Linklaters

Regulation AB and Swap Provider Disclosure: Part 1, The Basics

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About 10 years ago I had occasion to seek guidance from the staff of the United States Securities and Exchange Commission about the appropriate level and kind of disclosure for a swap provider that should be included in a registration statement for asset-backed securities. The answer that came back, in paraphrase, was, "We don't know. We really haven't thought about it enough to tell you our position."

In Item 1115 of the SEC's Regulation AB, published in final form in December 2004, the SEC has taken big strides in coming to grips with swap agreements. Reg AB establishes rules for the scope of disclosure of financial and other information about swap providers in offering documents for registered asset-backed securities. This three-part article describes the basic operation of Item 1115. It then discusses the measurement dates on which the determination of the level of required disclosure needs to be made and some related market practices that have developed under Item 1115.

Item 1115, titled "Certain derivatives instruments," relates to derivatives, such as interest rate and currency swap agreements, that are used to alter the payment characteristics of the cashflows from the issuing entity and whose primary purpose is not to provide credit enhancement related to the pool assets or the asset-backed securities.

In all cases, the depositor will be required to disclose the name of the derivative counterparty, its organizational form, and the general character of its business. The operation and material terms of the derivative instrument, including any limits on the timing or amount of payments or any conditions to payments, must also be described, along with any material provisions regarding substitution of the derivative instrument. These disclosures are all items that were generally disclosed under market practice prior to adoption of Reg AB.

In addition, the depositor will be required to disclose whether the "significance percentage," as calculated in accordance with Item 1115, is less than 10%, at least 10% but less than 20%, or 20% or more. Furthermore, the agreement relating to the derivative instrument must be filed as an exhibit to the registration statement.

If the significance percentage for a swap provider is 10% or more, but less than 20%, the depositor will be required to provide the financial data for the swap provider required by Item 301 of Regulation S-K. This consists of selected financial data for at least the last five fiscal years of the swap counterparty in comparative columnar format.

If the significance percentage is 20% or more, the depositor must provide financial statements for the counterparty meeting the requirements of Regulation S-X, Items 1-01 through 12-29, except for Article

3-05 (financial statements of business acquired or to be acquired) and Article 11 (pro forma financial information) of Regulation S-X. In addition to being disclosed in the registration statement, the financial statements for the counterparty [as required under 240.14a-3(b)] must be filed with the SEC.

The latter requirement essentially means full financial statement disclosure as would be required in a registration statement for the offering of the counterparty's own securities under the U.S. Securities Act of 1933, as amended (the "Securities Act"), or a Form 10-K or the equivalent filing for a foreign issuer under the Exchange Act. In either case, incorporation by reference of already-filed financial statements may be available.

The "significance percentage" will generally be equal to the fraction, expressed as a percentage, that the "significance estimate" represents of the aggregate principal balance of the pool assets. An exception to this rule exists if the derivative instrument relates only to certain classes of the asset-backed securities – in that case, the denominator of the fraction will be the aggregate principal balance of such classes instead.

The "significance estimate" of the derivative instrument is determined based on a reasonable good-faith estimate of "maximum probable exposure," made in substantially the same manner as that used in the sponsor's internal risk management process in respect of similar instruments. Since the only party with access to the sponsor's internal risk management process is the depositor, not the derivatives counterparty, it follows that the estimate is required to be made by the depositor (and not, for example, by the derivatives counterparty).

Next: What is "maximum probable exposure"?