Clients&FriendsMemo

SEC Proposed Rules Regarding Third-Party Due Diligence Disclosure

July 8, 2011

On June 8, 2011, the Securities and Exchange Commission (the "**SEC**") issued a release[1] (the "**Proposing Release**") describing proposed rules (the "**Proposed Rules**") implementing the portion of Section 932 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") relating to third-party due diligence. The Proposed Rules describe i) the obligations of issuers and underwriters to disclose the findings and conclusions of third-party due diligence reports and ii) the form this disclosure should take.

Highlights:

The Proposed Rules:

- Apply to all issuers or underwriters of all offerings, whether or not registered, of asset-backed securities ("**ABS**") rated by a nationally recognized statistical rating organization ("**NRSRO**");
- Require the issuer or underwriter to furnish[2] Form ABS-15G, which discloses the identity of the securitizer and the findings and conclusions of the third-party due diligence provider; and
- Do not require the issuer or underwriter to furnish Form ABS-15G if the NRSRO represents that it will publicly disclose such information in an information disclosure form newly required to be generated by NRSROs in connection with ratings actions under the Proposed Rules.

Background:

The Proposed Rules are not the first SEC rules to address due diligence requirements for ABS offerings. On January 20, 2011, the SEC issued final rules (the "**Section 945 Rules**")

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1 Release No. 34-64514; File No. S7-18-11. Available for review at http://sec.gov/rules/proposed/2011/34-64514fr.pdf.

2 Note that the form is furnished rather than filed. Documents furnished are not considered to be filed for the purposes of liability under the Securities Act of 1933.

implementing the provisions of Section 945 of the Dodd-Frank Act.[3] These rules require issuers of registered ABS offerings to:

- Conduct a review of the underlying assets;
- Disclose the nature, findings, and conclusions of the review; and
- Disclose assets that deviate from the disclosed underwriting criteria.

Under the Section 945 Rules, issuers may conduct the due diligence review through a third party. If a third party conducts due diligence to satisfy the Section 945 Rules and such diligence is provided to an NRSRO rating the transaction, the issuer would also be responsible for compliance with the third-party due diligence disclosure procedures of the Proposed Rules.

Third-Party Due Diligence Disclosure Applies to all ABS:

The Proposed Rules go beyond the Section 945 Rules in several ways. The Proposed Rules apply to all ABS[4] offerings rated by NRSROs, while the Section 945 Rules were limited to registered ABS offerings. Additionally, the Proposed Rules apply to the issuer[5] or the underwriter, while the Section 945 Rules apply solely to issuers.

Issuer Required to Disclose Findings and Conclusions:

1. Timeline

- The issuer or underwriter must furnish form ABS-15G five business days prior to the first sale in the offering.
- The issuer or underwriter is not required to furnish Form ABS-15G if the issuer or underwriter receives a representation from an NRSRO "that can reasonably be relied on"[6] that the NRSRO will publicly disclose the information through a form generated pursuant to Rule 17g-7(a)(1). Rule 17g-7(a)(1) identifies for disclosure a number of factors related to the NRSRO's methodology, the limitations of its analysis, potential conflicts of interest, and its conclusion.

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[3] See our Clients & Friends Memo, *SEC Issues Final Rules Regarding Diligence and Disclosure in ABS Offerings*, February 1, 2011.

[4] Both rules use the definition of asset-backed securities found in Section 3(a)(77) of the Exchange Act. This definition is broader than the definition in Regulation AB.

[5] The Proposed Rules contain a new definition for issuer that includes the sponsor or depositor.

[6] The SEC notes that the reasonable reliance standard is a facts and circumstances test intended to mirror an NRSRO's reasonable reliance on the representation made by arrangers under Rule 17g-5.

- If the NRSRO makes this representation but does not disclose the Rule 17g-7(a)(1) information within five business days of the first sale under the offering, the issuer or underwriter must furnish Form ABS-15G two business days prior to the first sale.

    - This suggests that issuers or underwriters who rely on NRSROs to file a Rule 17g-7(a)(1) form will be obligated to monitor the NRSRO to ensure that the necessary information was disclosed or, as an administrative matter, will choose simply to routinely furnish Form ABS-15G five business days prior to the first sale in order not to have to monitor the NRSRO's compliance with its representations.

2. Required information

If the issuer or underwriter is required to furnish information about the results of third-party due diligence, it must do so on Form ABS-15G, which requires the issuer or underwriter to:

- Identify the securitizer; and
- Identify the findings and conclusions of any third-party due diligence provider.

In the comments on the Proposing Release, the SEC states that Form ABS-15G would be signed by the senior officer of the depositor in charge of securitization if the third-party due diligence provider had been hired by the issuer. If the third-party due diligence provider had been engaged by the underwriter, a duly authorized officer of the underwriter would sign Form ABS-15G.

What Constitutes Due Diligence?

The Proposed Rules require disclosure of any third-party due diligence report, and a third-party due diligence report is defined as "any report containing the findings and conclusions of any 'due diligence services.'" As defined in the Proposed Rules, "due diligence services" include any review of the assets underlying an ABS for the purpose of making findings with respect to:

- The quality of the information about the assets;
- Whether the origination of the assets deviated from underwriting guidelines;
- The value of the collateral;
- Whether the originator of the assets complied with applicable laws; and
- Any other factor material to the likelihood that the issuer will pay interest and principal according to its terms.

In the comments of the Proposing Release, the SEC states that it intends the first four categories of review to describe current due diligence practices for issuances of residential mortgage-backed securities ("**RMBS**"), and the fifth category is designed to be a catchall for due diligence services used for pools of other asset classes, such as commercial loans, corporate loans, student loans, or credit card receivables.

In the Proposing Release, the SEC noted that, in the context of RMBS transactions, third party due diligence generally involves analyzing a sample of loans in the pool to:

- Compare the information on the loan tape to information contained on the hard-copy documents in order to assess the quality of the loan tape data;
- Determine whether each loan in the sample adheres to the underwriting guidelines;
- Assess the validity of the appraised value of the collateral; and
- Determine whether the originator complied with applicable laws when making the loans.

We note that, based on this description, typical accountants' comfort letters would appear to be within the scope of the Proposed Rules.

The Proposed Rules were published in the *Federal Register* on June 8, 2011 and comments on the Proposed Rules are due on or before August 8, 2011.

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