless the report(s) in question are "materially deficient." See, e.g., SEC Compliance and Disclosure Interpretation 115.02.
- 5 See the Regulation AB II adopting release, Section V.B.3.(c)(1)(a). *But see*, SEC Compliance and Disclosure Interpretation (CD&I) 115.03, which indicates in the context of Form S-3 that the Exchange Act reporting registrant requirement applies only to Exchange Act reports required to be filed during the related 12-month look-back period. Under the CD&I, it would seem that, assuming the ABS issuer was otherwise eligible, the related registration statement should be available for further takedowns at such time as the ABS issuer has filed all Exchange Act reports required to be filed for 12 consecutive calendar months (regardless of whether and, if so, when it filed Exchange Act reports that were due before that 12-month look-back period).
- 6 See the Regulation AB II adopting release, Section V.B.3.(c)(2)(c).
- 7 This could occur, for example, in a case where the ABS issuer's policies and procedures were sufficient to provide the issuer with a reasonable basis to believe, but not to guarantee, that it had satisfied the registrant requirements. It could also occur in a case where the ABS issuer was dependent on another transaction participant, such as an unaffiliated servicer, for information necessary to satisfy the issuer's Exchange Act reporting requirements, but the unaffiliated transaction participant's policies and procedures were not sufficient to assemble or convey the necessary information to the issuer in a timely fashion.
- 8 See Securities Act Rule 401(g)(4).
- 9 See Securities Act Rule 401(g)(1).

## Chapman and Cutler LLP

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To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

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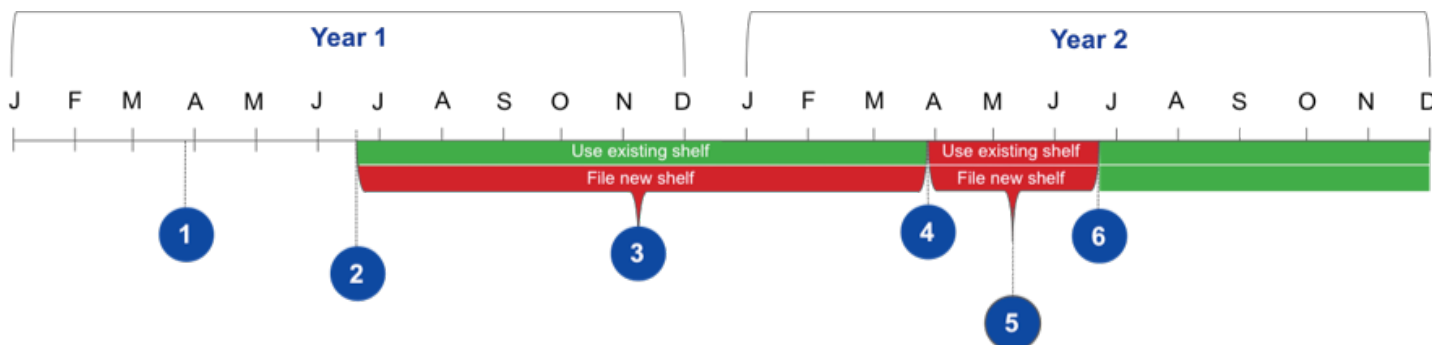
**At-A-Glance Summary:  
Revised Eligibility Criteria for ABS Shelf Offerings**

Transaction Requirements	Registrant Requirements
<b>Current requirements previously located in Form S-3 and carried over to Form SF-3:</b>	
<p><b>Delinquent-Asset Test.</b> Delinquent assets &lt; 20% of asset pool, as measured by dollar volume as of a specified measurement date.</p> <p><b>Residual-Value Test.</b> In the case of lease-backed ABS, the portion of the securitized pool balance attributable to the residual value of the leased assets &lt; 65% of the securitized pool balance (in the case of motor vehicles) or &lt; 20% of the securitized pool balance (in the case of all other leased assets), as measured by dollar volume as of a specified measurement date.</p>	<p><b>Exchange Act Reporting.</b> To the extent the depositor or any issuing entity previously established by the depositor or its affiliates is or was at any time during the twelve-month look-back period immediately preceding the filing of the registration statement required to file Exchange Act reports with respect to a class of ABS involving the same asset class, such depositor and each such issuing entity must have filed all material required to be filed regarding such ABS, and such material, other than specified reports on Form 8-K, must have been filed in a timely manner.</p>
<b>New transaction requirements adopted in place of investment-grade credit rating requirement:</b>	
<p><b>CEO Certification.</b> The CEO for the depositor must make certain certifications for each ABS shelf offering to the effect that, among other things, (i) the prospectus is materially accurate and not misleading and (ii) the securitization is structured, but not guaranteed, to produce expected cash flows at times and in amounts to service scheduled or required payments or distributions on the registered ABS. The exact form and content of these certifications is set forth in the final rules.</p> <p><b>Asset Review Provision.</b> The transaction agreements for each ABS shelf offering must include provisions appointing an independent asset representations reviewer, with access to any relevant underlying documents (i) to review assets for compliance with the reps/warranties included in the underlying transaction agreements (but not to determine whether noncompliance constitutes a breach of any contractual provision), which review would be required upon the occurrence of certain triggering events, and (ii) to provide a report of its findings and conclusions to the trustee.</p> <p><b>Dispute Resolution Provision.</b> The transaction agreements for each ABS shelf offering must set forth dispute resolution procedures — mediation or third-party arbitration (at the option of the party making a repurchase request) — to address assets not repurchased within 180 days of a repurchase request.</p> <p><b>Investor Communications Provision.</b> The transaction agreements for each ABS shelf offering must provide for the reporting of requests by investors to communicate with other investors in connection with the exercise of their rights under the terms of the ABS.</p>	<p><b>Registrant Requirement Relating to Compliance with New Transaction Requirements.</b> To the extent the depositor or any issuing entity previously established by the depositor or its affiliates is or was at any time during the twelve-month look-back period immediately preceding the filing of the registration statement required to comply with the new transaction requirements, with respect to a previous ABS offering involving the same asset class, then such depositor and each such issuing entity must have timely filed:</p> <ul style="list-style-type: none"> <li>▪ All CEO certifications; and</li> <li>▪ All transaction agreements containing the required asset review provisions, dispute resolution provisions and investor communication provisions.</li> </ul> <p><i>Cure provision:</i> If any such depositor or issuing entity fails any portion of this new registrant requirement, the requirement will be deemed satisfied 90 days after all delinquent certifications and transaction agreements have been filed.</p>

Graphical illustrations of the impact of a deficiency in compliance with the new registrant requirement on shelf eligibility (adapted from the SEC's narrative illustrations in the Regulation AB II adopting release).

### I. Annual Compliance Check (No Cure Scenario)

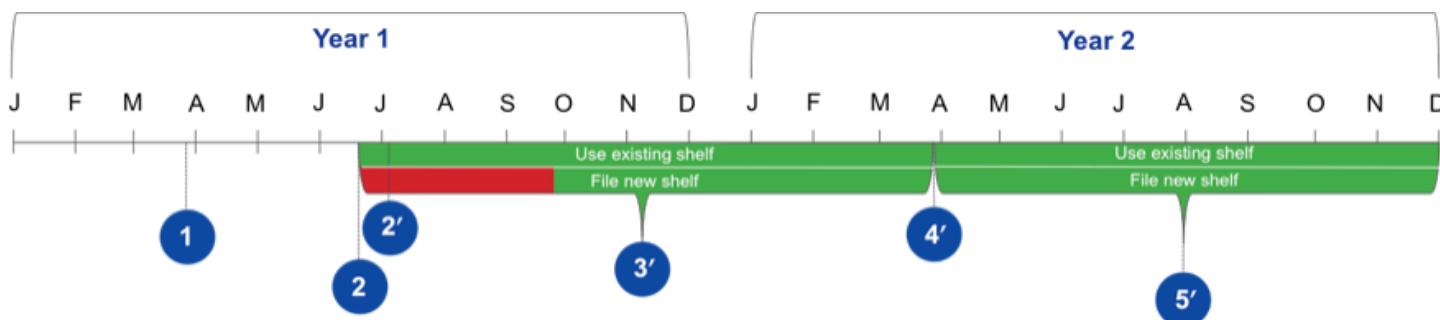
Assumes a depositor with a December 31 fye and an effective shelf registration statement.



- 1 **March 30 of Year 1:** Annual Compliance Check. **OK**
- 2 **June 20 of Year 1:** Depositor conducts ABS takedown, but does not file related transaction agreements.
- 3 **June 20 of Year 1 – March 30 of Year 2:** Depositor can continue to use existing shelf until it is required to perform its next annual compliance check, but would no longer be able to file a new shelf for a year.
- 4 **March 30 of Year 2:** Annual Compliance Check. **⊗**
- 5 **March 30 of Year 2 – June 20 of Year 2 (1 year after agreements should have been filed):** Depositor would not be able to use existing shelf and would not be able to file a new shelf.
- 6 **June 20 of Year 2:** Depositor would again be able to file a new shelf and, based on the adopting release, may be able to resume using existing shelf.

## II. Annual Compliance Check (Cure Scenario)

Assumes a depositor with a December 31 fye and an effective shelf registration statement.



- 1 **March 30 of Year 1:** Annual Compliance Check. **OK**
- 2 **June 20 of Year 1:** Depositor conducts ABS takedown, but does not timely file related transaction agreements that day.
- 2' **July 1 of Year 1:** Depositor cures deficiency by filing delinquent transaction agreements.
- 3' **June 20 of Year 1 – March 30 of Year 2:** Depositor can continue to use existing shelf until it is required to perform its next annual compliance check, and would be able to file a new shelf 90 days after July 1 (i.e., September 29 of Year 1).
- 4' **March 30 of Year 2:** Annual Compliance Check. **OK**
- 5' **March 30 of Year 2 – March 30 of Year 3:** Depositor can continue to use existing shelf until it is required to perform its next annual compliance check and, assuming it continues to meet shelf eligibility criteria, would be able to file a new shelf.