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GLOBAL FINANCE UPDATE

SEC Releases Final Rules On Third-Party Diligence Reports for Asset-Backed Securities

As part of the required rule-making related to nationally recognized statistical rating organizations ("NRSROs") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the SEC recently issued final rules (the "Diligence Report Rules") with respect to third-party diligence reports in asset-backed securities transactions.[1]

As adopted, the rules require:

- an issuer or underwriter of an asset-backed security that will be rated by an NRSRO to "furnish" on Form ABS-15G, at least five business days prior to the first sale in the offering, the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter;
- providers of third-party due diligence services to an NRSRO, issuer or underwriter to deliver a written certification on new Form ABS Due Diligence-15E to any NRSRO that produces a credit rating to which the services relate; and
- NRSROs to disclose:
  - any certification on Form ABS Due Diligence-15E received from a third-party due diligence provider in a report accompanying each rating action to which the certification relates; and
  - to what extent the NRSRO used due diligence services of a third party in taking the rating action.

The Diligence Report Rules are effective June 15, 2015.

Background on Third-Party Due Diligence Reports In Exchange Act Asset-Backed Securities Transactions

Section 15E(s)(4) of the Securities Exchange Act of 1934 (the "Exchange Act") as added by the Dodd-Frank Act contains a series of requirements with respect to third-party due diligence reports in transactions involving asset-backed securities as defined in the Exchange Act ("Exchange Act asset-backed securities")[2] and applies to both registered and private transactions. Section 15E(s)(4)(A) requires that the issuer or underwriter of any

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[1] *See* SEC Release No. 34–72936, Nationally Recognized Statistical Rating Organizations, Final Rule, 79 Fed. Reg. 178 (Sept. 15, 2014) available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-15/pdf/2014-20890.pdf.

[2] The definition of an "asset-backed security" under Section 3(a)(79) of the Exchange Act is broader than the definition of an "asset-backed security" in Regulation AB and includes registered and private securities. In previous releases, the SEC has taken the position that the Exchange Act definition of asset-backed securities extends to securities exempt from registration, such as mortgage-backed securities issued or guaranteed by Fannie Mae and Freddie Mac and securities issued by municipal issuers that otherwise come within the definition.

Exchange Act asset-backed security must make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

Sections 15E(s)(4)(B) and (C) provide that in any case in which third-party due diligence services are employed by an NRSRO, an issuer or an underwriter, the person providing the due diligence services must provide to any NRSRO that produces a rating to which such services relate, a written certification in the form established by the SEC to ensure that providers of due diligence services have conducted a thorough review of data, documentation and other relevant information necessary for an NRSRO to provide an accurate rating. Section 15E(s)(4)(D) requires that the SEC adopt rules requiring NRSROs at the time a rating is produced to disclose the certification to the public in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party.

In October 2010, the SEC proposed rules under Section 15E(s)(4)(A) that would have required registration statement disclosure of the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. However, in January 2011, at the time the SEC adopted Rule 193 under the Securities Act of 1933 (the "Securities Act") related to issuer reviews of underlying assets, it postponed consideration of the rules under Section 15E(s)(4)(A) until it undertook rulemaking with the rest of Section 15E(s)(4). In May 2011, the SEC issued proposed rules with respect to each of Sections 15E(s)(4)(A), (B) and (C)[3] which were finalized with the adoption of the Diligence Report Rules by the SEC in August 2014.

New Rule 15Ga-2 – Disclosure of Findings and Conclusions of Due Diligence Reports

Under new Rule 15Ga-2, which implements Section 15E(s)(4)(A), the issuer or underwriter of a public or private Exchange Act asset-backed security to be rated by an NRSRO is required to furnish on Form ABS-15G (through filing the report on the SEC's EDGAR system) the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. The report must be furnished at least five business days prior to the first sale in the offering (two days earlier than the preliminary prospectus filing requirement under new Rule 424(h) (effective November 23, 2015)).

New Rule 15Ga-2 defines a "third-party due diligence report" as any report containing findings and conclusions of any "due diligence services" (as defined in new Rule 17g-10) performed by a third party, including interim reports. New Rule 17g-10 defines "due diligence services" as a review of the assets underlying an Exchange Act asset-backed security for the purpose of making findings with respect to:

- The accuracy of the information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets;
- Whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria or other requirements; [4]

[3] *See* SEC Release No. 34-64514, Proposed Rules for Nationally Recognized Statistical Rating Organizations available at http://www.sec.gov/rules/proposed/2011/34-64514fr.pdf.

[4] The proposing release states that this type of review could involve determining if a sampled loan meets the originator's underwriting guidelines or, if not, if the originator provided a reasonable and documented exception to support the decision to make the loan or determining how the originator verified borrower information, such as occupancy status with respect to the residence (*e.g.*, primary residence, second home or rental property), the borrower's income, the borrower's assets and the borrower's employment status.

- The value of collateral securing the assets; [5]
- Whether the originator of the assets complied with federal, state or local laws or regulations; [6] or
- Any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the Exchange Act asset-backed security will pay interest and principal according to its terms and conditions.

In the adopting release, the SEC explains that the fifth category is intended as a catch-all reflecting, in part, that the first four categories address due diligence services which the SEC recognizes are more commonly undertaken in RMBS transactions than other asset classes. Despite the breadth of this definition, the adopting release states that "due diligence services" are not intended to cover services that are currently performed in Exchange Act asset-backed securities transactions that are not commonly understood as being third-party due diligence services. Rather, it is intended to cover reviews of the assets underlying Exchange Act asset-backed securities that are commonly understood in the securitization market to be third-party due diligence services (or services that may develop in the market). The adopting release specifically identifies a comparison of the loan tape and underlying loan files as a type of review that would fall into this category but states that procedures that are performed primarily for assisting issuers and underwriters to verify the accuracy of prospectus disclosure regarding the asset-backed securities, such as recalculating projected future cash flows and performing other procedures that address the information included in the offering document, should not be considered due diligence services under the Exchange Act. The adopting release further states that the SEC believes that the scope of Section 15E(s)(4)(A) is intended to address third-party due diligence reports obtained by issuers or underwriters from providers of due diligence services that are relevant to the determination of a credit rating for Exchange Act-asset-backed securities by an NRSRO. However, the SEC makes clear that Rule 15Ga-2 applies to diligence reports, regardless of whether the report is delivered to or used by an NRSRO.

In discussing due diligence services currently provided in the securitization market, the SEC estimates that there are approximately 15 providers of third-party due diligence services.

> This number comes from combining the names of third-party due diligence firms cited by Vicki Beal, Senior Vice President of Clayton Holdings, in her testimony before the Financial Crisis Inquiry Commission, and the names of third-party due diligence firms that S&P reviews as a part of its U.S. RMBS rating process. See Testimony of Vicki Beal, Senior Vice President of Clayton Holdings before the Financial Crisis Inquiry Commission, (Sept. 23, 2010), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0923-Beal.pdf ("Clayton Testimony"). S&P's updated list of third-party due diligence firms reviewed for U.S. RMBS is available at https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1246530&SctArtId=208825&from=CM&nsl_code=LIME. The [SEC] does not know whether the estimate of fifteen providers of third-party due diligence services captures all of the primary participants in this business but believes that, based on available information, this is a reasonable estimate for purposes of this economic analysis.[7]

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[5] The proposing release states that this type of review could involve an analysis of the quality of an appraiser and quality of an appraisal.

[6] The proposing release states that this type of review could entail analyzing legal documentation to verify compliance with, for example, truth-in-lending regulations, such as Regulation Z.

[7] *See* 79 Fed. Reg. 178 at 55089.

As for the content of the report, the SEC specifically states that a summary of the findings and conclusions is not sufficient because it believes a summary could exclude information useful to users of credit ratings. Instruction to paragraph (a) of Rule 15Ga-2 provides that "disclosure of findings and conclusions includes, but is not limited to, 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."

A Form ABS-15G furnished by a depositor must be signed by the senior officer in charge of the securitization, and a Form ABS-15G furnished by an underwriter must be signed by a duly authorized officer of the underwriter. Rule 15Ga-2 provides that where the issuer or one or more underwriters has obtained the same third-party due diligence report, so long as one of the parties has furnished the required information, the other parties are not separately required to furnish the information. Additionally, if the disclosure required under Rule 15Ga-2 has been made available in the prospectus–for example in a description of the review of the underlying assets required under Rule 193–the issuer or underwriter may refer to the section of the prospectus in the Form ABS-15G rather than including the findings and conclusions in the Form ABS-15G. Rule 15Ga-2 specifies that in order to rely on prospectus disclosure in lieu of Form ABS-15G reporting, the prospectus disclosure must include an attribution to the third party that provided the due diligence report (which, under Rule 193, would require the third party to consent to being named as an "expert" in accordance with Rule 436 under the Securities Act) and that the prospectus must be available at the time the Form ABS-15G is required to be filed (which is five business days prior to the first sale).

In the adopting release, the SEC reiterates its position that disclosure of the required information under Rule 15Ga-2 by an issuer or underwriter would not prevent the issuer from relying on a private placement exemption or on the Regulation S safe harbor.

In contrast to the proposed rules, Rule 15Ga-2 excludes offerings by certain municipal issuers (as defined under Rule 17g-10) if the offering is not required to be registered[8] and offshore offerings where the issuer is a non-U.S. person (as defined under Rule 902(k) under the Securities Act) and the securities are offered and sold and any underwriter will effect transactions after issuance, only in transactions that occur outside the United States.

New Rule 17g-10 – Reports By Third-Party Providers

New Rule 17g-10 implements Section 15E(s)(4)(B) and requires any person providing third-party "due diligence services" (discussed above) to deliver a certification in the form of Form ABS Due Diligence-15E to any NRSRO that produces a rating to which such services relate.

In response to concerns raised by due diligence services providers as to how they would know to which NRSRO a report must be delivered, the SEC created a safe harbor whereby the diligence service provider is deemed to have satisfied its obligations if the person promptly delivers an executed Form ABS Due Diligence-15E after completion of the due diligence services to:

- An NRSRO that provided a written request for the Form prior to the completion of the due diligence services stating that the services relate to a credit rating the NRSRO is producing;

[8] The SEC notes that while these municipal issuers are excluded from Rule 15Ga-2, they are still subject to the requirements of Section 15E(s)(4)(A) and must comply with the requirement to make the findings and conclusions of due diligence reports publicly available.

- An 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 nationally recognized statistical rating organization is producing; and
- The issuer or underwriter of the asset-backed security for which the due diligence services relate that maintains the Rule 17g-5 website with respect to the Exchange Act asset-backed security.

To address the format and content of the certification required under Section 15E(s)(4)(C), new Form ABS Due Diligence-15E requires the due diligence service provider to provide the following information:

- Identity of person providing the due diligence services.
- Identity of person who paid for the due diligence services.
- If the manner and scope of the due diligence performed by the third party is intended to satisfy the criteria for due diligence published by an NRSRO, identify the NRSRO and the title and date of the published criteria.
- 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 the following:
  - the type of assets that were reviewed;
  - the sample size of the assets reviewed;
  - how the sample size was determined and, if applicable, computed;
  - 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;
  - whether the origination of the assets conformed to stated underwriting or credit extension guidelines, standards, criteria or other requirements was reviewed and, if so, how the review was conducted;
  - whether the value of collateral securing such assets was reviewed and, if so, how the review was conducted;
  - 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
  - any other type of review conducted with respect to the assets.
- 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 who paid for the services.

Form ABS Due Diligence-15E requires a representation that the service provider conducted a thorough review in performing the described due diligence and that the information and statements contained in the form are accurate in all significant respects. In response to comments regarding reviews performed by accountants in agreed-upon procedures engagements, the SEC provides guidance in the adopting release that a description of any requirements and limitations resulting from relevant professional standards with respect to the services performed by accounting firms may be included in the Form ABS Due Diligence-15E.

Rule 17g-7 – NRSRO Requirements to Disclose Certifications From Third-party Due Diligence Service Providers

To address the Section 15E(s)(4)(D) requirement that the SEC adopt rules requiring an NRSRO, at the time it produces a credit rating, to disclose any certifications from providers of third-party due diligence services in a manner that allows the public to determine the adequacy and level of due diligence services provided by the third party, the SEC amended Rule 17g-7 to require that at the time an NRSRO takes a ratings action, it must disclose, among other things, whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party (or a cross reference to the Form ABS Due Diligence-15E of the party providing the due diligence services if the Form contains a description of the findings and conclusions of such party). Under Rule 17g-7, this disclosure must be accompanied by a copy of each Form ABS Due Diligence-15E the NRSRO has received.

If you have any questions regarding this update, please contact one of the following lawyers or the Sidley lawyer with whom you usually work.

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