

SEC Adopts Final Rules Related to Issuer Due Diligence Review of Assets and Disclosure of Underwriting Exceptions in Public Offerings of Asset-Backed Securities

On January 20, 2011, the US Securities and Exchange Commission (the “SEC”) issued final rules requiring the issuer in a registered public offering of asset-backed securities to perform a due diligence review of the assets being securitized in that transaction and to disclose the nature of such review in the prospectus (the “Final Rules”).¹ The rules were required by Section 945 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

The Final Rules also require the prospectus in a registered public offering of asset-backed securities to contain disclosure concerning the assets being securitized in that transaction, including the amount and characteristics of the securitized assets that deviate from the underwriting and other criteria disclosed in the prospectus.

The Final Rules apply only to registered public offerings under the Securities Act of 1933 (the “Securities Act”) commencing with an initial *bona fide* offer after December 31, 2011. Rule 193, as described below, applies not only to asset-backed securities as defined in Regulation AB (Regulation AB ABS),² but to all asset-backed securities as that term is broadly defined in the Securities Exchange Act of 1934 (the “Exchange Act”) as amended by Section 941 of the Dodd-Frank Act (such asset-backed securities being referred to as “Exchange

Act ABS”).³ The disclosure requirements of Item 1111(a)(7) and (8), as described below, apply only to Regulation AB ABS.

Background

Section 945 of the Dodd-Frank Act requires the SEC to adopt rules that require any issuer of Exchange Act ABS in a registered public offering to (i) perform a review of the assets underlying the Exchange Act ABS and (ii) disclose the nature of that review. On October 4, 2010, the SEC issued proposed rules (the “Proposed Rules”) pursuant to this requirement.⁴ The SEC received comment letters on the Proposed Rules from a wide variety of market participants.⁵ The Final Rules were adopted by the SEC with some significant modifications to the version contained in the Proposed Rules.

The Proposed Rules consist of three provisions:

- New Rule 193 under the Securities Act (requiring that the issuer conduct a review of the securitized assets);
- New Item 1111(a)(7) of Regulation AB (requiring prospectus disclosure of the nature, findings and conclusions of the review); and
- New Item 1111(a)(8) of Regulation AB (requiring prospectus disclosure of the securitized assets that deviate from the underwriting and other criteria disclosed in the prospectus).

The Proposed Rules also contained proposals for rules to implement Section 15E(s)(4)(A) of the Exchange Act (a provision added to the Exchange Act by Section 932 of the Dodd-Frank Act). Section 15E(s)(4)(A) requires that the SEC issue rules requiring the issuer or underwriter of any Exchange Act ABS (whether offered in a registered public offering or a private offering) to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. The SEC agreed with the argument in several of the comment letters that final rulemaking under Section 15E(s)(4)(A) should be postponed so as to coincide with final rulemaking under Section 15E(s)(4)(B)-(D) (requiring that a third party due diligence service that provides services to a rating agency deliver a certification). Therefore, the Final Rules do not contain any rules implementing Section 15E(s)(4) of the Exchange Act.⁶

Rule 193—Issuer Requirement to Conduct a Review of the Securitized Assets

Rule 193 requires that an issuer of Exchange Act ABS in a registered public offering perform a review of the pool assets underlying that Exchange Act ABS.⁷ The “issuer” for purposes of Rule 193 is the “depositor” or “sponsor” of the Exchange Act ABS, as those terms are defined in Regulation AB.

The issuer may either conduct the review itself or employ one or more third parties to conduct it. If the findings and conclusions of the review conducted by a third party are attributed to that third party, that third party must be named in the registration statement and consent to being named as an “expert” in accordance with Rule 436 under the Securities Act. However, if the findings and conclusions of the review conducted by a third party are attributed by the issuer to itself, that third party need not be named as “expert.”⁸ An issuer may not rely on a review

performed by an unaffiliated originator for purposes of performing the review.

At a minimum, the review must be designed and effected to provide reasonable assurance that the disclosure regarding the pool assets in the prospectus is accurate in all material respects.⁹ For example, if the prospectus disclosed that the pool assets are limited to borrowers with a specified minimum credit score or certain income level, the review, as designed and effected, must provide reasonable assurance that the assets in the pool meet those criteria.

Other than the reasonable assurance standard described above, no particular type of review is required. The SEC believes that Rule 193 provides a flexible, principles-based standard that would be workable across a wide variety of asset classes and issuers. The SEC acknowledges that the type of review may vary depending on the circumstances and that there are a range of judgments as to what will provide “reasonable assurance.” The SEC stated that sampling may be appropriate depending on the facts and circumstances, such as the type of asset-backed securities being offered.

It is unclear whether an accounting firm that performs “agreed upon procedures” for the issuer can be deemed a third party engaged for the purposes of performing the review required by Rule 193. Accounting firms perform agreed upon procedures pursuant to the protocols established by the American Institute of Certified Public Accountants.¹⁰ The procedures used by the accounting firms in preparing agreed upon procedures letters are not designed to ensure that the prospectus disclosure concerning the pool assets is accurate in all material respects. Rather, the procedures are usually limited to recalculating projections of future cash flows and verifying that the numerical data regarding the pool assets as disclosed in the prospectus corresponds to the numerical data in the data tape or other specified source data.¹¹

On the other hand, the SEC's instructions to Rule 193 specify that the reviews performed by the issuer and third parties, *in the aggregate*, must comply with the minimum standard of review. Although an agreed upon procedures letter, standing alone, is insufficient to ensure that the prospectus disclosure concerning the assets is accurate in all material respects, such a letter helps to ensure the accuracy of the numerical disclosure about the pool assets, thus contributing to the overall process of ensuring the accuracy of the disclosure about the pool assets. In any event, the issuer may not attribute the accounting firm's findings to the accounting firm without naming the accounting firm in the prospectus and obtaining the consent of the accounting firm to being named as an expert in accordance with Rule 436 under the Securities Act.

Item 1111(a)(7)—Prospectus Disclosure of the Nature, Findings and Conclusions of the Rule 193 Review

New Item 1111(a)(7) of Regulation AB requires that the prospectus contain information about (i) the nature of the assets performed by the issuer or sponsor as required by Rule 193, including whether the issuer of any asset-backed security engaged a third party for purposes of performing the review of the pool assets underlying an asset-backed security¹² and (ii) the findings and conclusions of the review of the assets by the issuer, sponsor or third party, as applicable.¹³ The prospectus disclosure must state whether the finding and conclusions are those of the issuer or a third party. In addition:

- If the issuer has engaged a third party for purposes of performing the review of assets, and attributes the findings and conclusions of the review to the third party in the prospectus, the issuer must provide the name of the third-party reviewer and obtain the third-party's reviewer consent;
- If the review is of a sample of assets in the pool, the prospectus must disclose the size of

the sample and the criteria used to select the assets sampled; and

- The prospectus must contain disclosure that provides an understanding of how the review related to the prospectus disclosure regarding the assets.¹⁴

The instructions to Item 1111(a)(7) state that the disclosure should provide an understanding of how the review related to the prospectus disclosure regarding the assets. The SEC indicated that disclosure of the findings and conclusions of the review necessarily requires disclosure of the criteria against which the pool asset were evaluated, and how the evaluated pool assets compared to those criteria. In the SEC's view, such disclosure is required in order to provide meaningful context to disclosure of the findings and conclusions of the issuer or its third-party due diligence providers.

Item 1111(a)(8)—Prospectus Disclosure of the Securitized Assets that Deviate from Disclosed Criteria

New Item 1111(a)(8) of Regulation AB provides that if any assets in the pool deviate from the disclosed underwriting criteria or other criteria or benchmark used to evaluate the assets, or any assets in the sample or assets otherwise known to deviate if only a sample was reviewed, the prospectus must:

- Describe how those assets deviate from the disclosed underwriting criteria or other criteria or benchmark used to evaluate the assets;
- Include data on the amount and characteristics of those assets that did not meet the disclosed standards; and
- Disclose which entity or entities (e.g., sponsor, originator, or underwriter) determined that those assets should be included in the pool—despite not having met the disclosed underwriting standards or other criteria or benchmark used to evaluate the assets¹⁵—and what factors were used to make the

determination, such as compensating factors or a determination that the exception was not material.¹⁶

Some originators employ underwriting criteria that are broad in nature or that involve the use of discretion. In those cases, it can be difficult to determine which pool assets “deviate” from the underwriting criteria. In the issuing release of the Final Rules, the SEC indicated that, to the extent the underwriting criteria disclosed in the prospectus are broad or describe the use of discretion, the prospectus must disclose how those subjective underwriting decisions were applied. In the case of underwriting criteria consisting of an initial approval level followed by higher levels of approval involving judgment in underwriting decisions, the assets that are included in the pool, despite not meeting the criteria for the initial approval level, should be disclosed under Item 1111(a)(8).

Endnotes

¹ The Final Rules are available at <http://www.sec.gov/rules/final/2011/33-9176fr.pdf>. The Final Rules were published in the *Federal Register* on January 25, 2011, and become effective on March 28, 2011. The compliance deadline for the Final Rules is discussed in this Legal Update.

² Item 1101 of Regulation AB defines “asset-backed security” as “a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.” The definition of “asset-backed security” in Regulation AB contains a number of further limitations that can cause securities that otherwise meet the above description to fall outside the definition of “asset-backed security” under Regulation AB (e.g., limits on the amount of delinquent assets in the securitized pool and limits on the prefunding and revolving periods).

³ The term “asset-backed security” is defined in Section 3(a)(77) of the Exchange Act as “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, including – (i) a collateralized mortgage obligation, (ii) a collateralized debt obligation, (iii) a collateralized bond obligation, (iii) a collateralized bond obligation, (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [SEC] by rule determines to be an asset-backed security for purposes of this section.” Section 3(a)(77) of the Exchange Act provides that the term “asset-backed security” “does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.”

⁴ The Proposed Rules were published in the *Federal Register* on October 19, 2010 and are available at <http://www.sec.gov/rules/proposed/2010/33-9150fr.pdf>.

⁵ Comment letters received by the SEC on the Proposed Rules are available at <http://www.sec.gov/comments/s7-26-10/s72610.shtml>.

⁶ According to the SEC’s anticipated rulemaking timeline (available at <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#0910>), the SEC expects to issue proposed rules under Section 15E(s)(4) by the end of March 2011 and to adopt final rules under that section by the end of July 2011.

⁷ According to the SEC, Rule 193 is not intended to change the due diligence defense against liability under Section 11 of the Securities Act or the reasonable care defense against liability under Section 12(a)(2) of the Securities Act.

⁸ The Proposed Rules would have permitted an issuer to engage a third party to conduct the review only if that third party is named in the registration statement and consents to being named as an “expert” in accordance with Rule 436 under the Securities Act. In response to comments on the Proposed Rules to the effect that many third parties would be unwilling to provide review services because of the risk of “expert” liability under the Securities Act, the SEC modified the requirement in the Final Rules so that an issuer could choose to attribute the findings of any third party review to itself rather than to the third party, thus permitting the third party to avoid “expert” liability.

⁹ The Proposed Rules did not include a minimum standard of review. The SEC indicated that it agreed with commentators that Rule 193 should contain a minimum standard of review. The SEC stated that in the absence of a minimum standard of review, issuers could satisfy Rule 193 with a review that was not designed or carried out in a way that would achieve the purpose of the Dodd-Frank Act to “re-introduce” due diligence into the offering process.

¹⁰ See the comment letter of the Center for Audit Quality (available at: <http://www.sec.gov/comments/s7-26-10/s72610-35.pdf>) for further information about the protocols governing “agreed upon procedures” letters.

¹¹ See the comment letter of PricewaterhouseCoopers LLP (available at: <http://www.sec.gov/comments/s7-26-10/s72610-54.pdf>) for further information about “agreed upon procedures” letters.

¹² The SEC indicated that consent to being named as an expert would not be required of a third party hired by the issuer to assist in performing the review solely based on the fact that the issuer provides disclosure pursuant to Item 1111(a)(7) of Regulation AB that the issuer engaged a third party for the purpose of assisting it to perform the Rule 193 review.

¹³ Note that with respect to a securitization sponsored by a bank in reliance on the safe harbor recently provided by the FDIC in its regulation entitled “Treatment of Financial Assets Transferred in Connection with a Securitization or Participation,” 12 CFR §360.6 (the “FDIC Safe Harbor Rule”), the disclosure about the securitized financial assets must comply with Regulation AB, even if the asset-backed securities are not required to be registered with the SEC. While this disclosure principle of the FDIC Safe Harbor Rule does not seem to require that the Rule 193 review be conducted in a transaction that is not registered with the SEC, this disclosure principle does seem to require the Item 1111(a)(7) disclosure about the nature, findings and conclusions of such a review if a review is conducted. The FDIC Safe Harbor Rule imposes its own separate due diligence report requirements with respect to securitizations in which the securitized assets include residential mortgage loans, but those separate due diligence report requirements are beyond the scope of this memorandum.

¹⁴ For example, if benchmarks or criteria different from those specified in the prospectus were used to evaluate the assets, those benchmarks or criteria should be described, as well as the findings and conclusions.

¹⁵ If multiple entities are involved in the decision to include assets despite not having met the disclosed underwriting standards, this should be described and each participating entity should be disclosed.

¹⁶ In the SEC’s view, this information is helpful to investors because it provides investors with information to determine whether the decision to include such assets in the securitized pool may be subject to a potential conflict of interest.

For more information about the Final Rules or any other matter raised in this Legal Update, please contact your regular Mayer Brown lawyer or any of the following lawyers. To learn more about our securitization practice, please visit <http://www.mayerbrown.com/securitization>.

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