

# Clients & Friends Memo

## Obama Administration Releases Legislative Language Regarding Asset-Backed Securitization

July 23, 2009

Earlier this week, the Obama Administration released legislative language attached as **Exhibit A** to this Memo proposing changes to laws affecting asset-backed securities (“**ABS**”). The proposed legislation is the Administration’s follow-up to its June 17, 2009 release of recommendations for reform of our financial regulatory system (the “**Proposal**”)<sup>1</sup>, which we described in our clients and friends memorandum summarizing the Proposal<sup>2</sup> and our clients and friends memorandum summarizing the Proposal’s impact on the securitization markets<sup>3</sup>.

The key features of the proposed legislation include:

- A regulatory mandate to impose a minimum of 5% credit risk retention by securitizers (no hedging allowed) for such period of time required by the applicable regulators;
- A requirement that the risk retention requirements apply to bank and non-bank securitizers;
- A definition of “securitizer” that includes issuers and underwriters of ABS;
- Continued periodic reporting under the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”), by issuers of ABS even after the number of registered holders falls below 300, at least for such period of time and under such conditions prescribed by the Securities and Exchange Commission (the “**SEC**”);
- A mandate for SEC regulations requiring (1) detailed disclosures regarding the assets underlying ABS (including loan-level detail), (2) disclosure of information identifying loan brokers and originators, the nature and extent of their compensation and the amount of risk retained by the originator or securitizer and (3) standardization of the format of data provided by issuers;

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<sup>1</sup> To view the Obama Administration’s white paper, see, [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

<sup>2</sup> See [http://www.cadwalader.com/assets/client\\_friend/061709\\_FinancialRegulatoryReformProposal.pdf](http://www.cadwalader.com/assets/client_friend/061709_FinancialRegulatoryReformProposal.pdf).

<sup>3</sup> See [http://www.cadwalader.com/assets/client\\_friend/062209RegulatoryReform\\_Securitization.pdf](http://www.cadwalader.com/assets/client_friend/062209RegulatoryReform_Securitization.pdf).

- A mandate for SEC regulations as to the use of representations and warranties, including analysis in rating agency reports of representations, warranties and enforcement mechanisms in ABS offerings, and required disclosure in ABS offerings as to historical repurchases by originators; and
- Repeal of Section 4(5) under the Securities Act of 1933, as amended (the “**Securities Act**”), which exempts offers and sales of mortgage notes from the registration requirements under the Securities Act.

The proposed legislation does not address certain matters addressed in the Proposal:

- There are no proposed changes to accounting principles relating to gain on sale or consolidation; and
- There is no required linking of compensation of loan brokers, originators and ABS deal participants to the performance of securitized assets.

### **Credit Risk Retention by Securitizers**

The proposed legislation would require federal banking agencies and the SEC to jointly prescribe regulations within 180 days requiring “any securitizer of an asset-backed security . . . to retain an economic interest in a material portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party.”<sup>4</sup> Securitizers would be required to retain at least 5% of the credit risk on any asset that is securitized.<sup>5</sup> Securitizers would be prohibited from directly or indirectly hedging or otherwise transferring credit risk that they are required to retain with respect to any asset.<sup>6</sup>

Regulations would specify the permissible forms of risk retention (e.g., first loss position or *pro rata* vertical slice) that would be required and the minimum time period that securitizers would be required to retain such risk.<sup>7</sup> Regulations would also provide for the allocation of risk retention obligations between securitizers and originators where a securitizer purchases assets from an originator.<sup>8</sup> Federal banking agencies would have the authority to jointly adopt or issue exemptions,

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<sup>4</sup> See Investor Protection Act of 2009, Subtitle E: Improvements to the Asset-Backed Securitization Process, 9 U.S.C. § 951, 15F(a).

<sup>5</sup> See *Id.* at § 951, 15F(b)(2).

<sup>6</sup> See *Id.* at § 951, 15F(b)(1).

<sup>7</sup> See *Id.* at § 951, 15F(b)(3).

<sup>8</sup> The term “originator” is defined as “a person who sells an asset to a securitizer.” See *Id.* at § 951, 15F(e)(3).

exceptions or adjustments to the 5% credit risk retention requirement and the prohibition on hedging.<sup>9</sup>

The obligation to retain credit risk will apply to both bank and non-bank securitizers.<sup>10</sup> Moreover, the term “securitizer” is defined as an issuer or an underwriter of ABS.<sup>11</sup> Based on this definition, regulations could be adopted that would impose a credit risk retention requirement on underwriters.

### **Periodic Reporting by Issuers of ABS Under the Exchange Act**

The proposed legislation would require continued reporting by issuers of ABS under the Exchange Act for such period of time and under such conditions as prescribed by the SEC, even if the number of holders of an issue falls below 300.<sup>12</sup> In addition, each issuer of ABS would be required to disclose, at a minimum, asset-level or loan-level data necessary for investors to independently perform due diligence for each tranche or class of security.<sup>13</sup> Disclosure would also be required of:

- the loan broker or originator of the assets backing the security;
- the nature and extent of compensation of the broker or originator; and
- the amount of risk retained by the originator or the securitizer of such assets.<sup>14</sup>

The SEC would also be required to set data formatting standards to facilitate comparison of data across securities for similar asset classes.<sup>15</sup>

The required disclosures described above apply to periodic reports filed pursuant to the Exchange Act, but do not appear to be mandated for Securities Act filings.

### **Representations and Warranties Relating to ABS Offerings**

Under the proposed legislation, the SEC would be required to prescribe regulations requiring rating agencies to include in reports accompanying credit ratings:

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<sup>9</sup> See *Id.* at § 951, 15F(c)(1).

<sup>10</sup> See *Id.* at § 951, 15F(b)(4), indicating that the proposed regulations will “apply regardless of whether the securitizer is an insured depository institution, as defined in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c))”.

<sup>11</sup> See *Id.* at § 951, 15F(e)(2).

<sup>12</sup> See *Id.* at § 952(a),(b).

<sup>13</sup> See *Id.* at § 952(c).

<sup>14</sup> See *Id.*

<sup>15</sup> See *Id.*

- a description of the representations, warranties and enforcement mechanisms available to investors, and
- a description of how such representations, warranties and enforcement mechanisms differ from those in similar transactions.<sup>16</sup>

The SEC would also be required to prescribe regulations requiring disclosure of fulfilled repurchase requests across all trusts aggregated by originator, “so that investors may identify asset originators with clear underwriting deficiencies”.<sup>17</sup>

### **Elimination of Securities Act Section 4(5) Exempting Offers and Sales of Mortgage Notes**

Section 4(5) of the Securities Act permits savings and loan associations, savings banks, commercial banks and other similar banking institutions to sell promissory notes (and participation interests therein) directly secured by a first lien on a single parcel of real estate upon which is located a dwelling without filing a registration statement under the Securities Act.<sup>18</sup> Interestingly, although not mentioned in the Proposal, the proposed legislation would eliminate this Securities Act registration exemption.

It is not clear why this repeal is proposed, as there is no evidence that this exemption was relied upon for mortgage loan ABS transactions in any meaningful way. We would not expect the repeal of Section 4(5) to adversely affect the private whole loan mortgage market, which generally involves negotiated sales of pools of loans between a sophisticated buyer and a sophisticated seller, although mortgage market participants may have concerns about the intent of the proposed repeal.

### **Issues Not Addressed by the Proposed Legislation**

*No Proposed Changes to Gain on Sale or Consolidation Accounting or Consolidation.* The Administration’s Proposal indicated that:

- accounting standards would be reviewed to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information; and

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<sup>16</sup> See *Id.* at § 953(1).

<sup>17</sup> See *Id.* at § 953(2).

<sup>18</sup> See 15 U.S.C. § 77d(5)(A).

- fair value accounting rules would also will be reviewed, with the goal of identifying changes that could provide market participants with both fair value information and greater transparency regarding the cash flows management expects to receive from investments.<sup>19</sup>

However, the Administration's proposed legislation does not contain any provisions related to accounting rules. So, as many people thought, it appears the references in the Proposal were to the changes to FAS 140 and FIN 46 recently adopted by the Financial Accounting Standards Board.

*No Required Linking of Compensation of Loan and ABS Deal Participants to Performance of Securitized Assets.* The Administration's Proposal indicated that banking regulators should issue regulations to align compensation of market participants with longer term performance of underlying loans.<sup>20</sup> Rather than mandating the type and method of compensation of market participants in order to link their compensation to the performance of securitized assets, the proposed legislation would require only disclosure of the nature and extent of compensation of loan brokers and originators.<sup>21</sup>

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<sup>19</sup> See supra, Note 2, at 5.

<sup>20</sup> See supra, Note 2, at 7.

<sup>21</sup> See Investor Protection Act of 2009, Subtitle E: Improvements to the Asset-Backed Securitization Process, 9 U.S.C. § 952(c). For public ABS transactions, disclosure is already required of ABS deal participants by Regulation AB.

Please feel free to contact any of the following if you have any questions about this memorandum.

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**EXHIBIT A**

**Obama Administration's Proposed Legislation Regarding ABS**

1 **TITLE IX**

2 **ADDITIONAL IMPROVEMENTS TO FINANCIAL**  
3 **MARKETS REGULATION**

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5 **SEC. 901. SHORT TITLE.**

6 This title may be cited as the “Investor Protection Act of 2009”.

7 . . .

8 **Subtitle E—Improvements to the Asset-Backed**  
9 **Securitization Process**

10 **SEC. 951. REGULATION OF CREDIT RISK RETENTION.**

11 The Securities Exchange Act of 1934 (15 U.S.C. 78a, *et seq.*) is amended by inserting  
12 after section 15E (15 U.S.C. 78o-7) the following new section—

13 **“SEC. 15F. CREDIT RISK RETENTION.**

14 **“(a) IN GENERAL.—**Within 180 days of the enactment of this Act, the Federal  
15 banking agencies and the Commission shall jointly prescribe regulations to require any  
16 securitizer of an asset-backed security (as defined in section 229.1101(c) of title 17, Code  
17 of Federal Regulations, or any successor thereto), to retain an economic interest in a  
18 material portion of the credit risk for any asset that the securitizer, through the issuance of  
19 an asset-backed security, transfers, sells or conveys to a third party.

20 **“(b) STANDARDS FOR REGULATIONS.—**Regulations prescribed under subsection

21 (a) shall—

1           “(1) prohibit a securitizer directly or indirectly from hedging or otherwise  
2 transferring the credit risk that such securitizer is required to retain with respect to  
3 any asset;

4           “(2) require a securitizer to retain at least 5 percent of the credit risk on  
5 any asset that is transferred, sold, or conveyed through the issuance of an asset-  
6 backed security by such securitizer;

7           “(3) specify the permissible forms of the risk retention that are required  
8 under this section (*e.g.*, first loss position or *pro rata* vertical slice) and the  
9 minimum duration of the required risk retention;

10           “(4) apply regardless of whether the securitizer is an insured depository  
11 institution, as defined in section 3(c) of the Federal Deposit Insurance Act (12  
12 U.S.C. 1813(c));

13           “(5) provide for a total or partial exemption for securitizations of assets  
14 issued or guaranteed by the United States, an agency of the United States, or a  
15 United States Government-sponsored enterprise, as may be appropriate;

16           “(6) provide for a total or partial exemption of other securitizations as may  
17 be appropriate in the public interest or for the protection of investors; and

18           “(7) provide for the allocation of risk retention obligations between a  
19 securitizer and an originator in cases where a securitizer purchases assets from an  
20 originator, as may be appropriate.

21           “(c) EXEMPTIONS, EXCEPTIONS, AND ADJUSTMENTS.—

22           “(1) IN GENERAL.—The Federal banking agencies shall have authority to  
23 jointly adopt or issue exemptions, exceptions, or adjustments to the requirements

1 of this section, including exemptions, exceptions, or adjustments for classes of  
2 institutions or assets relating to the 5 percent risk retention threshold and the  
3 hedging prohibition of subsection (b).

4 “(2) APPLICABLE STANDARDS.—Any exemption, exception, or adjustment  
5 adopted or issued by the Federal banking agencies shall—

6 “(A) help ensure high quality underwriting standards for  
7 securitizers and originators of assets; and

8 “(B) facilitate appropriate risk management practices by such  
9 securitizers and originators, improve access of consumers to credit on  
10 reasonable terms or otherwise serve the public interest.

11 “(d) ENFORCEMENT.—

12 “(1) The Federal banking agencies shall enforce the regulations prescribed  
13 under subsections (a) and (b) with respect to any securitizer that is an insured  
14 depository institution, as defined in section 3(c) of the Federal Deposit Insurance  
15 Act (12 U.S.C. 1813(c)).

16 “(2) The Commission shall enforce the regulations prescribed by the  
17 Federal banking agencies under subsections (a) and (b) with respect to any  
18 securitizer, except those specified in paragraph (1).

19 “(3) The authority of the Commission under this section shall be in  
20 addition to its existing authority to enforce the Federal securities laws.

21 “(e) DEFINITIONS.—For the purposes of this section—

1                   “(1) The term ‘Federal banking agencies’ means the Board of Governors  
2                   of the Federal Reserve System, the National Bank Supervisor, and the Federal  
3                   Deposit Insurance Corporation.

4                   “(2) The term ‘securitizer’ means an issuer or an underwriter of an asset-  
5                   backed security (as defined in section 229.1101(c) of title 17, Code of Federal  
6                   Regulations, or any successor thereto).

7                   “(3) The term ‘originator’ means a person who sells an asset to a  
8                   securitizer.”.

9   **SEC. 952. PERIODIC AND OTHER REPORTING UNDER THE SECURITIES**  
10 **EXCHANGE ACT OF 1934 FOR ASSET-BACKED SECURITIES.**

11 Section 15 of Securities Exchange Act of 1934 (15 U.S.C. 78o) is amended—

12           (a) in paragraph (d), by inserting “, other than securities of any class of asset-backed  
13 security (as defined in section 229.1101(c) of title 17, Code of Federal Regulations, or any  
14 successor thereto),” after “securities of each class”;

15           (b) by inserting at the end of subparagraph (d) the following—

16                   “The Commission may by rules and regulations provide for the suspension or  
17 termination of the duty to file under this subsection for any class of issuer of asset-backed  
18 security (as defined in section 229.1101(c) of title 17, Code of Federal Regulations, or  
19 any successor thereto) upon such terms and conditions and for such period or periods as it  
20 deems necessary or appropriate in the public interest or for the protection of investors.

21           The Commission may, for the purposes of this subsection, classify issuers and prescribe  
22 requirements appropriate for each class of issuer of asset-backed security (as defined in  
23 section 229.1101(c) of title 17, Code of Federal Regulations, or any successor thereto).”;

24           and

1 (c) in paragraph (d), by inserting after the fifth sentence the following—

2 “The Commission shall adopt regulations under this subsection requiring each issuer of an asset-  
3 backed security to disclose, for each tranche or class of security, information regarding the assets  
4 backing that security. In adopting regulations under this subsection, the Commission shall set  
5 standards for the format of the data provided by issuers of an asset-backed security, which shall,  
6 to the extent feasible, facilitate comparison of such data across securities in similar types of asset  
7 classes. The Commission shall require issuers of asset-backed securities at a minimum to  
8 disclose asset-level or loan-level data necessary for investors to independently perform due  
9 diligence. Asset-level or loan-level data shall include data with unique identifiers relating to  
10 loan brokers or originators, the nature and extent of the compensation of the broker or originator  
11 of the assets backing the security, and the amount of risk retention of the originator or the  
12 securitizer of such assets.”.

13 **SEC. 953. REPRESENTATIONS AND WARRANTIES IN ASSET-BACKED**  
14 **OFFERINGS.**

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16 The Commission shall prescribe regulations on the use of representations and warranties  
17 in the asset-backed securities market that:

18 (1) require credit rating agencies to include in reports accompanying credit ratings  
19 a description of the representations, warranties, and enforcement mechanisms available to  
20 investors and how they differ from representations, warranties, and enforcement  
21 mechanisms in similar issuances; and

22 (2) require disclosure on fulfilled repurchase requests across all trusts aggregated  
23 by originator, so that investors may identify asset originators with clear underwriting  
24 deficiencies.

1 **SEC. 954. EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933.**

2 (a) Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended—

3 (1) by striking paragraph (5); and

4 (2) by renumbering paragraph (6) as paragraph (5).

5 (b) Section 3(a)(4)(B)(vii)(I) of the Securities Exchange Act of 1934 (15 U.S.C.

6 78c(a)(4)(B)(vii)(I)) is amended by striking “4(6)” and inserting “4(5)”.