

Clients & Friends Memo

SEC Issues Final Rules Regarding Diligence and Disclosure in ABS Offerings

February 1, 2011

The Securities and Exchange Commission (the “SEC”) issued final rules (the “Final Rule”) on January 20, 2011, implementing the provisions of Section 945 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Section 945 of the Act directed the SEC to issue rules that require an issuer of publicly offered asset-backed securities (“ABS”) to perform a review of the assets underlying an ABS offering and disclose the nature of that review. The Final Rule adopts the SEC’s earlier proposal¹ with one important change, which is the inclusion of a minimum standard of review. The SEC also adopted amendments to Regulation AB that would require an ABS issuer to disclose information regarding assets that deviate from disclosed underwriting criteria.

For the time being, the SEC has only adopted rules for registered public ABS offerings. The SEC had previously proposed rules for privately offered ABS as well, however, the adoption of those rules has been postponed to a later date.²

Highlights:

The Final Rule:

- requires an issuer of registered (public) ABS to review the assets underlying an ABS offering, either directly or via a third party;
- requires an issuer of registered (public) ABS to disclose the nature, findings and conclusions of such review; and

¹ See our Client & Friends Memo, *SEC Proposes New Rules Regarding Diligence and Disclosure in ABS Offerings*, October 26, 2010.

² The proposed rules regarding privately offered ABS were issued to implement sub-section (A) of Section 15E(s)(4) of the Securities Exchange Act of 1934, as amended (Section 15E(s)(4) was adopted pursuant to Section 932 of the Act). However, in response to several commentators who suggested that Section 15E(s)(4) should be read as a whole, the SEC postponed the adoption of rules under sub-section (A) of Section 15E(s)(4) until the SEC is able to implement rules for the rest of Section 15E(s)(4).

- requires an issuer of registered (public) ABS to provide disclosure regarding assets that deviate from disclosed underwriting criteria.

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

In order to implement the provisions of Section 7(d) of the Securities Act of 1933, as amended (the “**Securities Act**”), which was adopted pursuant to Section 945 of the Act, the SEC adopted Rule 193, which requires 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 applies only to registered offerings.
- (b) Nature of Required Review. A review conducted under Rule 193 must, at a minimum, be designed and effected to provide reasonable assurance that the disclosure in the prospectus regarding the assets is accurate in all material respects. Rule 193 does not specify the particular type of review an issuer is required to perform and the review may vary based on numerous factors such as the nature of the assets being securitized and the degree of continuing involvement by the sponsor.

Note: It is unclear to some industry participants how the “reasonable assurance” standard adopted by the SEC imposes additional responsibilities on issuers who are already accountable for misleading disclosure under existing federal securities laws.
- (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 of the securitization; or
 - (ii) a third party engaged for purposes of performing the review; *provided, however,* that if an issuer engaged a third party to perform a review of assets and the issuer attributes the findings and conclusions of the review to such third party, then such third party must be named in the prospectus and consent to being treated as an expert in accordance with Rule 436 of the Securities Act. On the other hand, if an issuer obtains assistance from a third party but attributes to itself the findings and conclusions of the review, the third party would not be required to consent to being named as an expert.

- (d) Expanded Scope of ABS. Rule 193 relates to asset-backed securities as defined in new Section 3(a)(77)³ of the Exchange Act, which is broader than the definition provided in Regulation AB and includes securities such as CDOs. Nevertheless, as adopted, Rule 193 still only applies to registered (publicly offered) ABS.
- (e) Disclosure. The SEC adopted Item 1111(a)(7) of Regulation AB, which requires 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 such review.

2. Disclosure Regarding Exceptions to Underwriting Criteria

The SEC also adopted Item 1111(a)(8) of Regulation AB, which requires disclosure of the following information regarding any assets that deviate from disclosed underwriting criteria:

- how the assets in the pool deviate from the disclosed underwriting standards;
- data on the amount and characteristics of those assets;
- the identity of the entity that determined to include such assets in the pool, despite not having met the disclosed underwriting standards;
- factors that were used to determine to include such assets in the pool (such as compensating factors or a determination that the exception was not material); and
- if compensating factors were used, data on the amount of assets in the pool that met such compensating factors.

3. Compliance Date

Any registered offering of ABS commencing with an initial bona fide offer after December 31, 2011, will be required to comply with the Final Rule.

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³ "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 Securities Exchange Act of 1934, as amended by the Act.

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