Clients&FriendsMemo

New Rules for Third-Party Due Diligence Reports for Asset-Backed Securities

September 9, 2014

On August 27, 2014, the Securities and Exchange Commission (the **"SEC"**) adopted final rules[1] (the "**Final Rules**") implementing, among other things, provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the **"Dodd-Frank Act"**) relating to third-party due diligence reports for asset-backed securities[2] ("**ABS**"). As adopted, the Final Rules will require:

(i) issuers and underwriters of rated ABS, whether or not registered with the SEC, to file with the SEC, at least five business days before the first sale in the ABS offering, a Form ABS-15G containing the findings and conclusions of reports of third-parties who have been employed to provide due diligence services,

(ii) third parties who provided due diligence services in connection with ABS offerings to make available to nationally recognized statistical rating organizations ("**NRSROs**"), pursuant to a prescribed form, information regarding the scope of their due diligence services, a summary of their findings and conclusions, and a certification as to the due diligence review, and

(iii) NRSROs to make publicly available in connection with rating actions for ABS offerings the forms furnished by third-party due diligence services providers and referred to in clause (ii) above.

The Final Rules take effect nine months after they are published in the Federal Register.

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[1] For the text of the SEC's Final Rules adopting release (the "**Final Release**"), see http://www.sec.gov/rules/final/2014/34-72936.pdf. The Final Rules adopted in modified form the proposed rules (the "**Proposed Rules**") presented for public comment on May 18, 2011. For the text of the SEC's Proposed Rules release, see http://www.sec.gov/rules/proposed/2011/34-64514.pdf. The Proposed Rules were the subject of a prior Clients & Friends memorandum, dated July 8, 2011, "SEC Proposed Rules Regarding Third-Party Due Diligence Disclosure," available at http://www.cadwalader.com/resources/clients-friends-memos/sec-proposed-rules-regarding-third-party-due-diligence-disclosure.

[2] The portions of the Final Rules analyzed in this memorandum apply to "asset-backed securities" within the meaning of Section 3(a)(79) of the Exchange Act, as opposed to the more limited definition of that term in Item 1101(c) of Regulation AB.

New Rule 15Ga-2 and Amendments to Form ABS-15G

Background

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Securities Exchange Act of 1934 (the **"Exchange Act"**) to require the issuer[3] or underwriter[4] of any ABS to make publicly available the findings and conclusions of any third-party due diligence report[5] obtained by the issuer or underwriter. In the Final Rules, the SEC adopted new Rule 15Ga-2 and amendments to Form ABS-15G to implement this provision of the Dodd-Frank Act.

What Does Rule 15Ga-2 Require?

Rule 15Ga-2 requires any issuer or underwriter of any ABS that are to be rated by an NRSRO to furnish a Form ABS-15G containing the findings and conclusions of *any* third-party due diligence report obtained by the issuer or underwriter, not just third-party due diligence reports made available to NRSROs. Form ABS-15G must be filed at least five business days prior to the first sale[6] in the related offering.[7] The Final Rules clarify that a single Form ABS-15G may be filed when the issuer and/or one or more underwriters obtained the same third-party due diligence reports.[8]

Rule 15Ga-2 Applies to Registered and Unregistered Offerings of ABS

Rule 15Ga-2 applies to both registered and private offerings of ABS. The SEC stated that issuers and underwriters can disclose the information required by Rule 15Ga-2 without jeopardizing their reliance on private placement exemptions and safe harbors, so long as the only information made publicly available on Form ABS-15G is information required by Rule 15Ga-2, and the issuer does

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3 Because the Final Rules define "issuer" for the purposes Rule 17g-10 (implemented by the Final Rules), in the context of the Final Rules, that term includes the sponsor or depositor that participates in the offering of ABS. See Final Release at page 366.

4 For the purposes of the Final Rules, "underwriter" refers to underwriters of both public and private offerings. See Final Release at pages 368-9.

5 A "third-party due diligence report" means any report containing findings and conclusions of any due diligence services (as defined in Rule 17g-10, discussed below) performed by a third-party.

6 The date of first sale in the offering would be the date on which a purchaser first makes an investment decision and commits to purchase the securities offered. See Final Release at page 371, footnote 1431.

7 Form ABS-15G may be electronically filed with the SEC on the EDGAR system, so that all of the publicly filed information relating to an offering will be available in a single, central repository. The SEC noted that it already requires the filing of certain items on the EDGAR system in connection with private issuances.

8 If Form ABS-15G is being filed by the issuer, it must be signed by the senior officer of the depositor in charge of securitization, or if it is being filed by the underwriter, it must be signed by a duly authorized officer of the underwriter.

not otherwise use Form ABS-15G to offer or sell securities in a manner that conditions the market for offers or sales of its securities.

The Final Rule contains limited exclusions from the requirements of Rule 15Ga-2 for offshore transactions[9] and municipal issuer offerings.[10]

Required Content of Rule 15Ga-2 Disclosure

In the Final Release, the SEC rejected comments to the Proposed Rule that would have limited reporting pursuant to Rule 15Ga-2 to the findings and conclusions contained in final third-party due diligence reports. Therefore, the findings and conclusions of third-party due diligence reports contained in any draft or interim reports provided to the issuer and/or the underwriters must also be reported on Form ABS-15G.

In response to one commenter, the SEC also stated that a summary of findings and conclusions was contrary to Congressional intent, as expressed in the Dodd-Frank Act. In addition, the SEC stated that findings and conclusions themselves were required to be made public rather than having an issuer or underwriter summarize those findings and conclusions because a summary runs the risk of excluding information that could be important to a user of credit ratings. In the SEC's view, "users of credit ratings should be able to compare the totality of third-party due diligence information with what was provided to, and used by, an NRSRO, as disclosed under Rules 17g-7 and 17g-10"[11].

> *Note: In its discussion in the Final Release, the SEC stated that disclosure of the findings and conclusions necessarily requires disclosure of the criteria against which the loans were evaluated, and how the evaluated loans compared to those criteria along with the basis for including any loans not meeting those criteria.*[12]

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[9] For the purposes of Rule 15Ga-2, this means an offering that is not required to be, and is not, registered under the Securities Act of 1933 (the "**Securities Act**"), that is not issued by a U.S. person, as defined in Rule 902(k), and in which the securities are offered and sold in transactions that occur outside the United States.

[10] The SEC noted that municipal ABS are still subject to the requirement of Section 15E of the Exchange Act to make publicly available the findings and conclusions of any third-party due diligence report that they obtain, notwithstanding that they are exempted from filing Form ABS-15G. However, the SEC found municipal ABS are not subject to Rule 15Ga-2 because they are subject to a different regulatory scheme. The municipal ABS exclusion applies to issuers and underwriters of an offering of ABS if the issuer is a municipal issuer (as defined in Rule 17g-10), and the offering is not required to be registered under the Securities Act.

[11] See the Final Release at page 375, footnote 1442.

[12] See the Final Release at page 375.

Commenters on the Proposed Rule noted that Rule 193 requires issuers to review the underlying assets included in any ABS offering. This review may be substantially similar to the third-party due diligence services subject to Rule 15Ga-2. To avoid duplicative filings of substantially similar information, Rule 15Ga-2 provides that if the disclosure required by Rule 15Ga-2 has already been included in the prospectus (including an attribution to the third party that provided the due diligence report)[13], and the prospectus is publicly available at the time Form ABS-15G is furnished by the issuer or underwriter, the issuer or underwriter may refer to that section of the prospectus in Form ABS-15G rather than providing the findings and conclusions directly in Form ABS-15G. However, the SEC stated that the issuer and/or underwriter is still required to file Form ABS-15G referring to that information.

> *Note: If the issuer and an underwriter obtain the same third-party due diligence report, and one of them timely furnishes a Form ABS-15G for that report, the other of them would not be required to furnish a Form ABS-15G for the same report.*[14]

The Final Rules also clarify that Form ABS-15G need only be furnished in connection with the initial credit rating, and not with respect to any subsequent ratings actions, such as a ratings downgrade.[15]

New Rule 17g-10: Certifications Required From "Due Diligence Services" Providers

Background

The Dodd-Frank Act also amended Section 15E of the Exchange Act to require that, in any case in which third-party due diligence services are employed by an NRSRO, issuer or underwriter in connection with a rated ABS offering, the person providing the due diligence services provide a written certification to any NRSRO that produces a credit rating to which such services relate. The certification must state that the person has conducted a thorough review of data, documentation and other relevant information necessary for an NRSRO to provide an accurate rating. To implement this provision of the Dodd-Frank Act, the SEC adopted new Rule 17g-10 and a new Form ABS Due Diligence-15E that must be provided by third-party due diligence service providers to any NRSRO that produces a credit rating to which such services relate.

[13] Pursuant to Rule 436, any such third-party would be required to consent to being named as an expert in the related registration statement.

[14] See the Final Release at page 373.

[15] See the Final Release at page 373.

"Due Diligence Services"

As defined in Rule 17g-10, an entity is deemed to have provided "due diligence services" if it engaged in a review of the assets underlying an ABS offering for the purpose of making findings with respect to:

1. the accuracy of the information or data about the assets, provided, directly or indirectly, by the securitizer or originator of the assets;

2. whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria or other requirements;

3. the value of collateral securing the assets;

4. whether the originator of the assets complied with federal, state or local laws or regulations; or

5. any other factor or characteristics of the assets that would be material to the likelihood that the issuer of the ABS will pay interest and principal according to applicable terms and conditions.

The SEC stated in the Final Release that the first four prongs of the definition of "due diligence services" are based upon industry practices with respect to residential mortgaged-backed securities "because due diligence services traditionally have been performed with respect to RMBS"[16]. Although the fifth prong of the definition appears to be very broad, the SEC stated that the "catchall" fifth prong is intended to apply to reviews, current and future, that may cover additional asset classes, such as commercial loans, corporate loans, student loans, or credit card receivables.[17]

Note: There appears to be a disconnect between Rule 15Ga-2, which requires the filing of a Form 15G-ABS in connection with findings and conclusions in a third-party due diligence report obtained by the issuer or underwriter, and Rule 17g-10, which requires

[16] See the Final Rules at page 396.

[17] "While the catchall provision is not being eliminated, the definition of due diligence services in Rule 17g-10 (including the catchall prong) is not intended to bring within the definition's scope activities that are performed today in connection with the issuance of [ABS] that are not commonly understood as being third-party due diligence services. … For example, it is not intended to cover every type of service that involves the performance of diligence in the offering process. The catchall provision is designed to incorporate within the definition reviews that are commonly understood in the securitization market to be third-party due diligence services or analogous services that may develop in the future but are not expressly covered by the first four prongs of the definition." Final Release at page 398.

the delivery to NRSROs of a Form ABS Due Diligence-15E promptly after completion of the due diligence services by the third party. In other words, the obligations under Rule 17g-10 seem to be triggered upon completion of the due diligence services, whether or not a report has been delivered relating to those services.

Implications for AUP Letters

The SEC noted in the Final Release that the first prong of the definition of "due diligence services" includes findings typically covered within the scope of agreed-upon procedures engagement letters that issuers and/or underwriters enter into with accounting firms ("**AUP Letters**"). While the SEC agreed that certain other procedures performed by accounting firms pursuant to typical AUP Letters, such as recalculating projected cashflows and performing procedures that address information included in offering documents, are not intended to be "due diligence services," the SEC stated that one procedure typically reported in AUP Letters, comparing the information on a loan tape with the information contained on the hard-copy documents in a loan file, is an activity that falls under the first prong. The SEC stated that this may necessitate changes to the scope of typical AUP Letters to take into account applicable professional standards. The SEC further stated that the requirements and limitations resulting from relevant professional standards described in those AUP Letters may be included in the written certifications required by third-party diligence services providers on Form ABS Due Diligence-15E.[18]

Note: Although in the discussion of the definition of "due diligence services" in the Final Release, the SEC appears to be focusing on practices that are "commonly understood in the securitization market" to be third-party due diligence services, the broad definition of the term and the explicit application of it to accountants' AUP Letters raises the question as to what other activities by securitization participants or their representatives would constitute "due diligence services."

Non-U.S. Transactions Exempt from the Requirements of Rule 17g-10

Rule 17g-10 does not apply to ABS issuances with obligors or issuers who are non-U.S. persons if the NRSRO has a reasonable basis to conclude that the transactions in the ABS issued by the obligor or the issuer will be effected only outside of the United States. However, the third-party due diligence services provider is still required to deliver an executed Form ABS Due Diligence-15E to any NRSRO that requests it.

[18] The content of Form ABS Due Diligence-15E is discussed below.

Rule 17g-10 "Safe Harbor"

At the time they conclude their services, persons providing due diligence services may not know the identity of NRSROs to which the Form ABS Due Diligence-15E certification must be delivered. To address this concern, the SEC, following the suggestion of many commenters, agreed to include in Rule 17g-10 a "safe harbor" such that if the specified conditions are satisfied, the third-party due diligence services provider will be deemed to have satisfied its obligation to provide the Form ABS Due Diligence-15E under 17g-10. To avail itself of the safe harbor, third-party due diligence services providers must provide an executed Form ABS Due Diligence-15E to:

1. any NRSRO that provided a written request for the form prior to the completion of the due diligence services stating that the services relate to the credit rating the NRSRO is producing;

2. any NRSRO that provides a written request for the form after the completion of the due diligence services stating that the services relate to a credit rating the NRSRO is producing; and

3. the issuer or underwriter of the ABS for which the due diligence services relate that maintains the Rule 17g-5 website with respect to the ABS.

In this way, each NRSRO that is providing a credit rating will have access to the Form ABS Due Diligence-15E, even when an NRSRO is rendering an unsolicited credit rating. It also eliminates the obligation of third-party due diligence services providers to ascertain the identities of every NRSRO producing a credit rating based upon that third-party's due diligence services. To avail themselves of the safe-harbor, third-parties must deliver an executed Form ABS Due Diligence-15E "promptly" after completion of their due diligence services.[19]

New Form ABS Due Diligence-15E

Required Content of New Form ABS Due Diligence-15E

The new Form ABS Due Diligence-15E required to be filed pursuant to Rule 17g-10 requires the following five items:

1. the identity and address of the provider of third-party due diligence services;

[19] Generally, this will be in connection with the issuance of the ABS. However, if any third party is employed by an NRSRO, issuer or underwriter to perform subsequent due diligence services with respect to an issuance, the third party will incur new obligations under Rule 17g-10.

2. the identity and address of the issuer, underwriter, or NRSRO[20] that employed the provider of third-party due diligence services;

3. if the due diligence performed by the third party is intended to satisfy the criteria for due diligence published by an NRSRO, the third-party must identify the NRSRO and the title and date of the published criteria in a table provided in the form;

4. a description of the scope and manner of the due diligence services provided in connection with the review of assets that is sufficiently detailed to provide an understanding of the steps taken in performing the review, including in that description: (i) the type of assets that were reviewed; (ii) the sample size of the assets reviewed; (iii) how the sample size was determined and, if applicable, computed; (iv) whether the accuracy of information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets was reviewed and, if so, how the review was conducted; (v) whether the conformity of the origination of the assets to stated underwriting or credit extension guidelines, standards, criteria or other requirements was reviewed, and if so, how the review was conducted; (vi) whether the value of collateral securing the assets was reviewed and, if so, how the review was conducted; (vii) whether the compliance of the originator of the assets with federal, state, and local laws and regulations was reviewed and, if so, how the review was conducted; and (viii) any other type of review that was part of the due diligence services conducted by the person completing the Form ABS Due Diligence-15E; and

5. a summary of the findings and conclusions that resulted from the due diligence services that is sufficiently detailed to provide an understanding of the findings and conclusions that were conveyed to the person(s) identified in item 2 above.

Required Certification

Form ABS Due Diligence-15E is required to be executed by an individual who is duly authorized by the person providing the third party due diligence services to make the required certification. That person must represent and warrant that: (1) he or she has executed the form on behalf of, and on the authority of, the third party; and (2) the third party conducted a thorough review in performing the due diligence described in item 4 above and that the information and statements contained in the form, including the information and statements referred to in items 4 and 5 above, are accurate in all significant respects on and as of the date of the execution of the form.

[20] This requirement may be satisfied pursuant to the Rule 17g-10 "safe harbor" discussed above.

NRSROs Must Make Forms ABS Due Diligence-15E Publicly Available

In addition to the certifications required to be made available to NRSROs by third party due diligence providers, the Dodd-Frank Act also required the SEC to adopt a rule requiring an NRSRO that receives a certification from a provider of third-party due diligence services to disclose the certification to the public in a manner that allows the public to determine the adequacy and level of the due diligence services provided by the third party. As a result, the SEC amended Rule 17g-7 to require an NRSRO to publish with any rating action[21] it takes with respect to ABS any executed Form ABS Due Diligence-15E subject to the rating action that is received by the NRSRO or obtained by the NRSRO through a Rule 17g-5 website.

> *Note: The requirement for an NRSRO to publish any Form ABS Due Diligence-15E is irrespective of whether and to what extent the NRSRO used the information in the form in taking the rating action.*

Conclusion: Changes Ahead

The Final Rules impose new obligations and liabilities on providers of third-party due diligence services, NRSROs, issuers and underwriters of ABS. To satisfy the requirements of the Final Rules, we anticipate that participants in ABS transactions will need to do a review of their policies and procedures in connection with the employment of third-party providers of due diligence services, as well as a determination as to what services constitute due diligence services.

Parties to ABS transactions will also need to determine responsibility and liability for satisfying the requirements of the Final Rules, and determine the impact of the Final Rules on the timing of ABS transactions.

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[21] Under Rule 17g-7(a), the term "rating action" means: (a) the publication of an expected or preliminary credit rating before the publication of an initial credit rating; (b) an initial credit rating; (c) an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default); and (d) an affirmation or withdrawal of an existing credit rating if the affirmation or withdrawal is the result of a review of the credit rating assigned by the NRSRO using applicable procedures and methodologies for determining credit ratings.

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

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