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Financial Services & Products ADVISORY ■

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Application of the SEC's New Due Diligence Rules to Providers of Appraisal and Valuation Services

The U.S. Securities and Exchange Commission's (SEC) new due diligence rules may have significant implications for providers of valuation services for residential mortgage loans. As we previously reported in our September 18, 2014, advisory, "Summary of New Securitization Rules for Third-Party Due Diligence Reports" (http://www.alston.com/advisories/Due-Dilligence-new-rules/), the SEC adopted rules related to securitizations and nationally recognized statistical rating organizations (NRSROs) also relate to the responsibilities of issuers, underwriters and due diligence providers of rated asset-backed transactions.

This Due Diligence Rule[1] takes effect June 15, 2015, and may impose new obligations on providers of valuation services performed in connection with rated residential mortgage-backed securitizations (RMBS). That's because "due diligence services" include, among other things, a review of the underlying assets to determine the value of collateral securing those assets. Thus, providers of reconciled valuation reports, and, potentially, other parties involved in valuation services, must ascertain and understand whether the services requested by their clients are in connection with a securitization rated by an NRSRO within the meaning of Section 15E(s)(4)(B) of the Securities Exchange Act of 1934, as amended, or whether the services requested do not constitute due diligence services provided by a third party within the meaning of Rule 17g-10. Failure to do so could result in securities law liability.

Background

As mandated by Section 932(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC adopted rules that not only apply to NRSROs, but also apply to issuers, underwriters and providers of third-party due diligence services. These responsibilities primarily relate to two rules, Rule 15Ga-2 and Rule 17g-10. Due diligence providers have an obligation pursuant to Rule 17g-10 to provide a certification on Form ABS Due Diligence-15E ("Form 15E") with respect to activities that constitute due diligence services as provided in Rule 17g-10. This certification is the only documentation required to be provided by a due diligence provider under the Due Diligence Rule. However, issuers and underwriters of rated transactions have an obligation to file reports created by due diligence providers pursuant to Rule 15Ga-2. What constitutes a report required to be filed under Rule 15Ga-2 is not a responsibility of

[1] *See* http://www.sec.gov/rules/final/2014/34-72936.pdf

the due diligence provider, but due diligence providers can expect their due diligence reports to be filed in their entirety and be publicly available on the SEC's EDGAR system.

What Is a Due Diligence Service?

Under Rule 15Ga-2(d), a third-party due diligence report is any report containing findings and conclusions relating to due diligence services performed by a third party, and the phrase "due diligence services" in turn is defined in new Rule 17g-10(d)(1). Rule 17g-10 identifies four specific categories of due diligence services that the SEC believes are commonly provided in connection with RMBS. Of significance to providers of valuations is the third prong of the definition of "due diligence services," which reads a review of the assets for the purpose of making findings with respect to "the value of the collateral securing the assets."[2]

This definition raises several questions, the answers are not yet clear, and the guidance given by the SEC is limited. In the adopting release for the Due Diligence Rule, the SEC states that a review conducted by a third-party diligence provider in the RMBS context is to "to assess the validity of the appraised value of the property indicated on the loan tape that collateralizes each loan in the sample." [See page 406 of the adopting release.] How these statements would apply to the various activities of a provider of valuation services and how the rating agencies will interpret these statements is not yet clear.

What Does It Mean to Be a Provider of Due Diligence Services?

Rule 17g-10 requires any third-party due diligence provider to complete Form 15E for any due diligence report it produces. The due diligence provider must provide the completed form to any NRSRO that requests it and to the issuer or underwriter of the RMBS for posting to the related Rule 17g-5 website promptly after completion of due diligence services. Failure to comply with the new Due Diligence Rule could result in security law liability under Section 10(b) or liability under Section 18 of the Securities Exchange Act of 1934 or Section 11 or 12 of the Securities Act of 1933.

Alston & Bird Observations

Providers of valuation services should understand the Due Diligence Rule and its potential impact on the products and services it offers. As a valuation provider, do you know if your services are being provided in connection with a securitization rated by an NRSRO within the meaning of Section 15E(s)(4)(B) of the Exchange Act? If so, do your services constitute due diligence services provided by a third party within the meaning of Rule 17g-10? If so, what are your obligations? If your services are not being provided in connection with a securitization rated by an NRSRO, consider obtaining representations and warranties to that effect and that your client will not file any report of these services pursuant to Rule 15Ga-2 and will not provide any report of these services to any party that intends to file such report pursuant to Rule 15Ga-2 and will not provide any report of these services to any NRSRO.

If you need assistance preparing for these changes, our team, which includes attorneys focusing on securitizations and appraisal and valuation issues, is prepared to help. Please contact any of the attorneys listed on the following page.

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[2] See Section 240.17g-10(d)(1)(iii).

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Stephen F.J. Ornstein
202.239.3844
stephen.ornstein@alston.com

Scott D. Samlin
212.210.9408
scott.samlin@alston.com

Nanci L. Weissgold
202.239.3189
nanci.weissgold@alston.com

Morey Barnes Yost
202.239.3674
morey.barnesyost@alston.com

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