A Dodd-Frank Holiday Reminder: Ribbons, Reindeer and Rule 193

By Devin M. Swaney

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While wrapping your holiday presents, don't forget about another regulatory gift that springs to life as of the new year: Rule 193 and the accompanying joys of Items 1111(a)(7) and 1111(a)(8) of Reg AB. The final rules for Dodd-Frank's Section 945 – which we at CrunchedCredit.com have addressed before - are almost a year old and their effects are coming to a public transaction near you by requiring "issuers" (1) to perform (or have a third party perform) a due diligence review of a deal's underlying assets with the aim of reasonably assuring that disclosure included in the related offering documents is materially accurate and (2) to disclose in offering documents the nature of the review, any findings or conclusions of the review and any details regarding assets that deviate from the disclosed underwriting criteria. And this is a gift that keeps on giving.

Even though Dodd-Frank got one of our Golden Turkey Awards, issuers doing public deals must heed these new rules. Some things are clear: Rule 193 only applies to registered deals after December 31, 2011 and does not extend to Rule 144A and private placements, and the rule does not detail the nature or type of the required due diligence reviews or the content of required disclosure.

One might ask: to what extent will issuers (or other securitizers) be subject to additional legal exposure? In CMBS land, we already do detailed loan-level disclosure subject to 10b-5 materiality standards. All securitizers already have detailed underwriting policies and procedures and mortgage loan sellers and sponsors understand the value of internal due diligence standards, so does this new rule really bring with it any new headaches? You bet. Here's a few:

(1) Scope - the rule requires compliance by "issuers" but it remains unclear whether the goal of the regulators was to include other deal parties like sponsors, depositors or loan sellers within the scope of the new rule. Could the authors, having used the word "issuers," intended to limit the scope to issuers? Unlikely, according to industry chatter so far; instead, the expectation is that the rule will apply to parties beyond the issuer, including sponsors and depositors. So loan sellers and their counsel must deal with this – at least for now.

(2) Experts - the rule permits the hiring of a third party to conduct the due diligence review but it also requires that the third party consent to being an expert for '33 Act purposes if the issuer (or other securitizer) "attributes" the review to that third party. What if you hire and rely on your accountants to comfort diligence data? And what if your lawyers review loan documents? If you think that accountants and lawyers will sign up for expert liability under the '33 Act, I've got a bridge for sale. So just steer clear of "attributing" the review to third parties, right? Not so fast: there is some unclear commentary and related discussions among deal parties, questioning exactly what types of third-party back-up reviews may require expert consent even if the securitizer does not fully attribute the review to the third party. This one is also playing out as we blog.

(3) Hot Potato (or Risk Allocation) – How the foregoing scope and expert considerations get fleshed out impacts how lawyers and deal parties will allocate risk including by way of drafting and backing up offering document disclosure, negotiating indemnification agreements and providing 10b-5/159/Reg AB negative assurance letters and opinions.

Wait, there's more holiday spirit included in the hang-em-high stocking stuffing provisions of Item 1111(a)(8) of Reg AB. A securitizer is required not only to disclose specific asset deviations with respect to underwriting criteria but they must also disclose the identity of the entity responsible for determining that an asset should be included in a deal pool notwithstanding its deviations. Never mind the Reg AB II certifications that we recently discussed here - anybody eager to sign up for these due diligence determinations? We blogged about this last year when the rule was first published and what we thought then remains true. Rule 193 is likely to expand issuer liability and legal concern while producing little in the way of better disclosure. Just what we need right now.

Seasons greetings! And more to come.