

# Presentation to Mortgage Bankers Association

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## **Liability Provisions – MBS Issuer Perspective**

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# Speaking Today

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# Disclosure Liability

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- For all ABS, the “issuer” is deemed to be the depositor, acting in its role as depositor to the specific issuing entity that issues the ABS
  
- 1933 Act Section 11 liability (damages) for errors or omissions, or for omitting Reg AB required disclosure, in the registration statement and prospectus falls on:
  - Issuer (depositor) - with no diligence defense
  - Controlling persons of issuer (depositor) – with defenses
  - Underwriters – with diligence defense
  - Certain officers, directors and experts
  - Does not fall on 3rd parties (servicers, originators etc.)

# Disclosure Liability *(continued)*

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- 1933 Act Section 12 liability (rescission) for errors or omissions, in the prospectus or in any free writing prospectus (FWP) material, falls on:
  - Sellers (underwriters) – with diligence defense
  - Issuer (depositor) and controlling persons – with diligence defense, as to:
    - Entire prospectus
    - “Issuer information” in FWP – generally includes information about originators, servicers, trustees and credit enhancers
  - Does not fall on third parties (servicers, originators etc.)

# Reg AB Required Third Party Disclosure

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- The following may be required in the prospectus, and may appear in any FWP:
  - **Item 1105** - Static pool information (may be required as to a third party seller)
  - **Item 1108** – Servicers
    - Master, affiliate, 20%+: full disclosure
    - 10% - 20% non-affiliate: identify only
  - **Item 1109** - Trustees
    - All
  - **Item 1110** – Originators
    - 20%+: full disclosure
    - 10% - 20%: identify only

# Reg AB Required Third Party Disclosure

*(continued)*



- **Item 1114** - Credit enhancers
  - 20%+: full disclosure and financials
  - 10% - 20%: limited financial info and narrative
  
- **Item 1115** - Derivatives counterparties
  - 20%+: full disclosure and financials
  - 10% - 20%: limited financial info and narrative
  - All: narrative
  
- **Item 1117** - Legal Proceedings
  
- **Item 1119** - Affiliations and certain relationships
  
- Criteria for whether required are generally clear (except as to third party SPI)
  
- In a rent-a-shelf transaction, the seller may also provide the description of the mortgage loans, and generally would assume responsibility for that section.

# Is Third Party Seller SPI Required?

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- In all transactions, the sponsor will include SPI of its own prior securitizations or vintages, to the extent material
  
- There are a number of reasons for which a sponsor may determine that it does not need to provide static pool information of a third party seller or originator, which may include:
  - Originator is a “qualified correspondent” under the ASF model provisions, and therefore is not considered to be the originator
  - Loans were re-underwritten at the time of purchase to the sponsor’s underwriting standards, therefore SPI of originator or seller is not material.
  - Loans were selected for inclusion in the asset pool by the sponsor using selection criteria that cause the loans to not be representative of the originator or seller’s loans generally, thus their SPI is not material.

## Is Third Party Seller SPI Required? *(continued)*

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- Loans of a particular seller or originator are not a significant enough portion of the pool for the originator or seller's SPI to be material (Reg AB does not specify a threshold for this purpose, but some sponsors use thresholds ranging from 20% on up).
- Loans are generic and plain vanilla, therefore investors consider the specific originator to be fungible, thus the originator's SPI is not material.
- SPI relates to pools formed prior to 1/1/06, or vintages for periods prior to 1/1/06, and is excludable under Item 1105(f), because it is not known to the depositor and is not obtainable by the depositor without unreasonable effort or expense.
- SPI is excludable under Rule 409, because it is not known to the depositor and is not reasonably available to the depositor, either because i) it is not obtainable by the depositor without unreasonable effort or expense, or ii) it is held exclusively by persons not affiliated with the depositor who did not provide the information upon request made by the depositor.

# Relying on Third Party Disclosure

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- Issuers and underwriters may protect themselves from liability for disclosure provided by 3rd party transaction participants by means of:
  - Diligence –
    - Contractual representations and warranties as to no errors or omissions
    - Officer's certificates
    - Due diligence procedures (diligence calls, on sites)
    - Outside counsel 10b-5 letter
    - Outside counsel opinion as to compliance with Reg AB requirements
  - Indemnification –
    - Contractual agreement to cover liabilities caused by errors or omissions in the third party's disclosure section
    - Contribution rights if indemnification is not available
  
- Extent to which the above are actually provided in practice by various types of third party participants varies significantly

# 1934 Act Reporting

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- Along with Regulation AB the SEC adopted new reporting requirements for ABS including the following highlights:
  - 1934 Act reporting at a minimum is required during the year of issuance, plus a Form 10-K after the year of issuance
  - **Form 10-D:** Monthly distribution report
    - Updated Item 1117 (legal proceedings)
    - Updated financial information for credit enhancers and derivatives counterparties
  - **Form 8-K:** Used to report specified reportable events
    - Third party related reportable events include:
      - changes in material agreements,
      - bankruptcy
      - change of servicer (master, affiliated or 10%+) or trustee
      - change in credit enhancement

# 1934 Act Reporting *(continued)*

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- **Form 10-K:** Annual report
  - Updated Item 1117 (legal proceedings)
  - Updated Item 1119 (affiliations and certain relationships)
  - Updated financial information for credit enhancers and derivatives counterparties
  - Item 1122 - Assessment of Compliance and Attestation Report (all persons participating in the servicing function unless 5% or less)
  - Item 1123 – Servicer Compliance Statement (master, affiliated or 10%+)
  
- Securitization documents frequently use a chart that indicates which parties are contractually obligated to provide required information and reports

# 1934 Act Reporting and Form S-3 Eligibility

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- In order for a depositor to use a Form S-3 registration statement for ABS, the following requirements must have been met as of the date of initial filing of that registration statement:
  - For the period of 12 full calendar months plus portion of any month preceding the date of initial filing (“testing period”),
  - The depositor and any issuing entity established by the depositor or any affiliated depositor, as to any ABS backed by the same asset type,
  - Must have filed all reports and other materials that were required to be filed under the 1934 Act during the testing period,
  - And such filing must have been timely (except as to limited Form 8-K reportable events)
  
- Timely filing by the end of any 15 day extension period (Rule 12b-25) satisfies the requirement.
  
- Failure to include any required material, such as an assessment of compliance, would violate the eligibility requirement.
  
- A mere mistake in the reports or other material filed would not violate the eligibility requirement.

# 1934 Act Reporting and Form S-3 Eligibility

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- ❑ If at the time of filing of a Form S-3 registration statement, a failure to comply with a 1934 Act reporting requirement had occurred during the testing period, then the depositor must apply to the SEC for a waiver of the violation, which must be granted before the shelf can be used. (The shelf can be filed prior to obtaining the waiver, if the violation is mentioned in the filing.)
- ❑ A failure to comply with a 1934 Act reporting requirement after the filing of the registration statement will not affect the ability to use the registration statement, once effective.
- ❑ However, discovery after the registration statement is effective of a previous failure to comply that occurred during the testing period, would impair the ability to use the registration statement, until the violation is waived.
- ❑ Depositor is dependent on third parties for updated disclosure, notification of reportable events, and required assessments of compliance, attestation reports, and compliance statements.
- ❑ SEC has indicated that its attitude about granting waivers for noncompliance caused by third party's failure to provide reports or information, will depend in part on whether depositor reasonably relied on that 3rd party (the "one dog bite" rule).

# S-Ox Certification

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- The form of required Sarbanes-Oxley certification required with the Form 10-K report has been revised by Regulation AB (generally effective with Form 10-K filings beginning in 2007)
  
- The new form of S-Ox certification must generally state:
  - The signer has reviewed the Form 10-K and all reports on Form 10-D
  - Based on signer's knowledge, those reports taken as a whole do not contain any error or omission
  - Based on signer's knowledge, all information required to be provided under Form 10-D has been provided
  - Based on signer's knowledge and the Item 1123 servicer compliance statements, the servicer(s) have fulfilled their obligations under the servicing agreements, and
  - All Item 1122 assessments of compliance and attestation reports that are required to be included in the Form 10-K have been included as exhibits, except as disclosed in the Form 10-K, and the Form 10-K discloses any material instances of non-compliance disclosed in those reports.

## S-Ox Certification *(continued)*

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- ❑ The S-Ox signer is not required to assert the accuracy of any servicer compliance statements, assessments of compliance or attestation reports
  
- ❑ Determining which entities are required to provide an assessment of compliance is critically important.
  
- ❑ The Form 10-K and S-Ox certification must be signed by either
  - The senior officer in charge of securitization of the depositor, or
  - The senior officer in charge of the servicing function of i) the servicer, or ii) the master servicer if there are multiple servicers

# 1934 Act Report and S-Ox Liability

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- A person who signs a false certification included in a Form 10-K or other 1934 Act report can potentially be subject to liability under the following provisions:
  - Private action under Rule 10b-5 and certain sections of the 1934 Act,
  - SEC enforcement action under certain sections of the 1934 Act,
  - Civil liability under Sections 11 or 12 of the 1933 Act, if the report is incorporated by reference into the registration statement, and
  - Criminal penalties under Section 32(a) of the 1934 Act.
  
- Note that the criminal penalties imposed under Section 906 of Sarbanes-Oxley do not apply to 1934 Act reports, unless they contain “financial statements.”

# Questions?

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- Feel free to contact:

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