SEC Proposes Rules Regarding Third-Party Due Diligence Reports and Certifications for Asset-Backed Securities

As part of its continuing efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), on May 18, 2011, the U.S. Securities and Exchange Commission (the “Commission”) unanimously approved for public comment proposed rules that would require nationally recognized statistical rating organizations (NRSROs), issuers and underwriters to make public the findings and conclusions of any due diligence reports prepared by a third-party service provider in an asset-backed securities transaction. When hired by an NRSRO, an issuer or an underwriter, third-party diligence providers would also have to provide a certification to each NRSRO rating the securities.

The proposed rules are required by Section 932 of the Dodd-Frank Act. The Commission proposed similar rules in October 2010 as part of a larger package of proposals related to Section 945 of Dodd-Frank, but the Section 932 proposals were not included in the final rules when the Commission adopted rules based on those proposals.

At the meeting last week, the Commission also adopted proposed rules seeking to enhance the transparency and improve the integrity of credit ratings and credit rating agencies registered with the Commission as NRSROs. A summary of these proposed rules are the subject of a separate Alston & Bird advisory entitled “SEC Proposes Rules that Seek to Enhance Transparency and Improve the Integrity of Credit Ratings and NRSROs.”

Use of Third-Party Due Diligence Reports in the Industry.

Issuers and underwriters of asset-backed securities often hire third-party due diligence service providers to review a sample of the assets underlying a securitization transaction to ensure that such assets comply with underwriting standards. Issuers or underwriters may also hire third-party due diligence service providers to fulfill their obligations under Rule 193 and Section 7(d) of the 1933 Securities Act (the “Securities Act”) requiring issuers of registered “Exchange Act-ABS”¹ to perform a review of the pool assets underlying the asset-backed securities to be issued. A credit rating agency, if hired by an issuer or underwriter to rate asset-backed securities, may also rely upon or take into consideration the findings and conclusions of a third-party due diligence report.

¹ As defined by the Dodd-Frank Act, “Exchange Act-ABS” includes all securities, whether offered publicly or privately, that are collateralized by self-liquidating financial assets that allow the holders of such assets to receive payments based primarily on the cash flows from those assets. The definition of “Exchange Act-ABS” also includes collateralized debt obligations, securities issued or guaranteed by a government sponsored entity such as Fannie Mae or Freddie Mac, and municipal ABS.
A. Disclosure of Findings and Conclusions of Third-Party Due Diligence Reports.

The Commission re-proposed rules, with slight revisions, to implement Section 15E(s)(4)(A) of the Securities Exchange Act of 1934 (the “Exchange Act”). Rule 15Ga-2 as proposed would require an issuer or underwriter of any Exchange Act-ABS that has hired a third-party service provider to conduct diligence to furnish a Form ABS-15G via the EDGAR system. The Form ABS-15G would have to include the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. Disclosures under Rule 15Ga-2 would apply to both registered and unregistered offerings and to municipal entities that sponsor, issue or underwrite Exchange Act-ABS if such Exchange Act-ABS is to be rated by an NRSRO. Rule 15Ga-2 would apply only with respect to any Exchange-Act ABS that is to be rated by an NRSRO, and not to due diligence reviews conducted by third-party service providers to fulfill an issuer’s obligations under Rule 193.

An issuer or underwriter is not required to furnish a Form ABS-15G if such issuer or underwriter obtains a representation from each NRSRO engaged in the rating of the Exchange Act-ABS that such NRSRO will publicly disclose the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. The NRSRO must disclose the finding and conclusions of any third-party due diligence report with the publication of the credit rating in an information disclosure form prepared pursuant to new paragraph (a)(1) of Rule 17g-7 no less than five business days prior to the first sale in the offering.

Rule 17g-7 as amended by the proposed rules, would require an NRSRO to disclose in the information disclosure form:

- whether and to what extent it relied upon third-party due diligence services;
- a description of the information that such third-party reviewed in conducting its due diligence services; and
- a description of the findings or conclusions of such third-party.

Pursuant to new paragraph (a)(2) to Rule 17g-7, an NRSRO would be required to include with the publication of a credit rating any written certification related to the credit rating received from a provider of third-party due diligence services.

In the event an NRSRO fails to comply with its representation to the issuer or underwriter to publicly disclose the findings and conclusions of any third-party due diligence report, then such issuer or underwriter would have to furnish to the Commission a Form ABS-15G with the information required under proposed Rule 15Ga-2, no less than two business days prior to the first sale in the offering.

B. Third-Party Due Diligence Certification and Form.

The Commission proposed new Rule 17g-10 and Form ABS Due Diligence-15E to implement Section 15E(s)(4)(C) of the Exchange Act, which requires a third-party due diligence provider of Exchange Act-ABS to provide an NRSRO a written certification that includes a summary of the findings and conclusions of such provider’s due diligence. The Commission noted in its release that third-party due diligence providers are often

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used to perform review of mortgages to be securitized into residential-mortgage backed securities (RMBS).^{3} Although Rule 17g-10 and Form ABS Due Diligence-15E are particularly applicable to RMBS, the Commission emphasized that the proposed rule and form apply to all Exchange Act-ABS.

1. **Third-Party Due Diligence Certification Requirements.**

Proposed Rule 17g-10 would require a third-party due diligence provider of Exchange Act-ABS to:

- provide the written certification required pursuant to Section 15E(s)(4)(B) of the Exchange Act on a Form ABS Due Diligence-15E; and
- have the written certification executed by a duly authorized person.

Although the Dodd-Frank Act seeks to enhance the transparency of due diligence reports prepared by third-party service providers, the Dodd-Frank Act does not define “due diligence services.” The Commission has identified four categories of reviews undertaken by third-party due diligence providers. In absence of a definition in the Dodd-Frank Act, the Commission defines “due diligence services” in proposed Rule 17g-10 to mean an entity that engages in a review of the assets underlying an Exchange Act-ABS for purposes of making findings with respect to:

- the quality or integrity 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 stated underwriting or credit extension guidelines, standards, criteria or other requirements;
- the value of collateral securing such assets;
- whether the originator of the assets complied with federal, state or local laws or regulations; and
- any other factor or characteristic of such asset that would be material to the likelihood that the issuer of the Exchange Act-ABS will pay interest and principal according to its terms and conditions (the “catchall definition”).

Proposed Rule 17g-10 will also define “issuer” to include a sponsor (as defined in 17 CFR 229.11), or depositor (as defined in 17 CFR 229.1011) that participates in the issuance of an Exchange Act-ABS.

The terms “originator” and “securitizer” as used in proposed Rule 17g-10 will have the meanings given to them in Section 15Gf of the Exchange Act.

^{3} Release at 194-195.
2. *Form ABS Due Diligence-15E.*

In accordance with Section 15E(s)(4)(C) of the Exchange Act, the Commission proposed that the format of the certification in Form ABS Due-Diligence-15E include the following line items:

- the identity and address of the provider of the third-party due diligence services;
- the identity and address of the issuer, underwriter or NRSRO that hired the provider of the third-party due diligence services;
- the identity of each NRSRO who published criteria for performing;
- the scope and manner of the due diligence performed, including but not limited to (i) the type of assets that were reviewed, (ii) the same size of the assets reviewed, (iii) how the sample size was determined and (iv) any other type of review conducted with respect to the assets; and
- the findings and conclusions resulting from the review.

In addition, any individual executing the Form ABS Due Diligence-15E on behalf of a third-party due diligence provider will be required to represent that (i) he or she executed the form on behalf of, and on the authority of, the third-party due diligence provider and (ii) the third-party due diligence provider conducted a complete due diligence review.

The Commission has specifically requested comment on how a third-party due diligence service provider will know the identities of the NRSROs producing credit ratings to which its service relates, especially in cases where NRSROs produce unsolicited credit ratings and when such certification must be provided to an NRSRO.

The proposed rules have not yet been published in the Federal Register, but the Commission has posted the text of its 517-page release on its website at http://www.sec.gov/rules/proposed/2011/34-64514.pdf. The proposed rules are subject to a 60-day public comment period.
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