

Dodd-Frank And Asset-Backed Securities: Implementation Of Section 945 (Due Diligence)

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On January 20, 2011, pursuant to Section 945 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the U.S. Securities and Exchange Commission (the "SEC") released Rule 193 (the "Final Rule") that substantially revises the due diligence required by issuers of publicly registered asset-backed securities ("ABS"). The Final Rule overhauls the due diligence requirements for registered ABS by mandating (i) a minimum standard of review, (ii) which parties can perform such review and under what circumstances, and (iii) the required disclosure regarding the review.

The Final Rule will become effective sixty days after publication in the Federal Register. Registered offerings of ABS with a bona fide offer after December 31, 2011, must conform to the Final Rule. This article generally highlights the Final Rule.

Minimum Review Standard

The minimum review standard is as follows:

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- The issuer of registered ABS must perform a review of the underlying assets in a manner intended to provide a reasonable assurance that the disclosure regarding the underlying assets in the offering documentation is accurate in all material respects. As this is a minimum standard, a higher standard of review is permitted but not required under law.

- In connection with adopting the minimum review standard in a principles-based manner, the SEC acknowledged that the nature of the review (i) will be subject to the issuer's judgments as to reasonable assurance and (ii) can vary depending on factors in connection with the ABS issuance, which may include the type and number of assets as well as the type of securitization trust vehicle.

- The standard must include disclosure required pursuant to Item 1111 of Regulation AB (as revised by the Final Rule), as well as disclosure regarding the quality and underwriting of the assets.

- The issuer – who for the purposes of the Final Rule is the depositor or sponsor of the securitization – must have the review conducted for purposes of securitization. A review created for purposes of the origination of the underlying assets, therefore, would not suffice.

- Consistent with the guidance provided in connection with Regulation AB, the standard of review is (i) principles-based in lieu of specific review requirements and (ii) designed to be scalable across the wide variety of asset classes and issuers in the ABS markets.

Although the Final Rule does not specify the type of review the issuer is required to perform, the Final Rule offered some guidance by providing several examples:

- If a prospectus disclosed that the assets are limited to borrowers with a specified minimum credit score, the review would be required to provide reasonable assurance that the assets in the pool met this criterion.

- When the securitization trust consists of a large group of assets (such as in a residential mortgage-backed securities issuance), it may be appropriate to review a sample of assets representative of the pool. If a sampling of the assets is used, the size of the sample and the criteria used to select the assets sampled should be disclosed.

- When there is a single obligor or a small group of obligors (such as in commercial mortgage-backed securities issuance), it may be necessary for the review to include every asset in the pool.

Parties Undertaking The Review

An issuer may elect to engage one or multiple third parties to perform the review under the Final Rule, though aggregators cannot rely upon unaffiliated originators to perform the review. If the issuer chooses to engage a third party, the following rules will apply:

- If the issuer chooses to rely on a third-party's review by attributing the findings and conclusions of the review to the third party, then the issuer will satisfy the requirements of the Final Rule so long as the third party is named in the registration statement and consents to being named as an "expert" in accordance with the Securities Act and related Rule 436.

- Alternatively, the issuer may enlist the services of a third-party reviewer but attribute the findings and conclusions of the review to itself. The third party would not be required to consent to being named an expert. Importantly, in this case, the issuer is limited as to the type of disclosures it can

make regarding third-party diligence reviews in the marketing of the ABS.

- Regardless of whether the issuer attributes the findings and conclusions of the review to itself or to a third party, the issuer must disclose in the prospectus whether the findings and conclusions are those of the issuer or the third party.

Disclosure Requirements

The Final Rule amends the disclosure requirements regarding pool assets set forth in Item 1111 of Regulation AB in the following respects:

- The issuer must disclose the nature of the review. This would include disclosure of the scope of the review and whether the issuer had employed a third party to conduct or assist in the review.

- The issuer must disclose the findings and conclusions of the review. This includes disclosure of (i) the process governing which assets were evaluated, (ii) how the evaluated assets actually measured up to the review criteria, and (iii) a justification for the inclusion of assets that did not meet those criteria.

- Additional disclosure is required with respect to "Exception Loans" – assets that deviate from the disclosed underwriting criteria. This includes:

- Disclosure of the entity or entities that determined that such assets should be included in the pool;

- The factors that were used to make that determination; and

- If the factors justifying inclusion of Exception Loans in the pool include compensating factors, data on the amount of assets in the pool that are represented as meeting each factor and the amount of assets that do not meet those factors.

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