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Current Topics in the Power and Energy Capital Markets

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# Amendments to Regulation AB and Other Exchange Act Rules Impacting Dedicated Utility Rate Asset-Backed Bonds

The Securities and Exchange Commission (the "SEC") adopted three new sets of rules implementing changes to regulations affecting issuances of asset-backed securities ("ABS"). The rules have been adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The first set of these rules (known as "Regulation AB II"), adopted in August 2014, revises the disclosure requirements and offering process for registered ABS transactions.[1] A second set of regulations, adopted on the same day as Regulation AB II, addresses credit rating agencies and third-party due diligence reports prepared in connection with ABS transactions.[2] Finally, in October 2014, the SEC adopted "skin-in-the-game" rules to implement credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, as amended (the "1934 Act")[3] for certain sponsors of ABS.[4]

These new rules will affect all ABS registered public offerings. At this time, the SEC has exempted Rule 144A transactions under the Securities Act of 1933, as amended (the "1933 Act"),[5] from the requirements of Regulation AB II, but the SEC noted that it may revisit this decision at a later date.[6] In addition, the

[1] See Asset-Backed Securities Disclosure and Registration, Release Nos. 33-9638; 34-72982.

[2] See Nationally Recognized Statistical Rating Organizations, Release No. 34-72936.

[3] *Available at* https://www.sec.gov/about/laws/sea34.pdf.

[4] See Credit Risk Retention, Release No. 34-73407. The Credit Risk Retention Rules were adopted jointly by the SEC and the following federal agencies: the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the Federal Housing Finance Agency; and the Department of Housing and Urban Development.

[5] *Available at* http://www.sec.gov/about/laws/sa33.pdf.

[6] See Release Nos. 33-9638; 34-72982 at 29.

credit rating agency and third-party due diligence reports rules will not apply to unregistered offerings by municipal issuers and certain "offshore" transactions.[7] While these new rules impose a considerable number of new disclosure and procedural requirements for ABS offerings, some of the more onerous regulations are generally not applicable to dedicated utility rate bonds.

*(a) Regulation AB II*

Before addressing the new requirements that may affect dedicated utility rate bonds, it is important to note that one of the more significant changes to ABS public offerings from Regulation AB II—the requirement to disclose asset-level information—does not apply to offerings of dedicated utility rate bonds. The asset-level information rule (effective November 23, 2016) will apply only to ABS registered transactions backed by residential mortgage loans, commercial mortgage loans, auto loans or lease resecuritizations of ABS transactions backed by any of these asset types, and debt securities.[8]

The 2010 release that proposed the new rules specifically excluded ABS transactions backed by stranded costs from the proposed asset-level information requirement. The 2010 proposing release referred to transition property and system restoration property as the underlying assets for stranded cost ABS. The SEC reasoned that because the underlying assets for stranded cost ABS are not originated on a customer-by-customer basis and are instead the right to impose charges on customers based on electrical usage, the SEC did not believe it was appropriate to require asset-level data be provided for stranded cost ABS.[9] While the 2010 proposing release did not specifically include a discussion of the underlying assets of other types of dedicated utility rate bonds such as bonds backed by environmental recovery property, investment recovery property or rate-stabilization property, the SEC did refer to the type of property that is "usually created by the action of state legislature or other designated authority" and that such property includes a "right and interest to impose, collect and receive charges payable by electric customers in a particular territory" and "usually provides that a designated state authority may periodically adjust the charges billed to customers."[10] The traits highlighted by the SEC in the 2010 proposing release when establishing the exclusions for stranded cost ABS are traits generally shared by dedicated utility rate bonds.

(i) New Regulation AB Registration Statement Requirements

The most significant change resulting from Regulation AB II for issuers of dedicated utility rate bonds will be new forms of registration statements. For registration statements that become effective after November 23, 2015, issuers of ABS will be required to use the new ABS registration forms, Form SF-1 and Form SF-3.

The new forms are based largely on existing Forms S-1 and S-3. Pursuant to Regulation AB II, ABS offerings that qualify for shelf registration will be registered on Form SF-3 and all other ABS offerings will be registered on Form SF-1. To qualify for shelf registration, ABS offerings must meet certain shelf eligibility registrant requirements and new transaction requirements. The transaction requirements include: 1) a certification, at the time of each offering or takedown, by the chief executive officer ("CEO") of the depositor concerning the accuracy and adequacy of the disclosure; 2) a provision in the underlying transaction documents requiring a third-party review of the assets for compliance with the representations and warranties upon the occurrence of a specified level of defaults and a subsequent security holder action; 3) a provision in the underlying transaction agreements requiring repurchase request dispute resolution; and 4) a provision in the underlying transaction agreements obligating the issuer to disclose in a Form 10-D a request by an investor to communicate with other investors. These new transaction

[7] See Release No. 34-72936, instructions (e) and (f) to Rule 15Ga-2 at 650.

[8] Although "debt securities" is not specifically defined in the adopting release, the 2010 proposing release referred to this asset class as "Corporate Debt." See Release No. 33-9638 at 55.

[9] See Release No. 33-9117; 34-61858 at 127-128.

[10] See Release No. 33-9117; 34-61858 at 127.

requirements replace the previous Form S-3 investment grade rating requirement and are not required by the new Form SF-1.[11]

Form SF-3 also has two registrant requirements. First, similar to Form S-3, the depositor, each issuing entity and any affiliate of the depositor that is or was at any time during the 12-month period prior to the date of filing of the registration statement a registrant with respect to a previous offering of ABS of the same asset class must have timely filed all required 1934 Act reports. Second, new requirements have been added that the depositor, each issuing entity and any affiliate with respect to the same asset class must have timely filed all required CEO certifications described above and all transaction documents containing the required asset review, dispute resolution and investor communications requirements described above during the preceding 12 months (and any stub period). Failure to provide the CEO certifications or transaction documents can be cured 90 days after the date the registrant makes all required filings.[12] An annual evaluation of the two registrant requirements is also imposed on registrants.[13]

(ii) New Regulation AB II Prospectus Requirements

In addition to the new registration statement forms for ABS public offerings, Regulation AB II creates new prospectus requirements for shelf registration statements. New Rule 430D and an instruction to Form SF-3 require ABS issuers to file a single preliminary prospectus (without supplements) under new Rule 424(h) for each takedown from a shelf registration statement. The changes eliminate the traditional use of a base prospectus and prospectus supplement for registered ABS shelf transactions.[14] The new 424(h) preliminary prospectus must be filed with the SEC at least three business days prior to the first sale of securities in the offering.[15] In addition, should there be any material change to the information contained in a preliminary prospectus, such changes must be filed with the SEC at least 48 hours before the date and time of the first sale.[16] The three-day waiting period should not significantly change the current marketing practices for dedicated utility rate bonds because the current practice is to have a "pre-marketing" period during which time the preliminary prospectus is available for investors to review.

(iii) Filing Requirements of Final Documents as Exhibits

In the 2010 proposing release, the SEC originally proposed that all required exhibits, including final versions of transaction documents such as indentures, servicing agreements and other related documents, be filed and made part of the registration statement on Form SF-3 by the date the final prospectus is required to be filed pursuant to Rule 424.[17] In response to comments received, in a 2011 release, the SEC modified the proposal to require the documents be filed in substantially final form by the date the preliminary prospectus is required to be filed.[18] Responding to further comments, the final rule, as adopted, reverts back to the 2010 proposal and requires exhibits with respect to an ABS offering on Form SF-3 to be on file and made part of the registration statement by the date the final prospectus is filed.

One proposed rule change that was not adopted was to require that investors be provided with blacklines of how the issuer's representations and warranties compare against the industry-developed models or

[11] See Release Nos. 33-9638; 3472982 at 629 – 640.

[12] See Release Nos. 33-9638; 3472982 at 416.

[13] See New Rule 401(g)(4), Release Nos. 33-9638; 3472982 at 413.

[14] See Release Nos. 33-9638; 3472982 at 21.

[15] See Release Nos. 33-9638; 3472982 at 314.

[16] See Release Nos. 33-9638; 3472982 at 318.

[17] See Release No. 33-9117 at 247.

[18] See Release Nos. 33-9638; 3472982 at 444.

blacklines of how the transaction documents compare to the transaction documents from prior transactions or from prior versions of the transaction documents that had previously been filed.

(iv) Additional Regulation AB II Prospectus Disclosure Requirements

Regulation AB II also creates additional prospectus disclosure requirements including: (i) additional disclosure concerning the originators; (ii) the financial condition of parties contractually obligated to repurchase a pool asset for breach of a representation and warranty; (iii) the economic interests maintained in the pool assets by the sponsor, servicers and originators; (iv) disclosure of any transaction agreements governing the modification of pool assets; (v) more detailed disclosure covering static pool information; and (vi) additional instructions concerning the summary section of the prospectus.[19]

* * *

Because of the structure of a typical dedicated utility rate bond transaction, the nature of the underlying assets that back dedicated utility rate bonds and the fact that neither the underlying assets nor the other collateral securing dedicated utility rate bonds is or will be a static pool of assets, compliance with these additional Regulation AB II disclosure requirements should not be too difficult. However, after the new requirements come into effect in November 2015, sponsors of dedicated utility rate bond registered transactions will be faced with new more onerous registration statement forms. As a result, some sponsors might consider public offerings using Form SF-1 (non-shelf) registration statements to avoid the CEO certification requirements or possibly, the use of the Rule 144A market as an alternative to the registered public market.

*(b) Credit Rating Agencies and Third-Party Due Diligence*

New rules for Nationally Recognized Statistical Rating Organizations ("NRSRO") have been adopted, both amending the existing rules and introducing new rules for providers of third-party due diligence services for ABS. The new NRSRO rules apply to issuers and underwriters of both registered and unregistered offerings of rated ABS transactions (absent limited exemptions mentioned below). Included among these new rules is the requirement under Rule 15Ga-2 under the 1934 Act that issuers or underwriters of any NRSRO rated ABS transaction must furnish on EDGAR, five business days prior to the first sale, Form ABS-15G, containing the findings and conclusions of any "third-party due diligence report" obtained by the issuer or underwriter. "Third-party due diligence report" is defined in new Rule 17g-10 under the 1934 Act as any report containing findings and conclusions of any due diligence services performed by a third party. Rule 15Ga-2 applies regardless of whether the third-party due diligence report is made available to, or used by, the NRSRO. Several commentators noted the rule, as initially outlined in the proposing release, could require the public disclosure of agreed-upon procedures ("AUP") letters prepared by accountants. In response to those comments, the SEC specifically exempted AUP letters that (1) recalculate projected future cash flows due to investors or (2) perform procedures that address other information included in the offering documents from the definition of "third-party due diligence report."[20] Rule 15Ga-2 did not, however, exempt AUP letters that compare loan tape to the loan file as had also been requested by commentators. Unregistered offerings by municipal issuers are

[19] See Release Nos. 33-9638; 3472982 at 517 - 531.

[20] See Release No. 34-72936 at 399.

exempt from Rule 15Ga-2.[21] In addition, Rule 15Ga-2 does not apply to certain "off-shore" transactions.[22] These new NRSRO rules take effect June 15, 2015.[23]

*(c) Credit Risk Retention Rule*

The final major rulemaking finalized in the fall of 2014 releases involved risk retention. Otherwise known as "skin-in-the-game," the rule is designed to require sponsors of certain types of ABS to maintain at least a 5 percent economic interest in the credit risk of the securitized assets.[24] The Rule will become effective December 24, 2015, with respect to asset-backed securities collateralized by residential mortgages and December 24, 2016, with respect to all other classes of asset-backed securities.[25] The SEC release adopting new risk retention requirements specifically exempts dedicated utility rate bonds.[26] In order to qualify for the dedicated utility rate securitization exemption, the bonds must be secured by an intangible property right to collect charges for the recovery of specified costs. Such specified costs must be authorized by an irrevocable financing order issued by a local public utilities commission. In addition, the financing order must provide that the utility acquires an intangible property right to charge, collect and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's historic service territory. Lastly, the exemption requires a guarantee that neither the state nor its agencies have the authority to rescind or amend the financing order.[27] For dedicated utility rate bond transactions that use a municipal transaction structure, the Dodd-Frank Act exempts all municipal transactions from any risk retention rule.[28]

*Dedicated utility rate bonds have helped utilities over the last two decades to recover several categories of costs (including stranded costs, storm costs, environmental costs and investment recovery costs) in a fashion that minimizes the rate impact for utility customers and reduces stress on the utility's ongoing rate structure with off-credit (to the utility) financing. Lawyers from Hunton's Power and Energy Capital Markets group have been instrumental in the development of this asset class and have served key roles in a majority of the recent dedicated utility rate bond transactions.*

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[21] Although municipal issuers and underwriters are exempt from the requirement to furnish Form ABS-15G, the SEC notes that municipal issuers or underwriters are nonetheless subject to the statutory requirement and must make publicly available the findings and conclusions of any third-party due diligence report. See Release No. 34-72936, instruction (h) to Rule 15Ga-2 at 650.

[22] See Release No. 34-72936 at 650.

[23] See Release No. 34-72936 at 1 – 2.

[24] See Luis A. Aguilar, Skin in the Game: Aligning the Interests of Sponsors and Investors (Oct. 22, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543250034#.VOPRfy7081U.

[25] See Release No. 34-73407 at 2.

[26] See Release No. 34-73407 at 292.

[27] See Release No. 34-73407 at 292.

[28] 15 U.S.C. § 78o-11(c)(1)(G)(iii)(2014).