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Financial Industry Alert

STRUCTURED FINANCE ALERT

SEC Adopts Final Rules Relating to NRSROs and Third-Party Due Diligence Reports

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On August 27, 2014, the Securities and Exchange Commission (the "SEC") adopted a number of new rules and amendments[1] designed to improve the quality of credit ratings and increase credit rating agency accountability in accordance with Title IX, Subtitle C of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

A majority of the new rules and amendments are directed at nationally recognized statistical rating organizations registered with the SEC ("NRSROs"), and address an NRSRO's internal controls and procedures. However, the newly adopted Rule 15Ga-2 and Rule 17g-10 also impose new obligations on issuers[2] and underwriters of Exchange Act-ABS[3] — which includes both registered public offerings and unregistered exempt offerings — and are designed to improve transparency of third-party due diligence performed for Exchange Act-ABS issuances. Generally, Rule 15Ga-2 requires Exchange Act-ABS issuers and underwriters to publicly file any third-party due diligence reports that they obtain. Rule 17g-10 requires third-party due diligence providers to provide written certifications to each NRSRO that produces a rating related to the due diligence services rendered.

PUBLIC DISCLOSURE OF THIRD-PARTY DUE DILIGENCE REPORTS

Section 15E(s)(4)(A) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as added in accordance with Section 932 of the Dodd-Frank Act, requires issuers and underwriters of asset-backed securities to make publicly available the findings and conclusions of any third-party due diligence report obtained by them.

[1] The adopting release is available at http://www.sec.gov/rules/final/2014/34-72936.pdf.

[2] The term "issuer" is used in this alert interchangeably to refer to the issuing entity, the sponsor and the depositor, unless the context otherwise requires. See Section 240.17g-10(d)(2).

[3] The term "Exchange Act-ABS" references the definition of "asset-backed security" added to the Exchange Act by the Dodd-Frank Act and is defined under Section 3(a)(79) of the Exchange Act. The term includes, but is not limited to, "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset . . ."

Accordingly, under the newly-adopted Rule 15Ga-2, an issuer or underwriter of Exchange Act-ABS to be rated by an NRSRO must disclose on a Form ABS-15G findings and conclusions contained in any third-party due diligence report obtained by the issuer or underwriter.

The Scope of "Due Diligence Services"

Issuers or underwriters must disclose findings and conclusions of any third-party due diligence report. A third-party due diligence report includes any report containing findings and conclusions relating to due diligence services. Due diligence services is defined in new Rule 17g-10(d)(1) as a review of the assets underlying an asset-backed security in order to make findings with respect to:

i. The accuracy of the information or data about the assets;
ii. Whether the origination of the assets conformed to, or deviated from, stated underwriting guidelines, criteria, or other requirements;
iii. The value of collateral securing the assets;
iv. Whether the originator of the assets complied with federal, state, or local laws or regulations; or
v. Any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the asset-backed security will pay interest and principal in accordance with its terms.

The SEC stated in the adopting release that clause (v) above is intended to address a review of any other factor or characteristic of the underlying assets that is relevant to whether the Exchange Act-ABS will pay interest and principal according to its terms and is useful to an NRSRO assessing the creditworthiness of Exchange Act-ABS.

Despite strong objections, the SEC refused to exclude all agreed-upon procedures performed by accounting firms from the definition of due diligence services.[4] In particular, the SEC determined that comparing the information on a loan tape with the information contained in a loan file is an activity within the definition of due diligence services and is subject to Rule 15Ga-2.

Disclosure of the findings and conclusions includes disclosure of the criteria against which the loans were evaluated, how the loans compared to those criteria and the rationale for including any loans in the pool that do not meet those criteria.

Offshore Exemption

Rule 15Ga-2 does not apply if each of the following conditions is satisfied: (1) the offering is not required to be, and is not, registered under the Securities Act of 1933, as amended (the "Securities Act"); (2) the issuer is not a U.S. person; and (3) the security will be offered and sold upon issuance, and any underwriter or arranger will effect transactions of the security after issuance, only outside the United States.

[4] See the SEC's discussion of the agreed-upon procedures on pp. 398-400 of the adopting release.

Municipal Exemption

Rule 15Ga-2 also does not apply if (1) the issuer of the rated security is a municipal issuer[5] and (2) the offering is not, and is not required to be, registered under the Securities Act. The SEC, however, noted that the Dodd-Frank Act did not exclude municipal issuers from the third-party due diligence report disclosure requirements. Consequently, municipal issuers continue to be subject to the statutory requirement of making third-party reports publicly available. Municipal issuers can comply with the statutory requirement "through any means reasonably accessible to the public" by, for example, posting the information on a public website, voluntarily submitting Form ABS-15G via the Electronic Municipal Market Access system, or voluntarily submitting Form ABS-15G via EDGAR.

Form ABS-15G

The SEC revised the existing Form ABS-15G used to report repurchase demands to also include findings and conclusions of third-party due diligence providers. For the purposes of Rule 15Ga-2, the form must be signed by the senior officer in charge of securitization when filed by the depositor[6] or by a duly authorized officer when filed by the underwriter.

The Form ABS-15G may reference relevant sections of the prospectus if such prospectus has already been filed via EDGAR (including an attribution to the third-party that provided the third-party due diligence report) rather than including the findings and conclusions in the filing.

A Form ABS-15G must be filed via EDGAR with respect to both interim and final third-party due diligence reports.

Timing

Form ABS-15G is required to be filed at least five business days prior to the first sale[7] of the Exchange Act-ABS in connection with an initial rating. Form ABS-15G does not need to be filed in connection with subsequent rating actions.

Who Should File

The new rule applies to both registered and unregistered offerings. Only one filing with respect to a particular third-party due diligence report is required. An issuer and an underwriter do not need to both file with respect to the same report.

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[5] The term "municipal issuer" is defined as any "issuer" that is a state or territory of the United States, the District of Columbia, any political subdivision of any state, territory, or the District of Columbia, or any public instrumentality of one or more states, territories, or the District of Columbia. See Section 240.15Ga-2(g).

[6] Note that Form ABS 15G must be signed by the "depositor" when filed to comply with Rule 15Ga-2 requirements. However, the same form must be signed by the "securitizer" when filed to comply with Rule 15Ga-1 repurchase demand reporting obligations. Consequently, if the depositor and securitizer are different entities, they will have to file separately via EDGAR.

[7] The term "first sale" is defined as "the date on which the first investor is irrevocably and contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check." See Section 240.15Ga-2.

Issuers and underwriters are also exempt from Form ABS-15G filing requirements if they obtain a representation from an NRSRO that the NRSRO will publicly disclose the findings and conclusions of a third-party due diligence report obtained by such issuer or underwriter. If an NRSRO makes such representation but subsequently fails to make the filing within five business days prior to the first sale, the issuer or underwriter may cure the NRSRO's failure by filing a Form ABS-15G within two business days prior to the first sale.

CERTIFICATION BY PROVIDERS OF THIRD-PARTY DUE DILIGENCE SERVICES

Section 15E(s)(4)(B) of the Exchange Act, as added in accordance with Section 932 of the Dodd-Frank Act, requires providers of third-party due diligence services to provide a written certification to each NRSRO producing a credit rating for the Exchange Act-ABS to which the due diligence services relate.

The newly adopted Rule 17g-10 requires the providers of third-party due diligence services to provide the mandated certification on the newly created Form ABS Due Diligence-15E.

Form ABS Due Diligence-15E

The written certification required to be made on Form ABS Due Diligence-15E under Rule 17g-10 must include a description of the due diligence services provided, a summary of the findings and conclusions, and identification of any NRSRO due diligence criteria that the third-party intended to satisfy in performing the due diligence. The form must be signed by an individual who is duly authorized by the person providing the third-party due diligence services to make such a certification.

Safe Harbor

Rule 17g-10 also establishes a "safe harbor" under which the person employed to provide third-party due diligence services will be deemed to have fulfilled the requirements under Section 15E(s)(4)(B) if, promptly after completion of the due diligence services, such person provides an executed Form ABS Due Diligence-15E to (1) each NRSRO rating any Exchange Act-ABS that relate to the services provided, including any NRSROs providing unsolicited ratings, and that submits a written request and (2) the issuer or underwriter of the related Exchange Act-ABS maintaining a 17g-5 website.[8] Like Rule 15Ga-2, Rule 17g-10 applies to both registered and unregistered offerings.

Amendments to Rule 17g-5

The SEC also adopted amendments to Rule 17g-5 requiring each hired NRSRO to obtain an additional representation from the issuer or underwriter that such issuer or underwriter will promptly post on the 17g-5 website any executed Form ABS Due Diligence-15E delivered by a provider of third-party due diligence services. This is designed to ensure that all NRSROs that are producing a credit rating gain access to the written certification at approximately the same time, and also to remove the burden on the providers of third-party due diligence services of identifying all such NRSROs.

[8] "17g-5 website" refers to the website maintained by issuers, sponsors or underwriters of structured finance products referred to in clause (a)(3)(iii) of Rule 17g-5.

EFFECTIVENESS

The new rules discussed above will be effective nine months after their publication in the Federal Register. As of the date of this Client Alert these rules have not been published in the Federal Register.

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Please contact any of the below-listed authors of this Client Alert, any of the members of our Structured Finance Group or other Orrick attorneys with whom you work to discuss any questions you may have with regard to the foregoing.

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