Selected Risk Retention Questions and Answers for CMBS Securitizations

August 16, 2016

Introduction

On October 22, 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development (the "Agencies") released a joint final rule (the "Rule") implementing the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934. The adopting release was published in the Federal Register on December 24, 2014 (the "Release"). References to sections of the Rule set forth below are to the version of the common rule published in the Federal Register (79 Fed. Reg. 77602 (December 24, 2014)).

In an effort to facilitate implementation of the Rule, we have set forth below selected questions that we and certain other participants in the commercial mortgage-backed securities ("CMBS") market have identified as being raised by the Rule and the Release, and we have set forth our views as to the appropriate answers to those questions. These views do not constitute legal advice, have not been informed by formal or informal guidance provided by the Agencies and do not necessarily reflect the view of all CMBS market participants, but instead reflect what the group of legal participants identified below believes to be appropriate positions on the questions presented. These views are subject to change as market practices develop and/or if additional guidance from the Agencies becomes available.

Law Firms

Cadwalader, Wickersham & Taft LLP
Dechert LLP
Orrick, Herrington & Sutcliffe LLP
Sidley Austin LLP

Contact information for the primary law firm participants is located after the Questions and Answers below.

Questions and Answers

Question 1

Who qualifies as a "sponsor" under the Rule? Is it the same as a "sponsor" under Regulation AB?

Answer: The Rule defines a sponsor in the same manner as Regulation AB, *i.e.*, a person who "organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." The adopting release for the Rule states that a sponsor must have "actively participated in the organization and initiation activities that would be expected to impact the quality of the securitized assets underlying the asset-backed securitization transaction, typically through underwriting and/or asset selection." The Rule does not contain any quantitative qualification criteria or a minimum percentage of the collateral pool that must be contributed by an entity in order for it to serve as a "sponsor." In determining when an entity satisfies the qualifications as a "sponsor," the following factors may be taken into consideration (none of which is dispositive):

- the entity's level of involvement in "organizing and initiating" the securitization;
- the entity's level of involvement in underwriting and/or selecting the securitized assets;
- the entity's ability to reject assets proposed to be included in the securitization;
- the amount of assets being transferred by the entity as a percentage of all securitized assets;
- the point in time at which the entity becomes involved in the transaction; and
- the entity's exposure to risk of loss with respect to the assets transferred by such entity prior to their transfer to the securitization.

Question 2

Are there any limitations or constraints on the capital structure of a sponsor, an originator or a third-party purchaser ("TPP") when acting as the risk retention party (each, a "Retaining Party") or on the capital structure of a retaining majority-owned affiliate ("MOA") of any Retaining Party?

Answer: There are no express limitations or constraints on the capital structure of a Retaining Party or an MOA (other than the requirement, in the case of an MOA, that it remain an MOA of the Retaining Party). In addition, the retention by an MOA of a risk retention interest should not itself be viewed as impermissible just because the partial ownership of the MOA by third-party investors has the effect of reducing the Retaining Party's economic exposure to the risk retention interest. Nevertheless, limited purpose entities should be reviewed with care, and those that appear to have been primarily designed to circumvent the restrictions or prohibitions of the Rule may not withstand regulatory scrutiny.

Question 3

May a commercial real estate fund that is externally managed be the Retaining Party under the Rule?

> Answer: The Rule does not prohibit a Retaining Party, whether it is a TPP, an originator or a sponsor, from being externally managed. However, the facts and circumstances will need to be examined particularly when considering an externally managed entity as a retaining sponsor.[1]

Question 4

Can a Retaining Party transfer some but not all of its risk retention interest to an MOA?

> Answer: Yes, but subject to the cautionary note in the answer to question 2.

Question 5

Does the Rule restrict a Retaining Party's ability to transfer a non-controlling equity interest in an MOA that holds a risk retention interest?

> Answer: No, but subject to the cautionary note in the answer to question 2. So long as the Retaining Party, directly or indirectly, "majority controls" (as defined in the Rule), is "majority controlled" by, or is under common "majority control" with, the MOA through the ownership of a majority of the equity interests of, or any other "controlling financial interest" (as determined under GAAP) in, the MOA, then the non-controlling interests in the MOA should be freely tradable by the holders of such non-controlling interests.

Question 6

For multi-sponsor securitization transactions, what is the responsibility of the sponsors that do not assume the risk retention role when the sponsor that assumes the risk retention role fails to meet its risk retention requirements?

> Answer: Although it is the responsibility of each sponsor under § __.3(b) of the Rule "to ensure" that at least one of the sponsors (or at least one of their majority-owned or wholly-owned affiliates, as applicable) of the securitization transaction retains an economic interest in

[1] Note, however, the following discussion in the Release (p. 77609) regarding the phrases "active participation" and "organization and initiation": "Thus, for example, an entity that serves only as a pass-through conduit for assets that are transferred into a securitization vehicle, or that only purchases assets at the direction of an independent asset or investment manager, only pre-approves the purchase of assets before selection, or only approves the purchase of assets after such purchase has been made would not qualify as a 'sponsor'. . . because such activities, in and of themselves, do not rise to the level of 'organization and initiation'."

the credit risk of the securitized assets, the non-retaining sponsors should have no obligation with respect to the ongoing compliance of the retaining sponsor.

Unlike the express requirements in the Rule that the retaining sponsor remain responsible for a retaining TPP's or originator's compliance with the Rule, for the maintenance of and adherence to policies and procedures for the monitoring of such compliance, and for certain related ongoing disclosure (see §§ __7(c) and § __11(b)), there are no analogous post-closing requirements that apply to a non-retaining sponsor. In addition, § __.3(b) does not include § __.12 (transfer, hedging and financial restrictions) among the listed Rule provisions as to which the non-retaining sponsors must "ensure" credit risk retention by the retaining sponsor.

Nevertheless, it would be prudent for the non-retaining sponsors to perform due diligence to reach a level of comfort that the retaining sponsor (or its MOA) has, as of the date of the closing of the transaction, the proper capacity, intent and structure to retain the required risk.

Question 7

Does the Rule permit a Retaining Party to acquire and hold different portions of the risk retention interest in more than one MOA?

Answer: Yes, but subject to the cautionary note in the answer to question 2.

Question 8

What is required for a loan to qualify as providing "full recourse" under the Rule?

Answer: Neither the Rule nor the Release provides meaningful guidance regarding the meaning of § __.12(e), which prohibits a retaining sponsor and its affiliates from pledging "as collateral for any obligation . . . any ABS interest that the sponsor is required to retain with respect to a securitization transaction . . . unless such obligation is with full recourse to the sponsor or affiliate, respectively." Generally, a loan is considered "recourse" if the borrower or its affiliate is obligated to pay the debt even if the collateral for the debt is insufficient to satisfy the debt in full. A loan should be considered "full recourse" under the Rule if (a) the borrower or its affiliate has assets other than the risk retention interest available to repay the debt and (b) a third-party market lender would consider the assets and net worth of the borrower or its affiliate (together with other relevant factors, but excluding the foreclosure value of the risk retention interest) to be sufficient for such lender to make such loan.[2] In any case, whether any recourse arrangements would satisfy the Rule (including, among other considerations,

---

[2] The proposing release (p. 24116) and the re-proposing release (p. 57969) for the Rule indicate that a consensual or nonconsensual sale during the required holding period of a pledged risk retention interest by the counterparty to a recourse financing transaction would constitute a violation by the sponsor of the prohibition on transfer.

complying with the prohibition on hedging under § __.12(b)) must be determined based on the facts and circumstances.

Question 9

If a Retaining Party becomes insolvent and is subjected to reorganization under the United States Bankruptcy laws or similar laws of any state or other jurisdiction and the sale of the risk retention interest is ordered by a court of applicable jurisdiction, is such sale a violation of the Rule?

Answer: § __.12(f)(3) expressly permits sales of a risk retention interest in a securitization transaction in connection with conservatorships or receiverships involving the FDIC or a similar agency, but the Rule is silent as to a transfer in connection with a bankruptcy proceeding.[3] The fact that there is an express exception for transfers by the FDIC and similar federal or state agencies, but not for a bankruptcy court, leaves the law unclear.

Question 10

When the required five-year hold period expires for a TPP (or sponsor that holds a horizontal risk retention interest), are subsequent TPPs required to hold that horizontal risk retention interest for an additional five-year period?

Answer: No. The five-year hold period only applies to the initial TPP (or sponsor, if applicable).

Question 11

On or after the date that is five years after the closing date of the securitization transaction, can a single initial TPP or a retaining sponsor (that, in either case, acquired an eligible horizontal residual interest at the closing of a securitization transaction) or a subsequent TPP (that acquired an eligible horizontal residual interest from the initial TPP or a retaining sponsor after such five-year period) transfer its risk retention interest, or any portion of it, to a subsequent TPP so long as the eligible horizontal interest is at all times held by no more than two TPPs and such TPP interests are *pari passu* (as required by § __.7(b)(8)(ii)(C))?

Answer: Yes.

Question 12

How are rake bonds to be treated?

Answer: In most cases, a given series of loan-specific certificates (rake bonds) evidences the entire ownership interest in a junior note in a particular loan combination (*i.e.*, a group of two or

[3] See footnote 2.

more mortgage notes secured by the same mortgage or deed of trust on the same mortgaged property or properties), and is not entitled to any payments from the senior notes in such loan combination or any other senior notes or mortgage loans pooled with such senior notes. Notwithstanding that such series of rake bonds is in a first loss position with respect to the related loan combination, was issued in conjunction with a pooled securitization transaction for convenience purposes, and is serviced under the same servicing agreement that governs servicing of the entire related loan combination (together with one or more other mortgage loans), investors in a series of rake bonds have exposure only to a single financial asset and will generally be subject to a separate accounting and reporting regime tied to such asset. Therefore a series of rake bonds backed by a separate financial asset (*e.g.*, a separate mortgage note) should be viewed as a separate securitization and separate risk retention should apply to (i) the asset-backed securities backed collectively by the pooled mortgage loans and senior notes and (ii) each series of asset-backed securities backed by the junior note(s) in a given loan combination. However, where a given series of rake bonds evidences a subordinate interest in a particular mortgage note while a series of "pooled" certificates evidences a senior interest in that same note, further analysis may be necessary.

Question 13

Can non-sponsor transaction parties like trustees and custodians, which typically are major banks, provide financing to a TPP in light of the prohibition in § __.7(b)(3)(ii) against a TPP "obtaining financing, directly or indirectly, for the purchase of such interest from any other person that is a party to, or an affiliate of a party to, the securitization transaction"?

<u>Answer</u>: Although the plain language of the Rule does not allow for financing from "any other person that is a party to, or an affiliate of a party to, the securitization transaction," it is not clear that the provision was intended to be read literally so that, *e.g.*, non-sponsors or other, nominal deal parties (and their affiliates) are prohibited from entering into financing arrangements with a TPP. This is a facts and circumstances question that needs to be analyzed on a case-by-case basis.

Question 14

§ __.11(a)(1)(iv) provides that an originator that is taking a portion of the sponsor's risk retention has to pay a price that is equal, "on a dollar for dollar basis," to the amount by which the sponsor's retention is being reduced. The section's plain meaning in the context of eligible vertical interests would result in payment of par, even for the portion of the risk retention interest corresponding to classes that are priced at a discount or premium. Should "dollar for dollar" be read to literally require payment of par?

Answer: No, the provision should not be read literally.[4] The "dollar for dollar" reference appears to be a carry-over from an earlier proposed version of the Rule, which measured vertical retention by fair value (whereas the final Rule measures vertical retention based on par). Furthermore, a literal reading of this Rule provides no guidance on how to pay for an IO class, which is based off a notional amount. We believe that this provision of the Rule should be interpreted to require that an originator pay a price that is equal, "on a dollar for dollar basis," to the fair value of the amount by which the sponsor's retention is being reduced.

Question 15

If a sponsor elects to retain (or a sponsor and a TPP collectively retain) a combination of an eligible vertical interest and an eligible horizontal residual interest as the required risk retention, the percentage of the fair value of the eligible horizontal residual interest and the percentage of the eligible vertical interest must equal at least five. In that regard, should the eligible horizontal residual interest be calculated after netting out (and as a supplement to) the eligible vertical interest in the classes that comprise the eligible horizontal residual interest, and thus the fair value of the eligible horizontal interest be measured net of such eligible vertical interest?

Answer: Yes.

Question 16

Can a TPP be affiliated with a sponsor that is also an originator of less than 10% of the pool?

Proposed Answer: No. A TPP cannot be affiliated with any sponsor (whether or not such sponsor is below the threshold for originator affiliations) because there is no percentage threshold for affiliation with a sponsor. § __.7(b)(5)(ii)(B) provides that a TPP cannot be affiliated with any party to a securitization except for special servicers, investors and originators that originated less than 10% of the pool. A party to a securitization may be both an originator and a sponsor; however, when there is a restriction on affiliation with a sponsor, an originator that is also a sponsor cannot ignore its role as a sponsor for purposes of that restriction.

---

4 The literal reading of § __.11(a)(1)(iv) appears to be at odds with the Release on page 77665 (middle column), which provides as follows: "While section 11(a)(1)(iv) is unchanged from the reproposal, it should be noted that the amount that is required to be paid by the originator might need to be calculated differently from how this amount would have been calculated under the reproposal. In the event that the fair value of all ABS interests issued in a securitization transaction is not calculated, which would be the case if the sponsor opted for all of its required risk retention to be held as eligible vertical interests and one or more classes of ABS interests were not sold to investors, the amount by which the sponsor's risk retention is reduced by the sale of a portion thereof to an originator will not be determinable from the calculations required by section 4 of the rule. In this circumstance, the agencies would expect that the value of the retained portion of any unsold tranches for purposes of section 11 of the rule ***will be determined on a reasonable basis by the sponsor and the originator*** [emphasis added]."

Question 17

Where the risk retention interest is held by a TPP, can the operating advisor ("OA") that is appointed pursuant to § __.7(b)(6) also be the party that acts as an asset representation reviewer ("ARR") under Regulation AB?

> Answer: Yes. The duties of an OA that is appointed pursuant to § __.7(b)(6) are not limited to those set forth in § __.7(b)(6). The ARR is a regulatory requirement pursuant to amendments to Regulation AB, and the ARR that has been appointed for each CMBS securitization subject to Regulation AB since those amendments became effective has been the same entity that has been appointed as the OA. The OA obligations required under § __.7(b)(6) do not relate to the ARR obligations under Regulation AB, and there is no apparent conflict between the OA obligations and the ARR obligations. Therefore, an OA should also be able to act as the ARR.

Law Firm Contact Information

Cadwalader, Wickersham & Taft LLP

Michael Gambro	(212) 504-6825	michael.gambro@cwt.com
Jeffrey Rotblat	(212) 504-6401	jeffrey.rotblat@cwt.com

Dechert LLP

Richard Jones	(212) 698-3844	richard.jones@dechert.com
Laura Swihart	(212) 698-3644	laura.swihart@dechert.com

Orrick, Herrington & Sutcliffe LLP

Janet Barbiere	(212) 506-3522	jbarbiere@orrick.com
William "Butch" Cullen	(212) 506-3529	wcullen@orrick.com

Sidley Austin LLP

Kevin Blauch	(212) 839-5548	kblauch@sidley.com
Jonathan Nunes	(212) 839-5796	jnunes@sidley.com