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# **SEC ADOPTS RULES REGARDING THIRD-PARTY DUE DILIGENCE REPORTS IN CONNECTION WITH OFFERINGS OF ASSET-BACKED SECURITIES, AND OTHER RULES FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS**

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## SEC ADOPTS RULES REGARDING THIRD-PARTY DUE DILIGENCE REPORTS IN CONNECTION WITH OFFERINGS OF ASSET-BACKED SECURITIES, AND OTHER RULES FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

The Securities and Exchange Commission (the "SEC") has adopted a variety of rules (the "Adopting Release")<sup>1</sup> relating to nationally recognized statistical rating organizations ("NRSROs"), as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").<sup>2</sup> These rules, which originally were proposed in May 2011 (the "Proposing Release"),<sup>3</sup> will require any issuer or underwriter of registered or unregistered "asset-backed securities," as broadly defined by the Dodd-Frank Act ("Exchange Act ABS"), that are to be rated by an NRSRO, to furnish a form on EDGAR describing the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

Under the new rules, a "third-party due diligence report" is any report containing findings and conclusions relating to "due diligence services," which in turn are defined as a review of the pool assets for the purposes of making findings with respect to: the accuracy of the asset data; determining whether the assets conformed to stated underwriting standards; asset value; legal compliance by the originator; and any other factor material to the likelihood that the issuer will pay interest and principal as required. The SEC believes that these categories of due diligence services are commonly provided in securitization transactions and are relevant to credit ratings of Exchange Act ABS.

The rules also set forth a form of certification that providers of third-party due diligence services will be required to deliver to each NRSRO producing a credit rating to which those due diligence services "relate." The delivery obligation will be accomplished primarily by providing the certification to the issuer or underwriter for posting on its Rule 17g-5 website.

The rules adopted by the SEC also include a wide range of other provisions augmenting the SEC's existing NRSRO registration and oversight regime.

The new rules regarding third-party due diligence reports will become effective nine months after they are published in the Federal Register.<sup>4</sup>

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<sup>1</sup> Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-72936, available at <http://www.sec.gov/rules/final/2014/34-72936.pdf>.

<sup>2</sup> The Dodd-Frank Act is available at <http://banking.senate.gov/public/files/Rept111517DoddFrankWallStreetReformandConsumerProtectionAct.pdf>. Our summary of the Dodd-Frank Act is available at <http://www.bingham.com/Media.aspx?MediaID=10963>.

<sup>3</sup> Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-64514, 76 Fed. Reg. 33420 (June 8, 2011), available at <http://www.sec.gov/rules/proposed/2011/34-64514fr.pdf>. Our client alert regarding this proposal is available at <http://www.bingham.com/Alerts/2011/06/SEC-Proposes-Rules-Regarding-Third-Party-Due-Diligence-Reports-in-Connection-With-Offerings-of-Asset-Backed-Securities-and>

<sup>4</sup> The SEC established a variety of effective dates for the remaining portions of the new NRSRO rules, ranging from sixty days after publication in the Federal Register, to January 1, 2015, to nine months after publication in the Federal Register.

## Disclosure by Issuers and Underwriters of Findings and Conclusions of Third-Party Due Diligence Reports

Section 15E(s)(4)(A) of the Securities Exchange Act of 1934 (the “Exchange Act”), as added by Section 932 of the Dodd-Frank Act, requires an issuer or underwriter of Exchange Act ABS to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. Section 15E(s)(4)(A) applies to all Exchange Act ABS, whether offered publicly or privately, not just the more limited group of asset-backed securities subject to Regulation AB.

In order to implement this requirement, new Rule 15Ga-2 generally requires an issuer<sup>5</sup> or underwriter<sup>6</sup> of Exchange Act ABS that is to be rated by an NRSRO to furnish<sup>7</sup> a Form ABS-15G,<sup>8</sup> which will have a new section requiring disclosure of the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. The form must be furnished to the SEC via EDGAR five business days before the first sale in the offering. If the issuer and one or more underwriters have obtained the same third-party due diligence report, only one of them will be required to furnish Form ABS-15G.

While many commenters argued that the requirements of Rule 15Ga-2 should only apply to third-party due diligence reports that are actually provided to an NRSRO, the SEC rejected that view, because its final rules will require that “most, if not all, third-party due diligence reports...be made available to NRSROs pursuant to Rule 17g-10,” as described below.

In the Adopting Release, the SEC notes that commenters were concerned that requiring issuers and underwriters to make information available for private placements would violate rules prohibiting general solicitation, but goes on to reiterate its view that the required information can be disclosed “without jeopardizing reliance on private offering exemptions and safe harbors under the Securities Act of 1933 (the “Securities Act”), provided that the only information made publicly available on Form ABS-15G is required by the rule, and the issuer does not otherwise use Form ABS-15G to offer or sell securities or in a manner that conditions the market for offers or sales of its securities.” In any event, issuers may now use general solicitation to market securities offered pursuant to Rule 144A, which is the primary private offering exemption used for offerings of asset-backed securities.

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<sup>5</sup> For these purposes, the term “issuer” means the sponsor of the transaction as well as the depositor. Rule 15Ga-2(d) and Rule 17g-10(d)(2).

<sup>6</sup> The term “underwriter” generally is not used in connection with private offerings of securities. However, according to the SEC, the new rules apply to “underwriters” of unregistered securities, because “the definition of underwriter in the Exchange Act is not explicitly limited to registered offerings,” and “there are sound policy reasons why both registered and unregistered Exchange Act-ABS offerings should be covered” by the new rules. In connection with an earlier proposal of Rule 15Ga-2 that was abandoned, the SEC stated that “underwriter” refers to parties that perform functions in private offerings of Exchange Act ABS that are similar to those performed by underwriters in public offerings of Exchange Act ABS, including initial purchasers and placement agents. Issuer Review of Assets in Offerings of Asset-Backed Securities, SEC Release Nos. 33-9150, 34-63091, 75 Fed. Reg. 64182 (Oct. 19, 2010), available at <http://sec.gov/rules/proposed/2010/33-9150fr.pdf>. Our summary of this earlier release is available at <http://www.bingham.com/Media.aspx?MediaID=11379>.

<sup>7</sup> As noted by the SEC in the Proposing Release, information that is “furnished” rather than “filed” is not subject to the liability provisions of Section 18 of the Exchange Act. However, this is of little practical importance, as Section 18 is used only infrequently as a basis for securities fraud claims due to the difficulty of proving all of its elements and the various procedural obstacles. Information that is “furnished” remains subject to Rule 10b-5 under the Exchange Act, which is much more commonly used as a basis for securities fraud claims.

<sup>8</sup> Form ABS-15G has already been adopted for purposes of disclosures regarding fulfilled and unfulfilled repurchase requests for alleged breaches of representations and warranties, as required by Rule 15Ga-1.

## The Scope of “Third-Party Due Diligence Report” and “Due Diligence Services”

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 “due diligence services” in turn is defined in new Rule 17g-10(d)(1).

A third-party due diligence report is not the same as the required issuer review of the assets under Rule 193. However, if an issuer uses a third-party due diligence report in connection with its Rule 193 review of the assets, then as required by Item 1111(a)(7) of Regulation AB, the issuer must include the findings and conclusions of the review in the prospectus and (if the issuer attributes the findings and conclusions to the third party) must obtain the third party’s consent to being named as an expert in the registration statement.<sup>9</sup>

Rule 17g-10 identifies four specific categories of due diligence services that the SEC believes are commonly provided in connection with offerings of residential mortgage-backed securities (“RMBS”), “because due diligence services traditionally have been performed with respect to RMBS,” as well as a “catchall” for services that may in the future be provided for other asset classes, but which do not fall within one of the enumerated categories.

The first enumerated category of due diligence services is a review of the underlying assets for the purpose of making findings with respect to accuracy of the information or data about the assets provided by the securitizer or originator. Several commenters argued that the services provided by accountants in providing agreed-upon procedures letters should not be considered third-party due diligence services, with some asserting that accountants likely would decline to perform services captured by the rule. According to the SEC, recalculating projected cash flows to investors should not fall within the scope of “due diligence services,” nor would performing agreed-upon procedures to verify most information included in the offering document. “However, comparing the information on a loan tape with the information contained on the hard-copy documents in a loan file is an activity that falls within the definition” because it involves reviewing the accuracy of information about the assets provided by the securitizer or originator.

The second enumerated category of due diligence services is a review of the underlying assets for the purpose of determining whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards or other criteria. The Proposing Release noted that this could entail reviewing whether a sampled loan meets the originator’s underwriting guidelines or, if not, that the originator provided a reasonable and documented exception. This type of review also could encompass an examination of how the originator verified information in a sampled loan — such as, for RMBS, the borrower’s occupancy status, income, assets, or employment status.

The third enumerated category of due diligence services is a review of the underlying assets for the purpose of making findings with respect to the value of collateral securing those assets. The Proposing Release noted that this could entail analyzing how the originator verified the value of the asset — for example, for RMBS, an NRSRO might require that the review consider the quality of the appraiser of the property and the quality of the appraisal. It could include reviewing whether the appraiser used a

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<sup>9</sup> If all of the disclosures required by Rule 15Ga-2 are included in the prospectus (and are attributed to the third-party due diligence services provider), whether as part of the issuer’s Rule 193 review or otherwise, then the issuer or underwriter must still file Form ABS-15G but may refer to the prospectus disclosures rather than providing detailed disclosures in the form.

valuation model, as well as the performance of a separate valuation by the provider if it believes that the original appraised value of the property is less than the value presented by the originator.

The fourth enumerated category of due diligence services is a review of the underlying assets for the purpose of making findings with respect to whether the originator of the assets complied with applicable laws and regulations. The Proposing Release noted that this could entail, for RMBS, analyzing the documentation in a sampled loan file to verify that the loan was made in conformance with “truth-in-lending” requirements.

The fifth “catchall” category entails a review of the underlying assets for the purpose of making findings with respect to any other factor or characteristic that would be material to the likelihood that the issuer will pay interest and principal in accordance with the transaction requirements (*i.e.*, the likelihood of default or delinquency). According to the SEC, this category is intended to apply to due diligence services that may be used in the future for asset classes other than RMBS which, because the nature of the assets is different, may not fall within the other categories. Many commenters objected to the breadth of the catchall, but the SEC adopted it as proposed. In response to these comments, the SEC stated that it does not intend for “due diligence services” to cover activities that are performed today in connection with the issuance of Exchange Act ABS that are not commonly thought of as third-party due diligence services. The term is “designed to cover reviews...that are commonly understood in the securitization market to be third-party due diligences [sic] services” and analogous services that may develop in the future, not every type of service that involves the performance of diligence in the offering process.

## Exemptions for Offshore Transactions and Municipal Securities

Many commenters urged the SEC to exclude offshore transactions from the scope of Rule 15Ga-2 (and Section 15E(s)(4)(A)), and the SEC recognized the practical and legal impediments that would face issuers and underwriters in offshore transaction. Therefore, the final rule exempts offerings of Exchange Act ABS if:

- The offering is not registered (or required to be registered) under the Securities Act;
- The issuer is not a “U.S. person”;<sup>10</sup> and
- The security will be offered and sold upon issuance (and any underwriter or arranger will effect transactions after issuance) only in transactions that occur outside of the United States.

The SEC also accommodated commenters who objected to requiring municipal issuers and underwriters to comply with Rule 15Ga-2, because Sections 15B(d)(1) and 15B(d)(2) of the Exchange Act prohibit the SEC from requiring municipal issuers to make disclosure filings before their securities are sold to investors. The SEC exempted issuers and underwriters of Exchange Act ABS from Rule 15Ga-2 where the issuer is a “municipal issuer”<sup>11</sup> and the offering is not required to be registered under the Securities Act. However, issuers and underwriters of municipal Exchange Act ABS remain subject to the statutory requirement of Section 15E(s)(4)(A), so while they need not furnish Form ABS-15G, they must make the required disclosures available through some other means reasonably accessible to the public (*e.g.*, posting on a website or voluntarily furnishing Form ABS-15G on EDGAR or EMMA.)

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<sup>10</sup> Within the meaning of Rule 902(k) under the Securities Act.

<sup>11</sup> An issuer that is a state or territory of the U.S., the District of Columbia, or any political subdivision or public instrumentality of the foregoing.

## Form and Content of Required Certification by Provider of Third-Party Due Diligence Services

Whenever third-party due diligence services are provided to an NRSRO, issuer<sup>12</sup> or underwriter, Section 15E(s)(4)(B) of the Exchange Act (as added by Section 932 of the Dodd-Frank Act) requires the due diligence services provider to provide to any NRSRO rating any of Exchange Act ABS to which those services “relate” a written certification in a format to be prescribed by rule. Section 15E(s)(4)(C) requires the SEC to “establish the appropriate format and content...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.” To implement this requirement, Rule 17g-10 will require the mandated written certification to be made on new Form ABS Due Diligence-15E.

Form ABS Due Diligence-15E will require the provider to state its identity and address, the identity and address of the issuer, underwriter or NRSRO that engaged it, and the identity of each NRSRO whose published criteria were satisfied by the performance of the provider's due diligence services. The provider will be required to describe the scope and manner of due diligence that it performed in a manner “that is sufficiently detailed to provide an understanding of the steps taken in performing the review,” including: the type of assets reviewed; the sample size and how it was determined; whether the accuracy of information about the assets provided by the securitizer or originator was reviewed (and if so, how); whether conformity of the origination of the assets to stated underwriting or credit extension guidelines was reviewed (and if so, how); whether the value of collateral securing the assets was reviewed (and if so, how); whether compliance of the originator with applicable laws was reviewed (and if so, how); and any other type of review conducted. Most importantly, Form ABS-Due Diligence 15E also will require the provider to summarize the findings and conclusions of its due diligence review.

As described above, some customary agreed-upon procedures performed by accountants may fall within the scope of “due diligence services” and therefore trigger the requirement to provide a Form ABS-Due Diligence 15E. In a minor accommodation, the SEC states that it would not object to accountants including within their certifications a description of the requirements and limitations resulting from application of the professional standards that govern accounting services, to the extent that they are generally described within accountants' reports.

The certification will have to be signed by an individual duly authorized by the provider of the due diligence services. In signing the certification, the individual must represent that the provider conducted a “thorough review” in performing the described due diligence, and that the information in the certification (including the description of the due diligence performed and the findings and conclusions of that review) are “accurate in all significant respects” as of the date the certification is signed.

Section 15E(s)(4)(B) of the Exchange Act requires that the certification be provided to any NRSRO producing a credit rating to which the due diligence services “relate,” a term that is not defined in Section 15E(s)(4)(B) or in Rule 17g-10. Commenters questioned the extent to which due diligence services provided in connection with a transaction should be deemed to “relate” to a credit rating if those services were not required by and their results were not provided to an NRSRO as a part of its rating process. In adopting the final rules, the SEC appeared to conclude that almost any third-party report regarding “due

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<sup>12</sup> As noted above, Rule 17g-10 specifically defines “issuer” to mean the sponsor of the transaction as well as the depositor.

diligence services” provided in connection with a rated transaction “relates” to that credit rating, because the certification will be required to be made available to any NRSRO that wishes to see it, regardless of whether it is required by that NRSRO’s rating criteria. Therefore, a due diligence services provider will be deemed to have met its obligation to provide Form ABS Due Diligence-15E if it “promptly delivers” the form to:

- Any NRSRO that requests it, in writing, being provided before or after the completion of the due diligence services, stating that the services relate to a rating the NRSRO is producing; and
- To the issuer or underwriter that maintains the Internet website required by Rule 17g-5 under the Exchange Act.

Rule 17g-5 requires each NRSRO engaged to rate a structured finance product to obtain from the issuer, sponsor or underwriter a representation that the arranger will maintain a password-protected website that is accessible to any NRSRO that certifies, among other things, that it will access the website solely for the purpose of determining or monitoring credit ratings. The SEC amended Rule 17g-5 to include within the required representation a commitment by the arranger to post on that website, promptly after receipt, any Form ABS-Due Diligence 15E it receives from any third-party due diligence services provider that contains any information about the security being rated.

## **Additional Rules Augmenting the Existing NRSRO Registration and Oversight Regime**

The new rules adopted by the SEC will, among other things:

- Require an NRSRO, when taking a credit rating action (including publication of a preliminary credit rating, an initial credit rating, an upgrade or downgrade to a credit rating, and an affirmation or withdrawal of a credit rating), to publish a form containing a variety of prescribed information about the credit rating;
- Require each NRSRO to establish, maintain and enforce an effective internal control structure governing its credit ratings process, with respect to which it must consider a variety of specified factors;
- Require each NRSRO to furnish an annual report to the SEC with respect to its internal control structure;
- Prohibit NRSRO personnel involved in sales or marketing, or who are “influenced by sales or marketing considerations,” from also participating in the determination or monitoring of a credit rating or in the development of credit rating methodologies;
- Allow the SEC to suspend or revoke the registration of an NRSRO for certain rule violations that were not willful, but which affected a credit rating;
- Require NRSROs to have “look back” review procedures to determine whether the prospect of future employment by an issuer or underwriter influenced a credit analyst in determining a credit rating and, if such influence is discovered: promptly determine whether the current credit rating must be revised; promptly publish a revised credit rating or affirmation; and if the credit rating is not revised or affirmed within 15 calendar days of the discovery of the improper influence, place the rating on credit watch or review;

- Require disclosures of enhanced performance statistics by NRSROs with respect to initial credit ratings and subsequent changes to those ratings, for the purpose of allowing users to evaluate the accuracy of those ratings and to compare the performance of ratings issued by competing NRSROs;
- With respect to required ratings history disclosures by NRSROs: eliminate the so-called “10% rule” requiring disclosures with respect to 10% of the outstanding issuer-paid credit ratings in each class for which the NRSRO is registered; modify the so-called “100% rule” requiring disclosures for all types of credit ratings from those initially determined on or after June 26, 2007, to those outstanding as of or initially determined on or after three years before the effective date of the new rules; and increase the scope of the required disclosures;
- Require the establishment, maintenance and documentation of certain policies with respect to ratings methodologies;
- Require the design and administration of standards of training, experience and competence for NRSRO personnel;
- Require the establishment of universal rating symbols that clearly define and disclose their meanings and are applied consistently to all types of securities for which they are used; and
- Require an annual report of the NRSRO’s designated compliance officer.

*This memorandum was authored by Charles A. Sweet.*



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