

# Clients & Friends Memo

## SEC Proposes New Rules Regarding Diligence and Disclosure in ABS Offerings

October 26, 2010

As part of what is expected to be a wave of proposed rulemaking under The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"),<sup>1</sup> the Securities and Exchange Commission (the "**SEC**") issued proposed rules to implement the provisions of Section 945 and a portion of Section 932 of the Act (the "**Proposed Rules**"). Section 945 of the Act added Section 7(d) to the Securities Act of 1933, as amended (the "**Securities Act**"), directing the SEC to issue rules requiring an issuer of asset-backed securities ("**ABS**") to perform a review of the assets underlying an ABS offering and disclose the nature of that review. Section 932 of the Act added Section 15E(s)(4)(A) to the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), which requires an issuer or underwriter of ABS to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

### Highlights:

The Proposed Rules would:

- require an issuer of registered (public) ABS to review the assets underlying an ABS offering, either directly or via a third-party;
- require an issuer of registered (public) ABS to disclose the nature, findings and conclusions of such review;
- require an issuer of non-registered ABS and underwriter of both registered and non-registered ABS to file Form ABS-15G with the SEC to disclose the findings and conclusions of any report of a third-party engaged to review the pool assets; and

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<sup>1</sup> Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda, please see *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

- require an ABS issuer to provide additional disclosure regarding assets that deviate from disclosed underwriting criteria (would apply to registered and 144A offerings).<sup>2</sup>

**Discussion:****1. Issuer Required to Review Underlying ABS Assets**

In order to implement the provisions of Section 7(d) of the Securities Act, which was adopted pursuant to Section 945 of the Act, the SEC has proposed Rule 193, which would require issuers of registered ABS to perform a review of the underlying pool assets.

Details of Rule 193:

- (a) Applies Only to Registered Offerings. Rule 193 would apply only to registered offerings.
- (b) Nature of Required Review. The release does not include any information regarding the level or type of review that would be required. Recognizing that the level and type of review would vary based on circumstances and asset type, the SEC is instead relying on the disclosure requirements described below, reasoning that investors could evaluate for themselves whether the issuer's level of review was adequate.<sup>3</sup>
- (c) Persons Required to Perform the Review. The asset review is required to be performed by either:
  - (i) the ABS issuer, which for this purpose would be the depositor or the sponsor; or
  - (ii) a third-party engaged for purposes of performing the review, provided that the third-party is named in the registration statement and consents to being named as an expert in accordance with Rule 436 of the Securities Act. Note that the third-party would thus be subject to liability under Section 11 of the Securities Act.

Note: The SEC requested comments as to what entities should be considered a "third-party engaged for purposes of performing

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<sup>2</sup> Although the proposed requirement would be part of Regulation AB, which mandates disclosure in offering documents for registered offerings, the SEC's proposed revisions to Regulation AB, dated May 3, 2010, would require issuers relying on the safe harbor provided by Rule 144A to make the same information "available" to investors in 144A offerings.

<sup>3</sup> The SEC requested comments as to whether the SEC should mandate a minimum level of review that must be performed. The SEC also asked whether the Proposed Rules should require that the review, at a minimum, provide "reasonable assurance" that the disclosure in the prospectus regarding the assets is accurate in all material respects.

a review” and asked whether it should include accountants that perform agreed-upon procedures or lawyers that provide security interest opinions.

Reviews by unaffiliated originators would not qualify.

- (d) Expanded Scope of ABS. Rule 193 relates to asset-backed securities as defined in new Section 3(a)(77)<sup>4</sup> of the Exchange Act, which is broader than the definition provided in Regulation AB and includes securities typically sold in private transactions such as CDOs.
- (e) Disclosure. The SEC is proposing to revise Item 1111 of Regulation AB by adding clause (a)(7), which would require disclosure regarding (i) the nature of an issuer's or third-party's review of the assets under proposed Rule 193 and (ii) the findings and conclusions of the review.

*Note: Although Item 1111(a)(7) of Regulation AB, as proposed, would only apply to (i) registered offerings and (ii) the narrower definition of ABS that appears in Regulation AB, non-registered offerings and offerings of securities that are ABS within the broader definition that appears in Section 3(a)(77) of the Exchange Act would still be subject to the disclosure requirements discussed below with respect to the findings and conclusions of third-party asset reviews.*

## 2. Disclosure Regarding the Findings and Conclusions of Third-Party Due Diligence Reports

In order to implement the provisions of Section 15E(s)(4)(A) of the Exchange Act, which was adopted pursuant to Section 932 of the Act, the SEC proposed Rule 15Ga-2. This rule would require issuers and underwriters of ABS to file Form ABS-15G disclosing the findings and conclusions of any report of a third-party engaged by an issuer or underwriter to perform a review of pool assets. Unlike Section 7(d) of the Securities Act discussed above, Section 15E(s)(4)(A) is not limited to registration statements and therefore applies to both registered and non-registered offerings.

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<sup>4</sup> “Asset backed security (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including— (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if non of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.” See Section 3(a)(77) of the Exchange Act, as amended by the Act.

## Details of Rule 15Ga-2:

- (a) Types of Reports Covered. The Proposed Rule does not specifically describe the types of third-party reports that would be covered by this Rule, nor does it address the form in which the findings and conclusions may be presented. However, in its request for comments, the SEC noted that the scope of third-party diligence providers is broad enough to include appraisers and engineers but did not address the potential privacy and confidentiality concerns that this rule could raise.

*Note: Although the text of proposed Rule 15Ga-2 addresses reports obtained by an issuer or underwriter, the accompanying release and request for comment refers to findings and conclusions of third-parties that were hired by the issuer or underwriter.*

- (b) Timing. Issuer and/or underwriter would be required to file Form ABS-15G via EDGAR five business days before the first sale in the offering.
- (c) Signature Requirement. Form ABS-15G would need to be signed by the senior officer in charge of securitization of the depositor, if filed by an issuer, or by a duly authorized officer, if filed by an underwriter.
- (d) Issuer Exemption for Registered Offerings. An issuer that complied with the new disclosure requirements of Item 1111(a)(7) of Regulation AB and disclosed the findings and conclusions of any third-party asset review in its prospectus will not be required to file that same information via Form ABS-15G.

*Note: Although an issuer in a registered offering may not need to file a Form ABS-15G, an underwriter that separately hired third-parties to review pool assets would be required to file its own Form ABS-15G.*

- (d) Impact on Private Placements. The SEC indicated that merely filing a Form ABS-15G will not jeopardize reliance on exemptions and safe harbors from registration under the Securities Act as long as (i) the only information made publicly available is that which is required under the Proposed Rule and (ii) the issuer or underwriter does not use the filing to condition the market for sales of the securities.
- (e) Foreign Transactions. ABS issued in the U.S. and offered in a foreign jurisdiction would be subject to Rule 15Ga-2. In addition, ABS issued in a foreign jurisdiction, even if primarily offered to foreign investors, would also be subject to the filing requirements of Rule 15Ga-2 if offers are made in the U.S.

- (f) Expanded Scope of ABS. Rule 15Ga-2 relates to asset-backed securities as defined in new Section 3(a)(77) of the Exchange Act, which is broader than the definition provided in Regulation AB and includes securities typically sold in private transactions such as CDOs.

### 3. Disclosure Regarding Exceptions to Underwriting Criteria

The SEC also re-proposed its proposal to amend Regulation AB disclosure requirements regarding assets that deviate from disclosed underwriting criteria to add the following additional disclosure item:

- the identity of the entity that determined to include such assets in the pool.

The other Regulation AB disclosure items previously proposed remain unchanged and are listed below:

- address how the assets in the pool deviate from the disclosed underwriting standards;
- include data on the amount and characteristics of those assets;
- describe factors that were used to make such determinations (which could include compensating factors); and
- provide data regarding the compensating factors that were considered by the issuer and data on the amount of assets in the pool that met such compensating factors.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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