Clients&FriendsMemo

Reproposed Credit Risk Retention Requirements for Asset-Backed Securities Transactions

September 13, 2013

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") was signed into law by President Obama on July 21, 2010. On April 29, 2011, the Federal banking agencies (the Office of the Comptroller of Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System), the Securities and Exchange Commission ("**SEC**"), the Department of Housing and Urban Development ("**HUD**"), and the Federal Housing Finance Agency ("**FHFA**") (collectively, the "**Agencies**") published a joint notice of proposed rulemaking[1] containing proposed rules (the "**Original Proposal**") to implement the credit risk retention requirements of Section 941 of the Dodd-Frank Act, codified as Section 15G ("**Section 15G**") of the Securities Exchange Act of 1934 (the "**Exchange Act**"). On August 28, 2013, after receipt of comments from over 10,500 persons, institutions and groups on the Original Proposal, the Agencies released a notice of proposed rulemaking (the "**NPR**")[2] containing a revised set of proposed rules (the "**Proposed Rules**") to implement the credit risk requirements of Section 15G.

The Agencies have requested comments to the Proposed Rules by October 30, 2013. The regulations will become effective, with respect to residential mortgage-backed securities ("**RMBS**"), one year after publication of the final rules in the Federal Register, and, with respect to all other asset-backed securities ("**ABS**"), two years after such publication.

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1 See http://www.sec.gov/rules/proposed/2011/34-64148.pdf

2 See https://www.sec.gov/rules/proposed/2013/34-70277.pdf

Significant Changes from the Original Proposal

The Proposed Rules, which are described in detail below, contain a number of changes from the Original Proposal, the most significant of which are:

- *Fair Value*. The standard risk retention requirement has been modified to apply to the "fair value," determined in accordance with U.S. generally accepted accounting principles ("**GAAP**"), rather than the par value of the ABS interests issued in the securitization. Additional disclosures are required about the methodologies, inputs and assumptions used by the sponsor to determine fair value.
- *PCCRA Eliminated*. Because the fair value methodology eliminates the Agencies' concern that the risk retention requirement could be subverted through structuring retained classes with relatively low values while selling excess spread at a premium, the controversial requirement in the Original Proposal to fund a premium capture cash reserve account ("**PCCRA**") has been eliminated.
- *Combination of Retention Options Permitted*. Sponsors are now permitted to satisfy their risk retention requirement by holding any combination of eligible vertical and horizontal interests, rather than being limited to selecting only vertical retention, horizontal retention or a 50/50 "L shaped" combination, as contemplated in the Original Proposal.
- *Representative Sample Eliminated*. Because of the complexity involved in implementing it, the Agencies have eliminated the Original Proposal's option to satisfy the risk retention requirement through the retention of a "representative sample" of the assets designated to be securitized.
- *QRM Equals QM*. The detailed definition contained in the Original Proposal of "qualified residential mortgage" or "QRM", which provides an exemption from the risk retention requirement for ABS backed solely by QRMs, has been conformed to the definition of "qualified mortgage" or "QM" under the Consumer Financial Protection Bureau's ability to repay rule. This will allow more residential mortgage loans to qualify as QRMs than would have qualified under the Original Proposal because, among other things, the QM definition allows a back-end debt-to-income ratio of up to 43%, versus 36% as required under the Original Proposal, and there is no maximum loan-to-value ratio ("**LTV**") under the QM definition, whereas the QRM definition in the Original Proposal contained an 80% maximum LTV requirement.
- *Sunsets on Transfer and Hedging Restrictions*. The Original Proposal restricted transfer, hedging and non-recourse financing of the interest required to be retained for the life of the transaction. Recognizing that underwriting risks diminish as loans

become more seasoned, the Proposed Rules provide for sunset periods on the transfer and hedging restrictions, which differ for RMBS and other types of ABS. In addition, the Proposed Rules provide that where the risk retention is satisfied in CMBS transactions by the holding of a horizontal interest by the sponsor or a qualified third-party purchaser, the sponsor or purchaser may transfer the interest on or after five years from the date of issuance to another qualified third-party purchaser, subject to the same conditions that the initial third-party purchaser is required to satisfy.

- *Expansion of Master Trusts that May Use a Seller's Interest*. The Original Proposal restricted the use of a retained seller's interest to satisfy the sponsor's risk retention requirement for master trusts to trusts solely containing revolving assets. The Proposed Rules now permit a seller's interest to satisfy the sponsor's risk retention requirement in revolving master trusts used to securitize short-term non-revolving assets.
- *Alternative for Open Market CLOs*. The Proposed Rules confirm the view of regulators that, with respect to collateralized loan obligation transactions ("**CLOs**"), the manager of a CLO (a "**CLO Manager**") is a "securitizer" for purposes of Section 15G, but permit the risk retention with respect to certain "open market CLOs" to be held by the lead arranger of the securitized loans.
- *Alternative for Tender Option Bonds*. The Proposed Rules add a tailored alternative method of satisfying the risk retention requirements for tender option bonds.
- *Blending of Certain Qualified and Non-Qualified Loans*. The Original Proposal contained an exemption for ABS backed *exclusively* by "qualifying" commercial, commercial real estate or auto loans. The Proposed Rules allow qualified loans to be mixed with non-qualified loans of the same asset type in a single securitization to proportionately reduce the amount of risk retention required based on the percentage of qualified loans in the pool, but not below 2.5% of the fair value of the ABS.
- *Additional Exemptions Added, Including for Certain Student Loan ABS*. The Proposed Rules add new exemptions, which eliminate or reduce the required amount of risk retention for (i) certain resecuritizations of "first pay" classes that are already subject to risk retention, (ii) certain utility cost recovery securitizations, (iii) securitizations by the FDIC acting as receiver or conservator, (iv) student loan securitizations collateralized by FFELP loans and (v) ABS collateralized by seasoned loans.

I. The Proposed Rules

A. General

Section 15G generally requires the applicable Agencies to jointly prescribe regulations (i) to require a securitizer to retain at least 5% of the credit risk of any asset it, through the

issuance of asset-backed securities, transfers, sells, or conveys to a third-party, and (ii) to prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G and the rules implemented thereunder.

The Proposed Rules generally require sponsors to satisfy the 5% risk retention requirements for assets they securitize and provide some alternatives for retention by originators and other third parties as discussed below. The party or parties required to hold retained credit risk are generally prohibited from directly or indirectly hedging or transferring the credit risk required to be retained. However, as described below, the Proposed Rules permit transfers, under limited circumstances, by sponsors and qualified third-party purchasers in CMBS transactions, and the restrictions on hedging or transferring the retained risk are subject to sunset provisions, the terms of which differ for RMBS and all other ABS. The Proposed Rules also contain some exemptions that eliminate or reduce the required risk retention for certain ABS.

The Proposed Rules would apply to a sponsor of an ABS offering regardless of whether such offering is registered with the SEC under the Securities Act of 1933 (the "**Securities Act**") or is exempt from registration.

II. Party to Retain Risk

A. Sponsor

Under the Proposed Rules, the "sponsor"[3] of a "securitization transaction"[4] in which "asset-backed securities" ("**ABS**")[5] are issued would generally be required to retain an economic

[3] "**Sponsor**" means 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 NPR states that in the context of CLOs, the CLO Manager "typically organizes and initiates the transaction" (by having control over the formation of the CLO collateral pool) and the CLO Manager "indirectly transfers the underlying assets to the CLO issuing entity typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets". The regulators expressed concern that exempting CLOs and CLO Managers could allow market participants to avoid the requirements of Section 15G by employing third party agents to select assets to be purchased and securitized. CLO Managers would thus be required to satisfy the applicable risk retention requirements in connection with each CLO transaction they manage unless (x) the transaction is an open-market CLO whose assets and structure permit credit risk retention to be held by the lead arrangers of the loan tranches held by the CLO, as described in Part III.F of this memorandum, or (y) each loan held by the CLO qualifies for the exemption for "qualifying commercial loans" described in Part IV.B.1 of this memorandum. As a practical matter, CLO Managers may find it very difficult to structure a CLO transaction that satisfies the commercial loan exemption requirements.

[4] "**Securitization transaction**" means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

[5] "**Asset-Backed Security**" has the same meaning as in Section 3(a)(79) of the Exchange Act, which (a) means 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

interest in the credit risk of the "securitized assets",[6] unless otherwise exempted under the *Proposed Rules*. If there is more than one sponsor of a securitization transaction, each sponsor is required to ensure that at least one of the sponsors retains an economic interest in the credit risk of the securitized assets.

Note: The Proposed Rules contemplate that, in a multi-sponsor transaction, the required risk retention may be allocated among the sponsors.[7] *No particular parameters are specified with respect to the amount of any allocation among sponsors, other than that the risk be retained by "at least one sponsor," which raises the question of whether the originator allocation limitations described below would apply to a sponsor who is also an originator of less than all of the underlying assets.*

Note: The NPR provides no guidance on how sponsors can definitively satisfy their obligation to "ensure" compliance by another sponsor, raising the question of whether contractual provisions will be enough or whether active monitoring and disclosure to investors by the non-retaining sponsors is required.

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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 the purposes of the Exchange Act; and (b) 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. In the notice of the proposed rulemaking for the Original Proposal, which used the same definition of Asset-Backed Security, the Agencies made clear that "synthetic" securitizations are not within the scope of the Proposed Rules because the term asset-backed security for purposes of Section 15G includes only those securities that are collateralized by self-liquidating financial assets.

6 **Securitized Asset**" means an asset that: (1) is transferred, sold, or conveyed to an issuing entity; and (2) collateralizes the ABS interests issued by the issuing entity. Under the Proposed Rules, "**ABS interest**" (1) includes any type of interest or obligation issued by an issuing entity, whether or not in certificate form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and (2) does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) are issued primarily to evidence ownership of the issuing entity; and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

7 In a memorandum, dated August 19, 2013, from the staff of the FDIC (the "FDIC Staff") to the FDIC Board of Directors, recommending approval of the NPR and summarizing the Proposed Rules, the FDIC Staff stated that "In circumstances where two or more entities each meet the definition of sponsor for a single securitization transaction, one of the sponsors must retain the entire amount of credit risk required under the new proposal." That statement seems flatly contradictory to the actual text of the Proposed Rules.

B. Originator

The Proposed Rules would permit a sponsor to allocate its risk retention obligations to originator(s)[8] of the securitized assets in certain circumstances and subject to certain conditions.

For purposes of the Proposed Rules, an "originator" is the original creditor of a loan or receivable (i.e., the entity that "created" such loan or receivable), and not a subsequent purchaser or transferee. A sponsor that satisfies its risk retention requirement by holding either an eligible vertical interest or an eligible horizontal residual interest (including funding an eligible horizontal cash reserve account) would be allowed to allocate a portion of its risk retention obligation to any originator of underlying assets in the securitization transaction that contributes at least 20% of the underlying assets to the pool by selling a portion of the retained interest to the originator for cash or a reduction in the price paid by the sponsor to the originator for the securitized assets. The amount of risk retention that the originator may assume must be at least 20% but cannot exceed the percentage, by unpaid principal balance, of securitized assets it originated. The originator would be subject to all of the same requirements for holding the risk retention amount and would be subject to the same restrictions on transfer, hedging and financing imposed on the sponsor as summarized in Part III.H of this memorandum. Although a sponsor may transfer a portion of the retained risk to an originator, the sponsor is obligated to monitor compliance by the originator with the requirements of the Proposed Rules and to notify the holders of ABS interests of any instances of noncompliance by the originator. The sponsor is also required to disclose to investors, a reasonable period of time prior to sale of the ABS and, upon request, to the SEC and its applicable Federal banking regulators, certain information about the originator and the form, amount and nature of payment for, the interest retained by the originator.

> *Note: Although the percentage of the risk retention requirement that can be allocated to an originator cannot exceed the percentage of securitized assets originated by such originator, the risk retention by such originator is with respect to the entire pool of securitized assets, not just the assets originated by such originator.*
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> *Note: In some transactions, notably most CMBS "conduit" transactions, there are multiple sponsors that are also originators. The Proposed Rules are unclear about whether the obligation of a sponsor to ensure a minimum 5% risk retention*

[8] "**Originator**" means a person who: (1) through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and (2) sells the asset directly or indirectly to a securitizer or issuing entity.

overrides the limitation on such sponsor, in its role as originator, from retaining more than its pro rata portion of the aggregate 5% requirement (although presumably this was the Agencies' intention). Given the limitations that prevent a less-than-20% originator from helping to satisfy a transaction's risk retention requirement, a greater than pro rata burden is, by definition, imposed upon sponsors in any transaction where an originator contributes less than 20% of the collateral.

Note: In CMBS transactions where the sponsors elect to partially satisfy their risk retention obligation through the third-party purchaser retention option described below, it is not entirely clear whether the originator 20% minimum requirement applies to the aggregate 5% sponsor obligation (which would mean that no originator could retain less than 1% of fair value) or if it refers to the net obligation of the sponsors after taking into account B-piece buyer retention.

C. Other Parties

As discussed below, the sponsor could satisfy its risk retention obligations if risk is retained by B-piece buyers in CMBS transactions, originator-sellers in certain asset-backed commercial paper conduits or lead arrangers of CLO-eligible tranches in certain Open Market CLOs.

III. Form and Amount of Risk Retention

Unless one of the exemptions described in Part IV of this memorandum applies to reduce or eliminate the risk retention requirement, the sponsor is required to retain a portion of the transaction equal to at least 5% of the fair value of all ABS interests in the issuing entity issued as part of the transaction, including those retained by the sponsor. The fair value of the ABS interests is required to be determined in accordance with U.S. GAAP and as of the day on which the price of ABS sold to third party investors is determined.

Note: The price paid by investors for different classes in an ABS transaction may be determined on different days or, in the case of "at the market" offerings, investors who purchase at different times may pay different prices for the same class of ABS interests.

A. Standard Risk Retention

A sponsor may satisfy its risk retention requirements by retaining an "eligible vertical interest" or an "eligible horizontal residual interest" or any combination thereof having a fair value at least equal to 5% of the fair value of all ABS interests in the securitization.[9]

Note: In the NPR, the Agencies state that they "preliminarily believe that non-economic residual interests would constitute ABS interests." Failure by the Agencies to rethink this preliminary belief and at least carve out non-economic REMIC residual interests would be highly problematic for RMBS and CMBS transactions. In the case of vertical risk retention, it would force the sponsor to hold 5% of the REMIC residual which, in addition to requiring the sponsor to assume tax liabilities and burdens unrelated to the credit quality of the collateral, would create an untenable situation if the sponsor is a "disqualified organization," as defined in the REMIC regulations, because the credit risk retention rules mandate that the sponsor keep the residual, while the tax rules mandate that it dispose of it. Similarly, if the sponsor elects to hold a horizontal interest, because a REMIC residual, even though it is non-economic, is entitled, and indeed required, to receive any remaining cash flow after all classes of securities have been paid, even if no such cash flow is expected, the non-economic REMIC residual may be considered the most subordinate ABS interest in the structure and would thereby need to be retained in its entirety by the sponsor to satisfy the conditions for an eligible horizontal residual interest.

Note: Not only would considering non-economic REMIC residual interests to be ABS interests be problematic for sponsors, it would actually be counterproductive to the fundamental purpose of the Proposed Rules to require sponsors to retain 5% of the overall fair value of the ABS interests. Because non-economic REMIC residual interests generally have a negative value, since they are not entitled to any cash flow and have net tax liabilities associated with their ownership,

[9] This new formulation of the risk retention requirement generally requires a greater amount to be retained than would a requirement based on par value of the ABS interests. For sponsors utilizing horizontal risk retention (as described below), the fair value basis retention requirement results in a greater amount retained in two ways. First, since the aggregate fair value of all securities issued in ABS transactions would generally exceed the par value of the underlying assets (especially where the underlying assets are newly-originated), the base requirement for vertical or horizontal risk retention will generally be higher than 5% of the par value of ABS issued in the transaction. Second, with respect to horizontal risk retention, since the most junior classes in ABS transactions typically are sold at a discount, the fair value of such classes would be expected to be less than the par value thereof, which further increases the risk retention obligation beyond 5% of the par value of the entire transaction. So, for example, in a $100 securitization, where the fair value of all securities issued is 102% of par and the horizontal interest or interests retained have a fair value 50% of par, rather than a $5 par-based retention obligation, the sponsor's retention obligation would be $5.10 measured in fair value (i.e., $10.20 in principal balance).

including them in the fair value calculation would actually reduce the amount of risk that the holder of an eligible horizontal residual interest is required to retain.

Vertical Risk Retention. An eligible vertical interest is an interest in each class of ABS interests issued in the securitization that constitutes the same portion of the fair value of such class. Therefore, to satisfy its risk retention obligation solely through the use of an eligible vertical interest, a sponsor would need to retain 5% of the fair value of each ABS interest issued by the issuing entity. As an alternative to holding multiple interests in the issuing entity, which may increase the sponsor's administrative burden, the Proposed Rules specify that a "single vertical security," entitling the sponsor to specified percentages of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security), which specified percentages "result in the fair value of each interest in each such class being identical" would also meet the definition of eligible vertical interest.

Note: In the NPR, the Agencies note that the eligible vertical interest would require holding an interest in each class of ABS interests, regardless of whether certificated or uncertificated. Given the breadth of the definition of ABS interests, it might be helpful for the Agencies to clarify that uncertificated REMIC interests used in RMBS and CBMS transactions to structure cash flows for tax purposes and either held solely by one of the REMICs constituting the issuing entity or combined into a single certificated security would not be considered ABS interests for purposes of risk retention.

Note: While the language of the Proposed Rules literally states that the fair value of each interest in each class represented by a single vertical security would have to be identical, the more logical construction, and one supported by the Agencies' description in the NPR, is that the percentage of the fair value of each class represented by the single vertical security would need to be equal. A technical correction to the text of the Proposed Rules would seem in order.

Horizontal Risk Retention. An eligible horizontal residual interest is an ABS interest in the issuing entity that has the most subordinated claim to payments of both principal and interest by the issuing entity and, with respect to which, on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero).

The Proposed Rules permit multiple classes to constitute an eligible horizontal residual interest, as long as they are the most subordinate classes in the capital stack.

Because of concerns by the Agencies that the risk alignment between securitizers and investors would be diminished if an eligible horizontal interest were structured in such a fashion as to have its balance reduced disproportionately faster than that of other ABS interests in the securitization, the Proposed Rules require that the transaction be structured such that, based on the structuring assumptions, the sponsor not receive payments on its eligible horizontal residual interest at a faster rate than principal is received by investors in all ABS interests in the securitization. This is accomplished by requiring the sponsor to make and certify, prior to the issuance of the eligible horizontal residual interest, a one-time calculation of (i) the Closing Date Projected Cash Flow Rate for each payment date for the eligible horizontal residual interest and (ii) the Closing Date Projected Principal Repayment Rate for each payment date for all ABS interests in the securitization. Prior to the issuance of the eligible horizontal residual interest, the sponsor must certify to investors that it has calculated the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate for each payment date and that the Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date.

The "**Closing Date Projected Cash Flow Rate**" is the projected rate of payments on the eligible horizontal residual interest on each payment date, calculated as of the closing date of the securitization and using the same discount rates and assumptions used to calculate the fair value of the eligible horizontal residual interest. This calculation is performed by projecting the cumulative cash flow to be paid to the holder of the eligible horizontal residual interest through such payment date and dividing it by the projected cumulative cash flow to be paid to the holder of the eligible horizontal residual interest through maturity. The "**Closing Date Projected Principal Repayment Rate**" is the projected rate of payments on all of the ABS interests (including the eligible horizontal residual interest) on each payment date, calculated as of the closing date of the securitization and using the same discount rates and assumptions used to calculate the fair value of the ABS interests. This calculation is performed by projecting the cumulative amount of principal on all ABS interests through such payment date and dividing it by the aggregate principal amount of all the ABS interests issued in the securitization (including the eligible horizontal residual interest).

As part of its disclosures to investors prior to sale of the ABS interests, the sponsor must disclose the number of securitization transactions securitized by the sponsor during the previous five-year period in which the sponsor retained an eligible horizontal residual interest and the number (if any) of payment dates in each such securitization on which

actual payments to the sponsor with respect to the eligible horizontal residual interest exceeded the cash flow projected to be paid to the sponsor on such payment date in determining the Closing Date Projected Cash Flow Rate.

The Agencies have proposed for comment an alternative condition on eligible horizontal residual interests. The proposed requirement described above that the transaction be structured, as of the issuance date, so as not to provide disproportionate distributions on the eligible horizontal residual interest, does not actually restrict distributions to the sponsor on any payment date that are greater than anticipated if prepayments, losses and other factors vary from those assumed at issuance. By contrast, the alternative proposal would not impose any structuring conditions, but would instead prohibit distributions on the eligible horizontal residual interest on any payment date in excess of the eligible horizontal residual interest's proportionate share of cumulative distributions. The horizontal interest's proportionate share would be the proportion represented at issuance by the fair value of the eligible horizontal residual interest of the total fair value of all ABS interests.

> *Note: The imposition of a "projected cash flow" vs. "projected principal repayment" test essentially requires that the rate of cash flow to retained junior securities does not, on any payment date, exceed the rate of principal amortization on the transaction as a whole. This restriction may make horizontal retention unworkable in any ABS transaction where principal amortization occurs relatively later in the life of the transaction. For instance, CMBS transactions generally contain loans that require amortization based on an amortization schedule that is longer than the term of the loan (e.g., a 30-year amortization schedule on a 10-year loan), with many loans having an "IO period" during which no amortization is required. Such loans require a balloon payment at maturity, resulting in a highly disproportionate percentage of principal being paid in the later years of the transaction. In an extreme example of a single loan CMBS transaction in which the underlying loan has an initial IO period, the retained B-piece would not be permitted to receive any cash flow, including accrued interest, in the early part of the transaction, even though the loan is fully performing and interest cash flow on the underlying loan is available for distribution, but could only begin to receive cash when the underlying loan begins to amortize. Since the Agencies seem to understand that most commercial mortgage loans provide for back-ended principal amortization (see the discussion of Qualifying CRE Loans in Part IV.B.2 of this memorandum), it is unclear whether the Agencies intended this result. A similar unintended consequence could occur in RMBS transactions in which, due to the front-loading of interest in the actuarial amortization schedule used on the vast majority of residential mortgage loans, interest cash flow on the collateral is*

received at a faster rate than principal is received during the early years of a transaction.

A simple solution to the problem noted above would be for the Agencies to base the concept of Closing Date Projected Principal Repayment Rate on the rate on which total cash flows, rather than principal payments, are projected to be received on the ABS interests through any payment date. Interestingly, in the alternative condition described above, the Agencies did, in fact, choose to compare the horizontal interest's cash flow to total cash flow, rather than total principal payments.

Note: The interaction of the new fair value methodology with the definitions of eligible horizontal residual interest and ABS interest raises an interesting issue. Because fair value must be determined at the time of sale of the ABS interests, it is not possible to know the exact size of the eligible horizontal vertical interest until the transaction structure has already been set. A sponsor could presumably structure conservatively to make sure that the most subordinated class will represent at least 5% of the fair value of the ABS interests, but if that class turns out to represent, for example, 6% of the fair value at the time of sale of the ABS interests, the Proposed Rules are not clear about whether the sponsor could sell a portion of the class, representing 1% of fair value, to a third party. This is because an eligible horizontal residual interest is defined, in part, as an ABS interest that has the most subordinated claim to payments of principal and interest by the issuing entity and that will suffer a reduction in the amounts paid to it on any payment date on which the issuing entity has insufficient funds to make all payments of principal and interest due prior to any reduction in the amounts paid to any other ABS interest. Since the definition of ABS interest, in turn, refers to "any type of interest or obligation issued by an issuing entity, whether or not in certificated form," the question arises as to whether the "extra" 1% of the most subordinate class would itself be a separate ABS interest, thereby disqualifying the 5% piece from qualifying as an eligible horizontal residual interest because it is pari passu with, and not subordinated to, the 1% interest.

Horizontal Cash Reserve Account. In lieu of holding all or any part of an eligible horizontal residual interest, the Proposed Rules would allow a sponsor to fund a horizontal cash reserve account to be held with the securitization trustee in an amount equal to the fair value of the eligible horizontal residual interest or portion thereof. The account would be required to be structured to absorb the same first loss risks as would be absorbed by retained horizontal residual securities. To that end, cash in the reserve account must be released to satisfy payments on ABS interests in the issuing entity on any payment date on

which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest. Until all ABS interests are paid in full or the issuing entity is dissolved, amounts in the account (other than interest payments received in the account in respect of permitted investments specified in the Proposed Rules) may not be released to the sponsor unless (1) the sponsor has complied with its calculation and certification responsibilities with respect to the Closing Date Projected Cash Flow Rate and the Closing Date Principal Repayment Rate and (2) the amounts released to the sponsor or other holder of the horizontal cash reserve account do not exceed, on any release date, the Closing Date Principal Repayment Rate as of that release date. In calculating the Closing Date Projected Cash Flow Rate and the Closing Date Principal Repayment Rate, funds released from the horizontal cash reserve account are treated like amounts that would be paid on an eligible horizontal residual interest.

Required Disclosures: The Proposed Rules would require that the sponsor cause to be provided to potential investors a reasonable time prior to the sale of the related ABS and, upon request, to the SEC or appropriate Federal banking agency (if any) written disclosures under the caption "Credit Risk Retention" as follows:

Horizontal interest. With respect to any eligible horizontal residual interest held, a sponsor must disclose:

- The fair value (expressed both as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as an absolute dollar amount (or foreign currency amount, if the ABS interests are not denominated in U.S. dollars)) of (i) the eligible horizontal residual interest the sponsor will retain (or did retain) at the closing of the securitization transaction, and (ii) the eligible horizontal residual interest that the sponsor is required to retain under the Proposed Rules;
- A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
- A description of the methodology used to calculate the fair value of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;
- The key inputs and assumptions used in measuring the total fair value of all classes of ABS interests, and the fair value of the eligible horizontal residual interest retained by the sponsor, including but not limited to quantitative information, as applicable, about discount rates, loss given default (recovery), prepayment rates, defaults, lag time between default and recovery, and the basis of forward interest rates used; and

- The reference data set or other historical information used to develop the key inputs and assumptions used to measure fair value of all classes of ABS interests, including loss given default and actual defaults.

If the sponsor retains risk through the funding of a horizontal cash reserve account, the sponsor must disclose:

- The amount to be placed (or that is placed) by the sponsor in the horizontal cash reserve account at closing, and the fair value (expressed both as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as an absolute dollar amount (or foreign currency amount, if the ABS are not denominated in U.S. dollars)) of the eligible horizontal residual interest that the sponsor is required to fund through the cash reserve account under the Proposed Rules;
- A description of the material terms of the horizontal cash reserve account; and
- The same information required in connection with holding an eligible horizontal residual interest regarding methodology, inputs and assumptions used to determine the fair value of all ABS interests and the data and historical information used to develop key inputs and assumptions.

> *Note: The requirement to disclose the dollar value of the retained interest a reasonable amount of time prior to the sale of the ABS interests creates a circularity issue. Because the fair value of the ABS interests is required to be measured at the date that they are sold to third parties, by definition the dollar value of the retained interest can't be known prior to sale.*
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> *Note: The requirement to disclose the value of the eligible horizontal residual interest (or, as noted below, the eligible vertical interest) that the sponsor is required to retain is somewhat confusing, in that the Proposed Rules generally do not require a specific interest to be retained, but only mandate the minimum percentage of fair value of the ABS to be retained in any combination of eligible interests. For example, a sponsor with a 5% risk retention requirement may choose to hold 2% through an eligible vertical interest and 2% through an eligible horizontal residual interest and fund 1% through an eligible horizontal cash reserve account. It might be clearer if, rather than specifying disclosure, with respect to each type of risk retention, of the amount that the sponsor is required to hold, the Agencies were to mandate that the sponsor disclose the total percentage of the fair value of the ABS that it is required to retain.*

Vertical interest. With respect to any eligible vertical interest, the sponsor must disclose:

- Whether the sponsor will retain (or did retain) the eligible vertical interest as a single vertical security or as a separate proportional interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction;
- With respect to an eligible vertical interest retained as a single vertical security:
    - The fair value amount of the single vertical security that the sponsor will retain (or did retain) at the closing of the securitization transaction and the fair value amount of the single vertical security that the sponsor is required to retain under the Proposed Rule; and
    - Each class of ABS interests in the issuing entity underlying the single vertical security at the closing of the securitization transaction and the percentage of each class of ABS interests in the issuing entity that the sponsor would have been required to retain under the Proposed Rule if the sponsor held the eligible vertical interest as a separate proportional interest in each class of ABS interest in the issuing entity;
- With respect to an eligible vertical interest retained as a separate proportional interest in each class of ABS interests in the issuing entity, the percentage of each class of ABS interests in the issuing entity that the sponsor will retain (or did retain) at the closing of the securitization transaction and the percentage of each class of ABS interests in the issuing entity that the sponsor is required to retain under the Proposed Rules; and
- The same information as required in connection with holding an eligible horizontal residual interest regarding methodology, inputs and assumptions used to determine the fair value of all ABS interests and the data and historical information used to develop key inputs and assumptions.
- Sponsors are required to retain all required disclosures, as well as the certifications relating to the projected payment rate of any eligible horizontal residual interest, for three years after all ABS interests in the related securitization transaction are no longer outstanding.

B. CMBS B-Piece Buyer Retention

For CMBS transactions, the Proposed Rules allow a sponsor to satisfy all or a portion of its risk retention obligation if a third-party purchaser ("**B-piece buyer**") purchases and holds (for its own account) an eligible horizontal residual interest in the same form, amount and manner as would be held by a sponsor under the horizontal risk retention option. The Proposed Rules permit the use of the B-piece buyer retention option for either the entire

risk retention obligation or for a portion of the risk retention obligation in combination with a vertical interest held by the sponsor.

The eligible horizontal residual interests can be acquired by up to two B-piece buyers as long as each interest is *pari passu* with the other interest. Each B-piece buyer would be required to satisfy, and would be subject to, all of the requirements set forth in the Proposed Rules that would otherwise apply to a sponsor that was retaining an eligible horizontal residual interest, including the prohibitions on hedging and transferring any portion of the risk required to be so retained, except as set forth below.

Definition of Commercial Real Estate Loan. Use of the B-piece buyer alternative is only available for ABS transactions that are collateralized solely by commercial real estate loans and related servicing assets.[10] The Proposed Rules define "commercial real estate loans" as loans that are secured by five or more single family units or by nonfarm nonresidential real property if 50% or more of the source of repayment is expected to be the proceeds of the sale or refinancing of the property or rental income[11] from the property. Excluded from the definition of a "commercial real estate loan" are (i) a land development and construction loan (including one-to-four family residential or commercial construction loans), (ii) any other land loan and (iii) an unsecured loan to a developer.

> *Note: The Agencies stated in the NPR that a "commercial real estate" loan does not include a loan made to the owner of a fee interest in land that is ground leased to a third party who owns the improvements on the property. Therefore, such loans could not be included in a CMBS pool where the sponsor is relying on the B-piece buyer alternative for risk retention.*

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[10] "**Servicing assets**" are rights or other assets designed to assure the timely distribution of proceeds to ABS interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

[11] "**Rental income**" means (1) income derived from a lease or other occupancy agreement between the borrower or an operating affiliate of the borrower and a party which is not an affiliate of the borrower for the use of real property or improvements serving as collateral for the applicable loan, and (2) other income derived from hotel, motel, dormitory, nursing home, assisted living, mini-storage warehouse or similar properties that are used primarily by parties that are not affiliates or employees of the borrower or its affiliates."

The Original Proposal required that rental income be from entities that were not affiliated with the borrower. In response to industry comment that such a restriction would exclude many hotel and healthcare loans, the Proposed Rules modified the definition of rental income to permit such loans as long as the ultimate income stream is derived from parties that are unaffiliated with the borrower.

General Requirements. Satisfaction of all or a portion of the risk retention requirement for CMBS transactions by use of the B-piece buyer retention alternative is subject to satisfaction of the following conditions (among others):

- The CMBS are collateralized solely by commercial real estate loans, as defined above, and related servicing assets.
- Each B-piece buyer must pay for the eligible horizontal residual interest in cash at the securitization closing.
- A B-piece buyer may not obtain direct or indirect financing for the purchase of such interest from any other party (or an affiliate) to the securitization (other than a person that is a party solely by virtue of being an investor).
- Each B-piece buyer must conduct an independent review of the credit risk of each asset in the pool prior to the sale of the CMBS, which review must include, at a minimum, a review of the underwriting standards, collateral and expected cash flows of each loan in the pool.
- No B-piece buyer may be affiliated with any party to the securitization transaction (including, but not limited to the sponsor, depositor or servicer) other than (i) an investor, (ii) the special servicer or (iii) one or more originators that in the aggregate originated less than 10% of the unpaid principal balance of the asset pool.
- The securitization provides for the appointment of an operating advisor that is not affiliated with any of the other securitization parties and has no financial interest in the transaction (other than fees for its role as operating advisor), with the following rights and responsibilities:
    - the operating advisor is required to act in the best interest of, and for the benefit of, investors as a collective whole;
    - the operating advisor must meet standards of experience, expertise and financial strength that are set forth in the CMBS transaction documents (although the Proposed Rules do not set forth any such standards, leaving the transaction parties to determine what standards should apply);
    - when the horizontal residual interest is reduced to 25% or less of its initial principal balance, the special servicer must be required to consult with the operating advisor in connection with, and prior to, making any material decisions relating to the servicing of the mortgage loans, including, without limitation, any material modification or waiver of the terms of a loan agreement, foreclosure or acquisition of a mortgaged property;

- the operating advisor must have adequate and timely access to information and reports necessary to fulfill its duties;
- the operating advisor must be responsible for reviewing the actions of the special servicer, reviewing the reports of the special servicer, reviewing for accuracy and consistency the calculations made by the special servicer and issuing a report to investors periodically on whether the special servicer is operating in compliance with the standards provided for in the transaction documents (including any standards with which it believes the special servicer failed to comply); and
- the operating advisor must have the authority to recommend replacement of the special servicer if the operating advisor determines that (i) the special servicer has failed to comply with the standards provided in the transaction documents and (ii) such replacement would be in the best interest of the investors as a collective whole. If the operating advisor makes such a recommendation, then the special servicer may be replaced upon the affirmative vote of a majority of all CMBS holders voting on the matter (with a minimum of 5% of all CMBS holders constituting a quorum for such a vote).

Note: Although the NPR states that the purpose of the operating advisor is to serve as a check on a B-piece buyer's control over special servicing, the Proposed Rules do not make any distinction between transactions in which the holder of the B-piece is given special servicing control rights and those in which the holder of the B-piece has no such rights (such as large-loan or single asset CMBS). In addition, the Proposed Rules contain no phase-out for the role of the operating advisor after the B-piece buyer's interest has been written down as a result of realized losses. In fact, the Proposed Rules increase the operating advisor's role following a 75% reduction in the principal balance of the retained horizontal interest, which is typically when the B-piece buyer's rights are diminished.

Note: There is no requirement for an operating advisor if a sponsor retains a horizontal residual interest even if the interests held by the sponsor grant it control over special servicing activities.

Disclosure. The Proposed Rules require the sponsor to disclose the name and form of organization of each initial B-piece buyer, a description of each initial B-piece buyer's experience in investing in CMBS, and any other information regarding each B-piece buyer that is material to investors in light of the circumstances of the transaction. Additionally, the

sponsor must disclose the percentage of the fair value of CMBS that is represented by the eligible horizontal residual interest that each B-piece buyer will retain, the purchase price paid by each B-piece buyer and a description of the material terms of the interest retained by each B-piece buyer.

> *Note: The requirement to disclose the purchase price for which each B-piece buyer acquires its position seems to be particularly troublesome, because issuers, underwriters and investors generally consider that information as proprietary and confidential.*

Exception to Transfer Restriction. In general, each B-piece buyer must comply with the same restrictions on hedging, transfer and financing as are applicable to a sponsor that retains an eligible horizontal residual interest.[12] However, on or after the date that is five years after the closing date of a CMBS transaction, the B-piece buyer (and any subsequent B-piece buyer thereafter) can transfer a retained interest to another B-piece buyer who will in turn be subject to similar restrictions as the initial B-piece buyer (i.e., no more than two B-piece buyers, must purchase the interest for cash, may not obtain direct or indirect financing from any party to the securitization (or any affiliate), may not be affiliated with any of the deal parties (other than special servicer and less than 10% originator) and restrictions on hedging, transfer and financing).

> *Note: Given these requirements, which are intended to ensure that the subsequent B-piece buyer exercises the same discipline as the as the initial B-piece buyer (or a retaining sponsor), it is unclear why the five-year holding period by the sponsor and the initial B-piece buyer is justified, particularly with respect to the sponsor, who is otherwise permitted to transfer its retained interest to a B-piece buyer on the date of issuance.*

Responsibility for Compliance. Although a sponsor can satisfy all or a portion of its risk retention obligations through the B-piece buyer retention alternative, the sponsor remains responsible for compliance by each B-piece buyer and each subsequent B-piece buyer with the risk retention rules. As such, the Proposed Rules require the sponsor to maintain and adhere to policies and procedures to monitor each B-piece buyer's compliance. If the sponsor determines that a B-piece buyer no longer complies with the retention requirement it must notify investors in the related CMBS.

[12] For more detail on these restrictions and the narrow exceptions thereto, see Part III.H below.

C. Revolving Master Trusts (Seller's Interest)

Revolving master trusts are often used for securitizations when the underlying assets consist of revolving lines of credit (e.g., credit card accounts) or to create ABS having longer maturities than the short-term assets securitized by using the proceeds of maturing assets to acquire new assets during an initial non-amortization period. These trusts issue multiple series of ABS interests that are backed by a single pool of assets that are expected to change in composition over time. The sponsors of these trusts typically hold a direct interest in the assets backing the ABS interests. Prior to the occurrence of an early amortization event, the sponsor's interest in the assets backing the ABS interests is typically *pari passu* with the interests of the holders of the ABS interests.

The Proposed Rules would allow a sponsor of a revolving asset master trust to satisfy the risk retention requirement by maintaining a "seller's interest" in an amount not less than 5% of the unpaid principal balance of all outstanding investors' ABS interests issued by the issuing entity.[13] The seller's interest may be retained by one or more wholly-owned affiliates of the sponsor, including one or more depositors of the revolving master trust.

The Proposed Rules define a "revolving master trust" as an issuing entity that is (i) a master trust; and (ii) established to issue on multiple issuance dates one or more series, classes, subclasses, or tranches of ABS all of which are collateralized by a common pool of securitized assets that will change in composition over time. This definition is intended to be consistent with market practices and is intended to include revolving trusts that securitize short-term loans, such as insurance premium finance loans, and use the proceeds of maturing loans in order to acquire new loans to collateralize longer-term securities.

The Proposed Rules define a "seller's interest" as an ABS interest or ABS interests (i) collateralized by all of the securitized assets and servicing assets owned or held by the issuing entity other than assets that have been allocated as collateral only for a specific series; (ii) that are *pari passu* to each series of investors' ABS interests issued by the

[13] A sponsor of a revolving asset master trust may combine a seller's interest with an eligible horizontal residual interest in each series of ABS interests issued by the trust to satisfy the risk retention requirement or, to the extent that it can't meet the limitation discussed in Part III.A of this memorandum that eligible horizontal residual interests may not be structured to receive distributions at a rate greater than principal is paid on the ABS interests as a whole, may retain a horizontal interest (i) whose claim to any part of the series' share of the interest and fee cash flows for any interest payment period is subordinated to all accrued and payable interest and principal due on the payment date to more senior ABS interests in the series for that period, and is reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving master trust for that period, to the extent that such payments would have been included in amounts payable to more senior interests in the series and (ii) that has the most subordinated claim to any part of the series' share of the principal repayment cash flows.

issuing entity with respect to the allocation of all distributions and losses with respect to the securitized assets prior to an early amortization event (as defined in the securitization transaction documents); and (iii) that adjust for fluctuations in the outstanding principal balance of the securitized assets in the pool.

> *Note: Both the definition of "revolving master trust" and "seller's interest" are intended to be consistent with market practices. The definition of "seller's interest" is also designed to make sure that the interest retained by the sponsor would be aligned with the interests of investors at a series, rather than a pool, level.*

The required seller's interest must meet the 5% test at the closing of each issuance of ABS interests by the issuing entity, and at every seller's interest measurement date specified under the securitization transaction documents, but no less than monthly, until no ABS interest in the issuing entity is held by any person not affiliated with the sponsor.

In the case of a revolving master trust that holds collateral certificates issued by another revolving master trust having the same sponsor, the Proposed Rules allow the sponsor's risk retention to be met by retaining a seller's interest for the assets represented by the collateral certificates through either revolving master trust, provided that the proportion of the risk retention satisfied by the seller's interest in the master trust that issued the collateral certificates is not less than the proportion the collateral certificates represent of the total assets of the master trust that issues the ABS interests as of each required measurement date.

The 5% seller's interest required on each measurement date may be reduced on a dollar-for-dollar basis by the balance, as of such date, of an excess funding account in the form of a segregated account that (i) is funded in the event of a failure to meet the minimum seller's interest requirements under the securitization transaction documents by distributions otherwise payable to the holder of the seller's interest; (ii) is *pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of losses with respect to the securitized assets prior to an early amortization event; and (iii) in the event of an early amortization, makes payments of amounts held in the account to holders of investors' ABS interests in the same manner as distributions on securitized assets.

The Proposed Rules clarify that, in the case of a revolving master trust containing solely revolving assets, a reduction in the seller's interest below the percentage required by the Proposed Rules after an event of default triggers early amortization, as specified in the securitization transaction documents, of all series of ABS interests issued by the trust to persons not affiliated with the sponsor, will not violate the sponsor's risk retention

requirement if (i) the sponsor was in full compliance with its risk retention requirement on all measurement dates prior to the event of default that triggered early amortization; (ii) the terms of the seller's interest continue to make it *pari passu* or subordinate to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all losses with respect to the securitized assets; (iii) the terms of any horizontal interest relied upon by the sponsor to offset the minimum seller's interest amount continue to require the interests to absorb losses in accordance with the requirements specified by the Proposed Rules for the combination of a seller's interest with a horizontal interest; and (iv) the revolving master trust issues no additional ABS interests after early amortization is initiated to any person not affiliated with the sponsor, either during the amortization period or at any time thereafter.

Required Disclosure. If a sponsor of a revolving asset master trust elects to use the seller's interest option to satisfy the risk retention requirement, the Proposed Rules require that the sponsor disclose or cause to be disclosed in writing to potential investors a reasonable period of time prior to the sale of the ABS interests in the securitization transaction, under the caption "Credit Risk Retention" (i) the value (expressed both as a percentage of the unpaid principal balance of all of the investors' ABS interests issued in the securitization transaction and as an absolute dollar amount (or foreign currency amount, if the ABS are not denominated in U.S. dollars)) of the seller's interest that the sponsor will retain (or did retain) at the closing of the securitization transaction, the fair value (expressed as a percentage of the fair value of all of the investors' ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of any horizontal risk retention that the sponsor will retain (or did retain) at the closing of the securitization transaction, and the unpaid principal balance or fair value, as applicable (expressed as percentages of the values of all of the ABS interests issued in the securitization transaction and dollar amounts (or corresponding amounts in the foreign currency in which the ABS are issued, as applicable)) that the sponsor is required to retain; (ii) a description of the material terms of the seller's interest and of any horizontal risk retention; and (iii) if the sponsor will retain (or did retain) any horizontal risk retention the same information as is required to be disclosed by sponsors retaining horizontal interests.[14]

A sponsor must retain the required disclosures in written form in its records and must provide the disclosure upon request to the SEC and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

[14] See Part III.A of this memorandum for the disclosures required in connection with eligible horizontal residual interests.

D. Asset-Backed Commercial Paper Conduits

A sponsor of an eligible asset-backed commercial paper conduit ("**eligible ABCP conduit**") that issues commercial paper that has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace ("**ABCP**"), may satisfy the risk retention requirements if each originator-seller[15] that transfers assets to collateralize the ABCP retains an economic interest in the credit risk of such assets in the same form, amount and manner as would be required using the standard risk retention[16] or revolving master trusts[17] options.

> *Note: This risk retention option is narrow in scope and would not be available to many ABCP programs, including structured investment vehicles, securities arbitrage programs and other arbitrage programs and other programs that do not satisfy the "eligible ABCP conduit" criteria.*

The Proposed Rules define "**eligible ABCP conduit**" as an entity that issues ABCP meeting each of the following criteria:

1) The ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor and from any intermediate SPV from which it acquires any ABS interest.

2) The ABS acquired by the ABCP conduit are:

    i) collateralized solely by the following:

        (a) ABS collateralized solely by assets originated by an originator-seller or one or more majority-owned OS affiliates of the originator-seller, and by servicing assets:

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[15] "**Originator-seller**" means an entity that originates assets and sells or transfers those assets directly, or through a majority-owned OS affiliate, to an intermediate SPV. "**Majority-owned OS affiliate**" means an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, an originator-seller participating in an eligible ABCP conduit. For purposes of this definition, "majority control" means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

"**Intermediate SPV**" means a special purpose vehicle that: (1) is a direct or indirect wholly-owned affiliate of the originator-seller; (2) is bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit, the originator-seller, and any majority-owned OS affiliate that, directly or indirectly, sells or transfers assets to such intermediate SPV; (3) acquires assets that are originated by the originator-seller or its majority-owned OS affiliate from the originator-seller or majority-owned OS affiliate, or acquires asset-backed securities ("**ABS**") issued by another intermediate SPV or the original seller that are collateralized solely by such assets; and (4) issues ABS collateralized solely by such assets, as applicable.

[16] See Part III.A. above: Standard Risk Retention.

[17] See Part III.C. above: Revolving Master Trusts (Seller's Interest).

(b) Special units of beneficial interests or similar interests in a trust or special purpose vehicle that retains legal title to leased property underlying leases that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases originated by an originator-seller or majority-owned OS affiliate, and by servicing assets; or

(c) Interests in a revolving master trust collateralized solely by assets originated by an originator-seller or majority-owned OS affiliate and by servicing assets; and

ii) Not collateralized by ABS (other than those described in paragraphs (A), (B) and (C) above), otherwise purchased or acquired by the intermediate SPV, the intermediate SPV's originator-seller, or a majority-owned OS affiliate of the originator-seller; and

iii) Acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV (A) directly from the intermediate SPV, (B) from an underwriter of the securities issued by the intermediate SPV, or (C) from another person who acquired the securities directly from the intermediate SPV;

(1) Note: Paragraph (2) above clarifies that the assets being financed have been originated by the originator-seller or a majority-controlled OS affiliate and not purchased and aggregated. Eligible ABCP conduits may not purchase ABS interests in the secondary market.

3) The ABCP conduit is collateralized solely by ABS acquired from intermediate SPVs as described in paragraph (2) above of this definition and servicing assets.

(1) Note: Not all ABCP conduits utilize the intermediate SPV structure. This provision also prohibits intermediate SPVs from acquiring assets from non-affiliates or in the secondary market.

4) A regulated liquidity provider[18] has entered into a legally-binding commitment to provide 100% liquidity coverage (in certain specified forms) to all the ABCP issued by the ABCP

[18] "**Regulated liquidity provider**" means: (1) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (2) a bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof; (3) a savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or (4) a foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. With respect to the 100% liquidity coverage, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by it, the liquidity provider must be obligated to pay an amount equal to any shortfall, and the total amount that may be due pursuant to the 100% liquidity coverage must be equal to 100% of the amount of the ABCP outstanding at any time plus accrued and unpaid interest (amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit and liquidity support that only funds performing receivables or performing ABS interests does not meet the requirements of the eligible ABCP conduits section of the Proposed Rules).

> *Note: Not all ABCP conduits have 100% liquidity coverage and, if they do, it is not clear why a "regulated" (as defined in the Proposed Rules) liquidity provider is required so long as such provider has a high enough credit standing.*
>
> *Note: Not all ABCP conduits have liquidity coverage that covers the credit risk of the ABS held by the ABCP conduit and it is unclear why the Federal banking agencies would want the regulated provider to cover 100% of the credit risk when the originator-seller already covers the requisite risk retention required by the Proposed Rules.*
>
> *Note: If the ABCP conduit does not satisfy the "eligible ABCP conduit" criteria, the sponsor must retain credit risk in accordance with another risk retention option included in the Proposed Rules (unless an exemption for the transaction exists).*

Responsibility for Compliance. The Proposed Rules would require the sponsor of an eligible ABCP conduit that issues ABCP in reliance on this risk retention option to be responsible for compliance with the requirements of this option. The sponsor must maintain policies and procedures to monitor compliance by the originator-sellers and any majority-owned OS affiliates with the requirements of the proposal and must (A) promptly notify investors, the SEC and its appropriate Federal banking agency, if any, in writing of: (1) the name and form of organization of any originator-seller that fails to retain risk in accordance with this option and the amount of ABS issued by an intermediate SPV of such originator-seller and held by the ABCP conduit; (2) the name and form of organization of any originator-seller or majority-owned OS affiliate that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of this option and the amount of ABS issued by an intermediate SPV of such originator-seller or majority-owned OS affiliate

and held by the ABCP conduit; and (3) any remedial actions taken by the ABCP conduit sponsor or other party with respect to such ABS; and (B) take other appropriate steps pursuant to the requirements of this option which may include, as appropriate, curing any breach of the requirements of this option, or removing from the eligible ABCP conduit any ABS that does not comply with the requirements of this option. The sponsor would be required to (i) establish criteria governing the ABS interests, and the assets underlying the ABS interests, acquired by the ABCP conduit, (ii) approve (1) all originator-sellers and any majority-owned OS affiliate and (2) each intermediate SPV from which an eligible ABCP conduit is permitted to acquire ABS interests, and (iii) administer the ABCP conduit and maintain and adhere to policies and procedures for ensuring that all requirements have been met (including policies and procedures that are reasonably designed to monitor compliance by each originator-seller and any majority-owned OS affiliate which sells assets to the eligible ABCP conduit with the applicable risk retention requirements).

> *Note: The terms and conditions of the eligible ABCP conduit risk retention option are designed to ensure that the assets of "eligible ABCP conduits" have low credit risk and that originator-sellers and any majority-owned OS affiliates have incentives to monitor the quality of such assets. However, sponsors may have difficulty monitoring compliance by the originator-sellers and any majority-owned OS affiliates with the requirements of this option.*

Required Disclosure. Sponsors must disclose (A) the name and form of organization of each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit (including a description of the form, amount and nature of such liquidity coverage) and (B) with respect to each ABS interest held by the ABCP conduit: (i) the asset class or brief description of the underlying receivables; (ii) the standard industrial category code (SIC Code) for the originator-seller or majority-owned OS affiliate that will retain (or has retained), pursuant to the eligible ABCP conduit option, an interest in the securitization transaction; and (iii) a description of the form, fair value (expressed both as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as an absolute dollar amount (or foreign currency amount, if the ABS are not denominated in U.S. dollars)), as applicable, and nature of such interest in accordance with the disclosure obligations under the standard risk retention option under the Proposed Rules. In addition, an ABCP conduit sponsor relying upon the eligible ABCP conduit option shall provide, or cause to be provided, upon request, to the SEC and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors in the preceding sentence, and the name and form of organization of each originator-seller or majority-owned OS affiliate that will retain (or has retained), pursuant to this option, an interest in the securitization transaction.

Note: As is customary in the ABCP market, the names of any originator-seller and any majority-owned OS affiliate are not required to be disclosed to investors under the Proposed Rules. However, under the eligible ABCP conduit option, the sponsor must promptly notify investors, the SEC and its appropriate Federal banking agency, if any, of the name of any originator-seller or majority-owned OS affiliate that fails to retain risk in accordance with this option or hedges its risk retention in violation of this option.

E. Treatment of Government-Sponsored Enterprises

Guarantees provided by Fannie Mae or Freddie Mac (each, a "**GSE**") while operating under the conservatorship or receivership of the FHFA with capital support from the United States will satisfy the risk retention requirements of such GSE with respect to ABS issues if the guarantee is of the timely payment of principal and interest on all ABS interests issued by the issuing entity. The NPR notes that because the GSEs fully guarantee the timely payment of principal and interest on their ABS, GSEs are already exposed to the entire credit risk of the mortgages backing those ABS. An equivalent guaranty provided by a limited life regulated entity that has succeeded to the charter of a GSE and that is operating under the direction and control of the FHFA with capital support from the United States will also satisfy the risk retention requirements. If either GSE or limited-life regulated entity were to begin to operate other than under the conservatorship or receivership of the FHFA, such GSE or entity would no longer be able to avail itself of this option.

Required Disclosure. A GSE satisfying its risk retention obligations under this alternative would be required to disclose to investors and, upon request, to the FHFA, a description of the manner in which it has met its credit risk retention requirement.

Note: With respect to certain ABS sponsored by the GSEs, only a portion of the related securities are fully guaranteed, with the balance of the securities (generally a relatively small junior interest) not having the benefit of any GSE guaranty. Guidance from the Agencies is needed on whether risk retention requirements would apply in any such circumstance, and if so, how the required retention should be calculated.

Note: With respect to certain ABS sponsored by third parties, the GSEs will sometimes acquire the senior tranche and then sponsor a fully guaranteed ABS collateralized by that senior tranche, while the third-party sponsor sells the unguaranteed junior tranche (which is relatively small) to investors. The GSE-guaranteed ABS would presumably be exempt from credit risk retention because

it is the only ABS-interest in the related issuing entity. However, a question arises as to whether the third-party sponsor of the issuing entity that issued both the senior tranche that collateralizes the GSE's guaranteed ABS and the unguaranteed junior tranche should be required to hold a retained interest based on the fair value of both ABS interests or just the junior tranche.

F. CLOs

CLO Manager as Securitizer. The Proposed Rules confirm the Agencies' view that a CLO Manager is a "securitizer" under Section 15G because it selects the commercial loans to be purchased by the CLO issuing entity and then manages the securitized loans on behalf of the CLO. However, in recognition of the fact that many CLO Managers are not in a position financially to purchase 5% of each CLO they manage,[19] the Agencies have proposed an alternative risk retention option for "Open Market CLOs" where the risk retention is held by the Lead Arranger of the securitized loans.

Note: As many industry participants have commented in connection with the Original Proposal, risk retention by CLO Managers is not generally feasible and, absent a viable alternative, would likely lead to consolidation within the CLO management industry and smaller management companies exiting the CLO market entirely.

Note: It is possible that this retention requirement will lead to the consolidation of the CLO management industry, forcing smaller management companies to exit this space.

Open Market CLOs. Open Market CLOs can satisfy the risk retention obligation by purchasing and holding only CLO-eligible loan tranches. In addition, the Lead Arranger of each loan in the CLO-eligible loan tranche must retain at least 5% of the face amount of the term loan tranche purchased by the CLO until repayment, maturity, acceleration, payment default or bankruptcy. The Proposed Rules further require, among other things, that the Lead Arranger of the underlying loan must take an initial allocation of at least 20% of the face amount of the broader syndicated credit facility, and no other member of the syndicate could take a larger share.

Note: The rationale for this provision appears to be that the Agencies believe holding the largest allocation of the credit facility will provide the Lead Arranger with significant influence over the negotiation of the loan underwriting terms.

[19] See further discussion of horizontal and vertical risk retention in Part III.A of this memorandum.

The Proposed Rules define an "**Open Market CLO**" as a CLO (1) whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in Open Market Transactions and of servicing assets, (2) that is managed by a CLO Manager, and (3) that holds less than 50% of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.

To qualify under this alternative risk retention proposal, such Open Market CLO must meet the following criteria:

- It may acquire and hold only CLO-eligible loan tranches and servicing assets.
- Its governing documents require it, at all times, to own only Senior, Secured Syndicated Loans that are CLO-eligible loan tranches (and servicing assets).

  Note: The Agencies have requested comments on whether an Open Market CLO should be permitted to hold a small bucket of non-Senior, Secured Syndicated Loans. For example, such bucket might include second lien loans and/or high yield bonds that are typically found in current CLOs.

- It may not invest in ABS interests or in credit derivatives (other than hedging transactions that are servicing assets to hedge its payment risks).
- It may purchase assets only in Open Market Transactions on an arms-length basis.
- Its CLO Manager is not entitled to receive any management fee or gain on sale at the time the CLO issues its notes.

The Proposed Rules define an "**Open Market Transaction**" as either (1) an initial loan syndication transaction or a secondary market transaction in which a seller offers Senior, Secured Syndicated Loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or (2) a reverse inquiry from a prospective purchaser of a Senior, Secured Syndicated Loan through a dealer in the loan market to purchase a Senior, Secured Syndicated Loan to be sourced by the dealer in the loan market.

The Proposed Rules define a "**Senior, Secured Syndicated Loan**" as a loan made to a commercial borrower that: (1) is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower; (2) is secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan; and (3) the value of the collateral subject to such first priority

security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO Manager exercised at the time of investment) to repay the loan in accordance with its terms and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO Manager certifies as to the adequacy of the collateral and attributes of the borrower under this paragraph in regular periodic disclosures to investors.

> *Note: This is substantially identical to the standard senior secured loan definition currently used by most CLOs.*

The Proposed Rules define a "**CLO-eligible loan tranche**" as a term loan tranche of a syndicated loan that meets (at all times) the following criteria:

- A minimum of 5% of the face amount of the CLO-eligible loan tranche is retained by the Lead Arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche. Such 5% interest must be retained un-hedged in accordance with the same anti-hedging, transferring and pledging restrictions that apply to ABS risk retention, as discussed above.

  > *Note: A proposed alternative to the above requirement would be to permit the Lead Arranger to satisfy its retention obligations by retaining a percentage interest in the customary pari passu revolving tranche issued under the same facility as the CLO-eligible loan tranche. In practice, banks already typically retain such revolving loan tranche.*

- The lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to money terms, alterations to pro rata provisions, changes to voting provisions, and waivers of conditions precedent.
- The pro rata provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranches are not materially less advantageous to the obligor than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

The Proposed Rules define "**Lead Arranger**" as an institution that:

- is active in the origination, structuring and syndication of commercial loan transactions and has played a primary role in the structuring, underwriting and distribution in the primary market of the CLO-eligible loan tranche;
- has taken an allocation of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20% of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group at origination has taken a greater allocation;

  Note: This allocation requirement could preclude all but a handful of the largest banks with respect to very large loan facilities.

- is clearly identified in the underlying loan credit;
- represents in the underlying credit agreement that such Lead Arranger and the CLO-eligible loan tranche satisfy the requirements of the Proposed Rules; and
- covenants in the underlying loan agreement to undertake the required 5% retention as set forth in the definition of CLO-eligible loan tranche.

G. Tender-Option Bonds

Tender option bonds (sometimes called "TOBs") involve the creation of a trust that holds municipal securities (typically a single series of a highly rated, tax-exempt municipal bond), and the issuance by the trust of two classes of certificates. One class distributes interest based on a floating rate (the "floaters"); the other class distributes interest based on the inverse of the floating rate security (the "residuals"). The structure is designed to pass through the interest on the municipal securities to the floaters and residuals on a tax-exempt basis and to allow the floaters to be eligible for investment by money market funds.

The holders of the floaters have the right to tender their floaters for purchase at par plus accrued interest, and the payment of the tender price is supported by a liquidity facility delivered by a highly rated provider. Upon the occurrence of a default or bankruptcy of the municipal bond issuer, a downgrade of the bond below investment grade, or certain events adversely affecting the tax-exempt status of the bond (each such event, a "tender option termination event"), each class suffers a loss based on then-current market price of the bond.

Note: Although tender option bonds were not addressed in the Original Proposal, they likely would have come within its scope. In the Proposed Rules, the

Agencies acknowledge that commenters had offered numerous reasons for tender option bonds to be exempt from the risk retention requirements. However, rather than exempting tender option bonds, the Agencies proposed requirements for this asset class that they believe "reflect and incorporate the risk retention mechanisms currently implemented in the market." By not exempting tender option bonds, the Proposed Rules could color the as-yet unsettled treatment of tender option bonds under related regulatory initiatives, including the SEC's proposed revisions to its Regulation AB under the Securities Act.

The Proposed Rules would allow a "sponsor" of a "qualified tender option bond entity" to use the standard risk retention methods described in Part III.A above. The sponsor may retain an eligible horizontal residual interest at issuance that is subsequently converted into an eligible vertical interest upon the occurrence of a "tender option termination event." The sponsor may also satisfy the risk retention requirement by holding municipal securities from the same issuance deposited into the qualified tender option bond entity in an amount equal to 5% of the face value of the municipal securities deposited.

Note: The Agencies suggest that the residual interest in a tender option bond entity could meet the risk retention requirements of the Proposed Rules by being an eligible horizontal residual interest at issuance and "converting" to an eligible vertical interest upon the occurrence of a tender option termination event. However, it is not clear that a typical TOB residual security would meet these requirements before "converting." For example, a typical TOB residual security does not absorb losses prior to the floater class and does not have a claim against the bond issuer that is subordinated to the floater class, which are criteria for an eligible horizontal residual interest.

Note: Where the residual security funded the premium of the municipal bond purchase price, it may satisfy the 5% requirement of the eligible horizontal residual interest definition at issuance, but may not satisfy the 5% requirement of the eligible vertical interest upon the occurrence of a tender option termination event.

The Proposed Rules define "qualified tender option bond entity" as an entity that issues 'tender option bonds" and meets criteria that include:

- The issuing entity must be collateralized solely by servicing assets and municipal securities that have the same issuer and the same underlying obligor or source of payment (determined without regard to third-party credit enhancement).

- The holders of all securities issued by the entity must be eligible to receive tax-exempt interest or, in the case of regulated investment companies, exempt interest dividends.

  Note: Query whether and how the sponsor of a tender option bond entity can determine and monitor compliance with this requirement, and whether failure of an investor, knowingly or unknowingly, to satisfy this requirement would have consequences for the sponsor or other investors.

- A regulated liquidity provider (as defined in Part III.D of this memorandum) must have entered into a legally-binding commitment to provide 100% liquidity coverage to all outstanding tender option bonds issued by the issuing entity.
- The issuing entity must qualify for monthly closing elections pursuant to IRS Revenue Procedure 2003-84, as amended or supplemented from time to time.

The Proposed Rules define a "tender option bond" as a security that has (i) features which entitle the holders to tender such securities to the issuing entity for purchase at any time upon no more than 30 days' notice, for a purchase equal to the par about of such securities plus accrued interest and (ii) "all necessary features" so that such security is eligible for purchase by money market funds under Rule 2a-7 under the Investment Company Act of 1940, as amended.

Note: Query whether the language of clause (ii) could shift responsibility for compliance with the requirements of Rule 2a-7 from the floater investor to the sponsor of the tender option bond entity.

Disclosure and Prohibited Hedging. Sponsors of qualified tender option bond entities are subject to the disclosure requirements generally applicable to ABS interests, as described in Part III.A. of this memorandum, and to the prohibitions on hedging and transfer described in Part III.H of this memorandum. The Agencies do not provide guidance on how these rules, which are generally applicable to ABS interests, would apply to tender option bonds.

H. Hedging, Transfer and Financing Restrictions

General. The Proposed Rules would prohibit a sponsor from transferring any interest or assets that it is required to retain thereunder to any person other than a majority-owned affiliate.[20] Even absent a transfer from the sponsor, the NPR states that if an affiliate were

[20] A "**majority-owned affiliate**" of the sponsor is defined as an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the sponsor. For purposes of this definition, majority control means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

permitted to hedge the risks required to be retained under the Proposed Rules, the net effect of the hedge on the organization controlling the sponsor would offset the credit risk retention required and defeat the purpose of Section 15G. Accordingly, affiliates also would be prohibited from hedging the credit risk the sponsor is required to retain under the Proposed Rules.

Under the Proposed Rules, sponsors and their affiliates would be prohibited from purchasing or selling a security or other financial instrument or entering into an agreement (including an insurance contract), derivative or other position with any other person if:

- payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the ABS; and
- the security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests that the retaining sponsor is required to retain or one or more of the particular securitized assets that collateralize the ABS.

The Agencies' stated intention is to focus the hedging prohibition on the credit risk associated with the interest or assets that the sponsor is required to retain, which credit risk is based on the underlying credit risk of the securitized assets backing the ABS interests issued. Therefore, hedge positions that are not materially related to the credit risk of ABS interests or exposures required to be retained by the sponsor are not prohibited by the Proposed Rules. Examples offered by the Agencies that would not violate the Proposed Rules are hedges related to (i) overall market movements, such as movements of market interest rates (but not the specific interest rates known as spread risk associated with the ABS interest that is otherwise considered part of the credit risk), (ii) currency exchange rates, (iii) home prices, or (iv) the overall value of a particular broad category of ABS. Hedges tied to securities that are backed by similar assets originated and secured by other sponsors also would not be prohibited. On the other hand, any security, instrument, derivative or contract that references the particular interests or assets or requires payment in circumstances where there is or could reasonably be expected to be a loss due to the credit risk of such interests or assets (i.e., credit default swaps referencing such interests or assets) would be prohibited.

The Proposed Rules allow certain hedges based on indices that may include one or more tranches from a sponsor's ABS transactions, such as ABX or LCDX Index hedges, so long as:

- any class of ABS interests in the issuing entity that was issued in connection with the securitization transaction and that is included in the index represented no more than 10% of the dollar-weighted average (or weighted average in the corresponding currency in which the ABS is issued, as applicable) of all instruments included in the index, and
- all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain an interest pursuant to the Proposed Rules and that are included in the index represent, in the aggregate, no more than 20% of the dollar-weighted average (or weighted average in the corresponding currency in which the ABS is issued, as applicable) of all instruments included in the index.

According to the Agencies, these limitations are designed to prevent a sponsor from evading the hedging restrictions through the purchase of indexed hedges based to a significant degree on ABS from securitization transactions in which a sponsor is required to retain risk under the Proposed Rules.

Issuing entities are not prohibited from engaging in hedging transactions that are for the ultimate benefit of investors in the ABS. However, the Proposed Rules restrict any credit protection or hedge of the exposure on the particular interests that the sponsor is required to retain under the Proposed Rules. For example, if the sponsor elects to satisfy its risk retention obligation by holding an eligible vertical interest representing 5% of the fair value of each class, an issuing entity may purchase credit protection covering up to 95% of the tranches, but not the 5% required to be retained by the sponsor.

The Proposed Rules would also prohibit a sponsor and its affiliates from pledging as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) any interest or asset that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or its affiliate, as applicable.[21]

Sunset Provisions. The Proposed Rules specify that the hedging and transfer restrictions expire as follows:

(1) In the case of securitizations of assets other than residential mortgages, on or after the date that is the latest of:

[21] Although the Proposed Rules do not expressly address the disposition of a pledged retained interest, in the NPR the Agencies commented that, where a pledge of an interest or asset to support full recourse financing subsequently results in such interest or asset being taken by the counterparty to the financing transaction (whether by consent, pursuant to exercise of remedies or otherwise), the sponsor will be viewed as having violated the prohibition on transfer.

(i) The date on which the total unpaid principal balance of the securitized assets that collateralize the securitization transaction has been reduced to 33% of the total unpaid principal balance of the securitized assets as of the closing of the securitization transaction;

(ii) The date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33% of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or

(iii) Two years after the date of the closing of the securitization transaction.

(2) In the case of securitizations wholly collateralized by residential mortgages, on or after the date that is the earlier of:

(i) the later of (A) five years after the date of the closing of the securitization transaction or (B) the date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25 percent of the total unpaid principal balance of such residential mortgages at the closing of the securitization transaction; or

(ii) Seven years after the date of the closing of the securitization transaction.

Note: It is not clear why the sunsets apply to the restrictions on transfer and hedging, but not the restriction on non-recourse pledging.

IV. Asset Category Exemptions from the Risk Retention Requirements

A. Qualified Residential Mortgages

The risk retention requirements described above would not apply to an issuance of RMBS if all of the assets backing the transaction are qualified residential mortgages ("**QRMs**") currently performing[22] at the closing of the securitization or servicing assets. The Proposed Rules define a QRM to be the same as a qualified mortgage ("**QM**"), as defined in Section 129C of The Truth in Lending Act[23] and implemented by the Consumer Financial Protection Bureau ("**CFPB**") in its ability to repay rule. The CFPB issued a final ability to repay rule on January 10,

[22] Under the Proposed Rules, "**currently performing**" means the borrower in the mortgage transaction is not currently 30 days past due, in whole or in part, on the mortgage transaction.

[23] See 15 U.S.C. 1639c.

2013 and issued finalized supplemental rules in May 2013 (together, the "**Final Ability to Repay Rule**").[24] The Final Ability to Repay Rule is effective January 10, 2014.[25] In general, a QM must have the following features[26]:

- regular periodic payments that are substantially equal;
- no negative amortization, interest only or balloon features;
- a maximum loan term of 30 years;
- total points and fees that do not exceed 3% of the total loan amount, or the applicable amounts specified in the Final Ability to Repay Rule for small loans up to $100,000;
- payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due;
- consideration and verification of the consumer's income and assets (including employment status, if relied upon), current debt obligations, mortgage-related obligations, alimony and child support; and
- total debt-to-income ratio ("**DTI**") that does not exceed 43%, including mortgage-related obligations.

By virtue of alignment of the definition of QRM with QM under the Proposed Rules, QRMs could consist of both first and junior lien positions and could be any closed-end loan secured by any dwelling (e.g., home purchases, refinances, home equity lines and second or vacation homes). The proposed QRM definition would exclude home equity lines of credit ("**HELOCs**"), reverse mortgages, timeshares, temporary loans or "bridge" loans of 12 months or less and most loan modifications (unless they satisfy certain requirements).

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[24] See 12 C.F.R. 1026.43.

[25] According to the NPR, the definition of QRM may change as the CFPB clarifies, modifies or adjusts the definition of QM.

[26] The Final Ability to Pay Rule includes several additional definitions of QM, all of which would be encompassed by the definition of QM in the Proposed Rules:

1. Based upon the current mortgage market conditions and expressed concerns over credit availability, the CFPB finalized a second, temporary definition of QM, pursuant to which a QM must have the following features: (1) regular periodic payments that are substantially equal; (2) no negative amortization, interest only or balloon features; (3) a maximum loan term of 30 years; (4) total points and fees that do not exceed 3% of the total loan amount, or the applicable amounts specified for small loans up to $100,000; and (5) be eligible for purchase, guarantee or insurance by Freddie Mac, Fannie Mae, HUD, the Veterans Administration, the U.S. Department of Agriculture or the Rural Housing Service ("**GSE-eligible**").
2. The CFPB provided additional definitions of QM to facilitate credit offered by certain small creditors that meet certain criteria. These additional small creditor-specific definitions of QM include greater underwriting flexibility (e.g., no quantitative DTI ratio applies) and the ability to originate and hold balloon mortgages, but, because the small creditor is required to keep the loan in portfolio for three years, these would generally be ineligible as QRMs for three years from origination.

In order for a QRM to be exempt from the risk retention requirements described above, the Proposed Rules impose evaluation and certification conditions that must be met by the depositor and the sponsor involved in the securitization. The depositor for the securitization would be required to certify that it evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all of the assets that collateralize the securities issued in the transaction are QRMs or servicing assets, and that it has determined that its internal supervisory controls are effective. Such evaluation must be performed within 60 days prior to the cut-off date (or similar date) for establishing the composition of the collateral pool. The sponsor also would be required to provide a copy of the certification to potential investors within a reasonable period of time prior to the sale of the securities in the issuing entity and, upon request, to the SEC and its appropriate Federal banking agency, if any.

Repurchases. Under the Proposed Rules, a sponsor would not become ineligible for the QRM exemption if it is determined that, after the closing date of the securitization, one or more of the mortgages collateralizing the ABS do not meet all of the criteria to be a QRM. However, to maintain the exemption, (i) the depositor must have certified as to the effectiveness of its internal supervisory controls as described above, (ii) the sponsor must repurchase the loan(s) determined not to be QRMs from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest not later than 90 days after it is determined the loan(s) do not satisfy the QRM requirements, and (iii) the sponsor must cause prompt notice to be given to holders of the ABS of any loans required to be repurchased, including the amount of such repurchased loans and the cause for such repurchase.

In the NPR, the Agencies also request comments on an alternative QRM approach ("**QM-plus**") that was considered by the Agencies but ultimately was not incorporated into the Proposed Rules. QM-plus would use the QM criteria as a starting point for the QRM definition and add the following criteria: (1) a maximum 70% LTV ratio; (2) the collateral must be a first lien on one-to-four family real property that constitutes the borrower's principal dwelling; (3) for purchase loans, no other liens could exist; but refinance loans could have junior liens subject to the LTV requirement on a combined basis; and (4) credit history metrics regarding delinquencies and other legal actions. In addition, loans that are QMs because they meet the CFPB's provisions as GSE-eligible or are small credit or balloon loan exceptions would not be considered QRMs under the QM-plus approach.

B. ABS Backed By Qualifying Commercial, Commercial Real Estate or Automobile Loans

The risk retention requirements described above would not apply or would be reduced for an issuance of ABS if all or a portion of the assets backing the transaction are commercial loans,

commercial real estate (CRE) loans, or automobile loans that satisfy specified underwriting standards ("**qualifying loans**"). The proposed underwriting standards are meant to ensure that the loans that qualify for the exemption are those that pose a very low credit risk.

For pools that are comprised entirely of qualifying loans, the risk retention percentage would be zero. For pools that are partially comprised of qualifying loans, the risk retention percentage would be reduced, but not by more than 50%, by the ratio that the unpaid principal balance of the qualifying loans bears to the total unpaid principal balance of the loans that are included in the pool. For example, if 20% of the unpaid principal balance of a pool was comprised of qualifying loans, the risk retention requirement would be reduced by 20% and therefore would be 4%. In no event, however, can the risk retention be reduced to less than 2.5% for a pool that has a combination of qualifying and non-qualifying loans.

> *Note: The NPR indicates that the Agencies are also considering the possibility of raising or lowering the 2.5% limit by one or more percent.*

In order to be eligible for the risk retention exemption/reduction, in addition to the specific requirements described below for each asset class, the following conditions must be satisfied:

- the securitization transaction has to be collateralized solely by loans of the same asset class (and related servicing assets);
- the securitization may not permit a reinvestment period;
- the sponsor is required to provide certain disclosure regarding the qualifying and, if applicable, non-qualifying loans; and
- the depositor must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that the assets collateralizing the ABS meet all of the underwriting requirements for such asset class, as specified below, and has concluded that its internal supervisory controls are effective. This evaluation must occur for each issuance of ABS, within 60 days of the cut-off date for the transaction (or similar date). Furthermore, the sponsor must provide (or cause to be provided) a copy of such certification to potential investors a reasonable period of time prior to the time of sale of the ABS and, upon request, to its applicable Federal banking agency.

1. Underwriting Standards for Qualifying Commercial Loans

Under the Proposed Rules, a "**commercial loan**" is defined as a secured or unsecured loan to a company or an individual for business purposes, other than (1) a loan to purchase or refinance a one-to-four family residential property; or (2) a commercial real estate loan. For

ABS comprised solely of commercial loans to qualify for the risk retention exemption/reduction, in addition to the general requirements described above, such loans must meet the criteria specified in the Proposed Rules as summarized below.

- Security Interest/Lien. The Proposed Rules do not require that a commercial loan be secured by collateral. However, if the loan is secured, the originator must have obtained a perfected security interest over the pledged property. In addition, if the purpose of the loan is to finance the purchase of tangible or intangible property, or the refinance such a loan, the originator must have obtained a first lien on such property.
- Ability to Repay. The Proposed Rules require the following:
    - The originator must verify and document the financial condition of the borrower (1) as of the end of the borrower's two most recently completed fiscal years and (2) during the period, if any, since the end of its most recent completed fiscal year.
    - The originator must analyze the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections.
    - The originator must determine that based on the prior two years' actual performance and based on two years of projections (which include the new debt obligation) following the closing of such loan, the borrower had, and will have: (1) a total liabilities ratio[27] of 50% or less; (2) a leverage ratio[28] of 3.0 or less; and (3) a debt service coverage ratio[29] of 1.5 or greater.
    - The primary source of repayment for the commercial loan must be revenue from the business operations of the borrower.
- Loan Terms. The Proposed Rules require the following:
    - Loan payments must be based on straight-line amortization of principal and interest that fully amortize the debt over a term not to exceed five years from the origination date.

[27] "**Total liabilities ratio**" means the borrower's total liabilities, determined in accordance with GAAP divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with GAAP.

[28] "**Leverage ratio**" means the borrower's total debt divided by the borrower's EBITDA. "**EBITDA**" means the annual income of a business before expenses for interest, taxes, depreciation and amortization are deducted, as determined in accordance with GAAP.

[29] For commercial loans, "**debt service coverage ratio**" means (i) the borrower's EBITDA as of the most recently completed fiscal year divided by (ii) the sum of the borrower's annual payments for principal and interest on all debt obligations.

- Loan payments must also be required to be made no less frequently than quarterly.
- The loan must be funded within six months prior to the closing of the related securitization transaction.
- At the closing of the securitization transaction, all payments due on the loan must be contractually current.

- Risk Management and Monitoring Requirements. The Proposed Rules require the loan documentation for commercial loans to include the following covenants:
  - Covenant to provide the servicer with financial statements and supporting schedules on an on-going basis (and not less frequently than quarterly);
  - Covenant prohibiting the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;
  - Covenants placing limitations on transfers of any of the borrower's assets that serve as collateral for the loan, restricting the borrower's ability to create other security interests or liens with respect to any of its assets that serve as collateral for the loan and restricting any change in the name, location or organizational structure of the borrower (or any other party that pledges collateral for the loan); and
  - Covenants designed to protect the value of any pledged collateral securing the loan by requiring the borrower (and any other party that pledges collateral for the loan) to: (i) maintain insurance protecting against loss on any collateral at least up to the amount of the loan and naming the originator (or any subsequent holder) as an additional insured or loss payee; (ii) pay taxes, charges, claims and fees where nonpayment could give rise to a lien against any collateral securing the loan; (iii) take any action necessary to perfect or defend the security interest (and first lien, if applicable) of the originator or any subsequent holder of the loan in the collateral for the commercial loan or the priority thereof, and to defend the collateral against claims adverse to the lender's interest; (iv) permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect the collateral and the books and records of the borrower; and (v) maintain the physical condition of any collateral for the loan.

2. Underwriting Standards for Qualifying Commercial Real Estate (QCRE) Loans

Under the Proposed Rules, a commercial real estate loan ("**CRE loan**") is a loan secured by real property that meets the terms of the definition described in Part III.B. above. The definition

of a CRE loan excludes land development loans, construction loans (including one-to-four family residential or commercial construction loans), other land loans, farm loans and unsecured loans to developers. For a CRE loan to qualify as a "qualifying CRE loan" ("**QCRE loan**"), such loan must meet the criteria specified in the Proposed Rules as summarized below.

- First Lien. Each QCRE loan must be secured by:
    - an enforceable first lien, documented and recorded pursuant to applicable law on commercial real estate and improvements; and
    - an assignment of leases and rents and other occupancy agreements and all franchise, license and concession agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate has rights thereunder.
- Ability to Repay; DSCR. The Proposed Rules provide that the originator must verify and document the current financial condition of the borrower and each operating affiliate and determine that, based on the previous two years' actual performance, the borrower had, and based on two years of projections (which include the new debt obligation), the borrower will have, the following debt service coverage ratio:[30]
    - a DSCR of 1.5 or greater, if the loan is a qualifying leased CRE loan[31] (net of any income derived from any tenant that is not a qualified tenant);
    - a DSCR of 1.25 or greater, if the loan is a qualifying multi-family loan;[32] or

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[30] For commercial real estate loans, "**debt service coverage ratio**" ("**DSCR**") means (i) the annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loans divided by (ii) the sum of the borrower's annual payments for principal and interest on any debt obligation. "**NOI**" means the income a CRE property generates for the borrower after all expenses have been deducted for federal income tax purposes, except for depreciation, debt service expenses, and federal and State income taxes, and excluding any unusual and nonrecurring items of income.

[31] "**Qualifying leased CRE loan**" means a CRE loan secured by commercial nonfarm real property (other than a multi-family property or a hotel, inn, or similar property):

1. that is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one month; and
2. where no more than 20 percent of the aggregate gross revenue of the property is payable from one or more tenants who;
    a. are subject to a lease that will terminate within six months following the date of origination; or
    b. are not qualified tenants.

"**Qualified tenant**" means:

1. A tenant with a lease who has satisfied all obligations with respect to the property in a timely manner; or
2. A tenant who originally had a lease that subsequently expired and currently is leasing the property on a month-to month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

- a DSCR of 1.7 or greater, if the loan is any other type of CRE loan (which would include all hotel loans).

Note: The Proposed Rules require an analysis of the financial condition of the borrower and not just the mortgaged property. While the NPR clearly indicates that a property without two years of operating history would not qualify as a QCRE loan, it does not address the status of a newly formed SPE borrower that lacks a two year operating history.

- Loan Terms. The Proposed Rules require the following:
  - A QCRE loan must have a fixed stated interest rate (or adjustable rate if the borrower obtains a derivative product that results in the borrower paying a fixed interest rate).
  - A QCRE loan must have a term that is at least ten years.
  - Payments on a QCRE loan must be (i) no less frequent than monthly and (ii) based on straight-line amortization over a term that does not exceed 25 years, or 30 years in the case of a qualifying multi-family loan.
  - A QCRE loan must not (1) permit the borrower to defer principal or interest payments; or (2) contain an interest reserve to fund all or part of a payment on the loan.
  - At the closing of the securitization transaction, all payments due on the loan must be contractually current.
- Loan-to-Value Ratio. At origination, the loan-to-value ratio ("**LTV**") must be less than or equal to 65% and the combined loan-to-value ratio ("**CLTV**") of the first-lien mortgage loan and any junior-lien mortgage loan must be less than or equal to 70%;[33] provided, that if the capitalization rate used in the appraisal is less than or equal to the sum of the 10-year interest rate swap rate plus 300 basis points, the maximum LTV would be 60% and the maximum CLTV would be 65%. For purposes of calculating the LTV and CLTV, the value of the property will be (1) in the case of an acquisition, the lesser of the purchase price or the estimated market value and (2) in the case of a refinancing, the

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[32] "**Qualifying multi-family loan**" means a CRE loan secured by any residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents):

(1) that consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and

(2) where at least 75% of the NOI is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs, and dry cleaning), and not from other commercial uses.

[33] This represents a slight relaxation of the 60%/65% requirements in the Original Proposal.

estimated market value. In each case, estimated market value will be based on an appraisal meeting the requirements set forth below.

> *Note: The definition of CLTV refers to any junior-lien mortgage loan that is secured by the "same property." As written, a mezzanine loan that is secured by equity interests in the mortgage borrower should not be included in this calculation.*

- Appraisal; Valuation of Collateral. The originator must obtain an appraisal of the real property securing the loan that was performed not less than six months from the origination of the loan by an appropriately state-certified or state-licensed appraiser. The appraisal must give an "as is" opinion of the current market value of such property, which includes an income valuation approach that uses a discounted cash flow analysis.
- Environmental Assessment. The originator must conduct an environmental risk assessment of the property and take appropriate steps to mitigate any environmental liability determined to exist based on such assessment.[34]
- Risk Management and Monitoring Requirements. The loan documents must contain certain covenants to facilitate monitoring and managing of the credit risk of the term of the loan, which are generally consistent with covenants in recent CMBS loans. The covenants include the following:
    - Covenant to provide the servicer with financial statements on an on-going basis, but not less than quarterly.
    - Restrictions on creating other security interests in the collateral, transferring the collateral, or changing the name, location or organizational structure of the borrower (or other party pledging collateral).
    - Requirements that the borrower and each operating affiliate (a) maintain certain insurance, (b) pay taxes, charges or fees that may give rise to a lien on any collateral, (c) take actions to protect, perfect and defend the security interest of the originator (or any subsequent holder), (d) permit inspection of the collateral and books and records, (e) maintain physical condition of the collateral, (f) comply with environmental, zoning, building code, licensing and other laws applicable to the collateral, (g) comply with

[34] As noted in the notice of proposed rulemaking for the Original Proposal, such measures may include a reduction in the loan amount sufficient to reflect potential losses; however, where the assessment reveals significant environmental hazards, originators are encouraged to reconsider the primary loan decision. The originator can have a qualified third party perform the assessment, but remains responsible for ensuring that appropriate measures are taken to mitigate any risk of loss due to environmental risks.

leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of the collateral, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator (or any subsequent holder) or the servicer and (h) not materially alter the collateral without the consent of the originator (or any subsequent holder) or the servicer.

- Prohibitions on obtaining loans secured by a junior lien on any property that serves as collateral for the loan, unless (1) the sum of the principal amount of such junior lien loan, plus the principal amount of all other loans secured by such collateral does not exceed the applicable CLTV described above or (2) such loan finances the purchase of machinery or equipment and the borrower pledges such machinery or equipment as additional collateral for the CRE loan.

3. Underwriting Standards for Qualifying Automobile Loans

Under the Proposed Rules, an "**automobile loan**" is defined as a loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family, or household use.[35] The loan may be for a new or used vehicle.

For ABS comprised solely of automobile loans to qualify for risk retention exemption/reduction, such loans must meet the underwriting standards specified in the Proposed Rules as summarized below.

- First Lien. Each automobile loan must be secured by a first lien on the purchased vehicle that is recorded in accordance with applicable state law.
- Ability to Repay. As of the origination of the loan, the borrower must have a monthly debt-to-income ratio that is less than or equal to 36%, the determination of which must be documented by the originator. In connection with such determination:
    - The originator needs to document and verify the borrower's effective monthly income using payroll stubs, tax returns, profit and loss statements or other similar documentation.

[35] An automobile loan does not include any (a) loan to finance fleet sales; (b) personal cash loan secured by a previously purchased automobile; (c) loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes; (d) lease financing; or (e) loan to finance the purchase of a vehicle intended to be used for scrap or parts.

- The originator also needs to obtain a credit report from national consumer reporting agency and verify the outstanding debts reported on the credit report are incorporated into the debt-to-income ratio calculation.

- Loan Terms. Loans must have a fixed interest rate and the monthly payments must be a level amount that fully amortizes the loan over its term with the first payment due within 45 days of the closing date. Deferred repayment of principal or interest is also prohibited. The maturity date may not exceed the lesser of (1) six years from the date of origination, or (2) ten years minus the difference between the current model year and the subject vehicle's model year.[36]

- Originator Review of Credit History. The originator must verify and document that within 30 days of origination:
  - the borrower was not 30 days or more past due, in whole or in part, on any debt obligation;
  - the borrower has not been 60 days or more past due, in whole or in part, on any debt within the past 24 months; and
  - within the past 36 months, (i) the borrower was not a debtor in a bankruptcy proceeding or the subject of any Federal or State judicial judgment for the collection of any unpaid debt, (ii) no one-to-four family property owned by the borrower was the subject of a foreclosure, deed in lieu of foreclosure, or short sale and (iii) the borrower did not have any other personal property repossessed.
  - The originator may take advantage of a safe harbor to satisfy the foregoing requirement if, no more than 30 days prior to the closing of the loan, it obtains a credit report regarding the borrower from a national consumer reporting agency and determines based on such information that the borrower meets the credit history requirements set forth above. The safe harbor is not available if the originator obtains a report prior to closing the loan that contains contrary information.
  - The originator is also required to determine and document that the borrower has at least 24 months of credit history.

- Down-Payments. The Proposed Rules require that a borrower under a qualifying automobile loan must make minimum down payment from its own personal funds (and trade-in allowance) that is sufficient to pay the full cost of the vehicle title, tax and registration fees, any dealer-imposed fees, the full cost of any additional warranties,

[36] The Proposed Rules removed the distinction between new and used vehicles that was in the Original Proposal.

insurance or other products purchased in connection with the purchase of the vehicle and 10% of the purchase price of the vehicle. The purchase price for a vehicle is calculated as the net amount paid for the vehicle after application of incentive payments or manufacturer cash rebates.

4. Buy-Back Requirements

If a sponsor relied on the qualification of a commercial loan, a CRE loan or an automobile loan for the risk retention exemption/reduction described above but then, after the closing of a securitization, it is determined that one or more loans did not meet the specified standards, the sponsor will not lose the benefit of the exemption/reduction if (1) the failure of such loans to meet such standard is not material or (2) within 90 days after the determination is made the sponsor cures the unsatisfied criteria or repurchases the subject loans from the issuer at a price equal to par plus accrued interest on the loan.

Note: Consistent with the Proposed Rules' overall allocation of responsibility for compliance to the sponsor, the repurchase requirement is the liability of the sponsor (although there is no restriction on the sponsor's ability to seek indemnification from the respective originator or loan seller).

V. Other Exemptions

Under the Proposed Rules, certain types of ABS or securitization transactions would be exempt from the credit risk retention requirements of the Proposed Rules. These additional exemptions are intended to be consistent with, and to implement, the applicable requirements of Section 15G.

A. General Exemptions

Under the Proposed Rules, the risk retention requirements would not apply to the following types of transactions:

- Any securitization transaction that (i) is collateralized solely by residential, multi-family or health care facility mortgage loan assets that are insured or guaranteed (in whole or part) as to the payment of principal and interest by the United States or an agency of the United States, and servicing assets or (ii) involves the issuance of ABS that (A) are insured or guaranteed as to the payment of principal and interest by the United States or any agency of the United States; and (B) are collateralized solely (excluding cash and cash equivalents) by residential, multi-family, or health care facility mortgage loan assets or interests in such assets, and servicing assets.

Note: For example, the exemption under clause (i) would apply to loans that are insured or guaranteed by the FHA, the Department of Veterans Administration, or the Department of Agriculture and Rural Development. This exemption implements Section 15G(e)(3)(B) of the Exchange Act. Also, the exemption under clause (ii) would apply to securities guaranteed by the Government National Mortgage Association.

- Any ABS that is collateralized solely by loans or other assets made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and servicing assets.
- Any ABS that is a security issued or guaranteed by any State,[37] or by any political subdivision of a State, or by any public instrumentality of a State that is exempt from the registration requirements of the Securities Act.
- Any ABS that meets the definition of a qualified scholarship funding bond, as set forth in Section 150(d)(2) of the Internal Revenue Code of 1986.
- Any securitization that: (i) is collateralized solely by servicing assets, and by existing ABS issued in a securitization transaction: (A) for which risk was retained under the Proposed Rules; or (B) that was exempted from the credit risk retention requirements pursuant to the Proposed Rules; (ii) is structured so that it involves the issuance of only a single class of ABS interests; and (iii) provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class.

  Note: Most resecuritizations are structured with at least two senior/subordinate classes. Because the proposed exemption restricts resecuritizations to a single pass-through class, multiclass resecuritizations of underlying ABS that were exempt from, or otherwise satisfied, the risk retention requirements would subject the sponsor of such resecuritizations to the risk retention requirements.

- Any securitization transaction that: (i) is collateralized solely by servicing assets, and by first-pay classes[38] of ABS collateralized by first-lien residential mortgages on properties located in any state and servicing assets for which credit risk was retained as required

[37] "**State**" is defined as any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

[38] A "**first pay class**" is defined as a class of ABS interests for which all interests in the class are entitled to the same priority of payment and that, at the time of closing of the transaction, is entitled to repayments of principal and payments of interest prior to or pro-rata with all other classes of securities collateralized by the same pool of first-lien residential mortgages, until such class has no principal or notional balance remaining.

under the Proposed Rules or that was exempted from the credit risk retention requirements of the Proposed Rules; (ii) does not provide for any ABS interest issued in the securitization transaction to share in realized principal losses other than pro rata with all other ABS interests based on current unpaid principal balance of the ABS interests at the time the loss is realized; (iii) is structured to reallocate prepayment risk; (iv) does not reallocate credit risk (other than as a consequence of reallocation of prepayment risk); and (v) does not include any inverse floater or similarly structured ABS interest.

- Any securitization transaction that is collateralized solely by servicing assets, and by "seasoned loans"[39] that (i) have not been modified since origination and (ii) have not been delinquent for 30 days or more.
- Any securitization transaction where the ABS issued in the transaction are secured by the intangible property right to collect charges for the recovery of specified costs[40] and such other assets, if any, of an issuing entity that is wholly-owned, directly or indirectly by an investor-owned utility company that is subject to the regulatory authority of a State public utility commission or other appropriate State agency.
- Any securitization transaction if the ABS issued in the transaction are: (1) collateralized solely by obligations issued by the United States or an agency of the United States and servicing assets, (2) collateralized solely by assets that are fully insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States, or (3) fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

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[39] A "**seasoned loan**" is (i) with respect to ABS backed by residential mortgages, a loan that has been outstanding and performing for the longer of (A) a period of five years; or (B) until the outstanding principal balance of the loan has been reduced to 25% of the original principal balance; but in any event any residential mortgage loan that has been outstanding and performing for a period of at least seven years and (ii) with respect to all other classes of asset-backed securities, a loan that has been outstanding and performing for the longer of (A) a period of at least two years; or (B) until the outstanding principal balance of the loan has been reduced to 33% of the original principal balance. The definition of seasoned loans is structured similarly to the sunset provisions on transfer and hedging restrictions, although the hedging sunset is not qualified by loan performance.

[40] "**Specified costs**" are any cost identified by a State legislature as appropriate for recovery through securitization pursuant to legislation enacted by a State that (i) authorizes the investor-owned utility company to apply for, and authorizes the public utility commission or other appropriate State agency to issue, a financing order determining the amount of specified costs the utility will be allowed to recover; (ii) provides that pursuant to a financing order, the utility acquires an intangible property right to charge, collect, and receive amounts necessary to provide for the full recovery of the specified costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's historic service territory who receive utility goods or services through the utility's transmission and distribution system, even if those customers elect to purchase these goods or services from a third party; and (iii) guarantees that neither the State nor any of its agencies has the authority to rescind or amend the financing order, to revise the amount of specified costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the specified cost recovery legislation.

- Any securitization transaction that is sponsored by the Federal Deposit Insurance Corporation acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or of Title II of the Dodd-Frank Act.

In addition to the exemptions described above, which provide complete relief from the sponsor's risk retention requirements in the applicable securitizations, the Proposed Rules also contain reduced risk retention requirements for student loan securitizations collateralized solely by student loans made under the Federal Family Education Loan Program ("**FFELP loans**"). Specifically, (i) with respect to a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to 100% of defaulted principal and accrued interest, and servicing assets, the risk retention requirement is reduced to 0%; (ii) with respect to a securitization transaction that is collateralized solely by FFELP loans that are guaranteed as to at least 98% of defaulted principal and accrued interest, and servicing assets, the risk retention requirement is reduced to 2%; and (iii) with respect to any other securitization transaction that is collateralized solely by FFELP loans, and servicing assets, the risk retention requirement is reduced to 3%.

The Proposed Rules specify that securitization transactions involving the issuance of ABS that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a Federal home loan bank will not on that basis qualify for exemption under the Proposed Rules. Nevertheless, although Fannie Mae and Freddie Mac do not independently qualify for an exemption, the Proposed Rules allow Fannie Mae and Freddie Mac securitizations to be exempt for so long as they are under the conservatorship or receivership of the FHFA with capital support of the United States, as described under "Permissible Forms of Risk Retention—Treatment of Government-Sponsored Enterprises" in Part III.E of this memorandum.

> *Note: In the NPR, the Agencies noted that they had considered, but declined to propose, exemptions for a number of other types of ABS, including securitizations of loans made prior to the effectiveness of the final credit risk retention rules, corporate debt repackagings, non-conduit CMBS transactions (i.e. single asset or single borrower deals and transactions backed by pools of 10 or fewer loans), tax lien securitizations by municipal entities and rental car securitizations.*

B. Additional Exemptions

The Proposed Rules provide that the Agencies with rule writing authority under Section 15G with respect to the type of assets involved may jointly provide a total or partial exemption of any

securitization transaction as such Agencies determine may be appropriate in the public interest and for the protection of investors.

Under the Proposed Rules, the Federal banking agencies and the SEC, in consultation with the FHFA and HUD, may jointly adopt or issue exemptions, exceptions or adjustments to the risk retention requirements, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with Section 15G.

C. Foreign Transactions Safe Harbor

The Proposed Rules would provide a "safe harbor" provision intended for certain foreign transactions if all of the following requirements are satisfied:

- The securitization transaction is not required to be and is not registered under the Securities Act.
- No more than 10% of the dollar value (or equivalent in the currency in which the ABS is issued, if applicable) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons.
- Neither the sponsor of the securitization transaction nor the issuing entity is: (i) chartered, incorporated, or organized under the laws of the United States or any State; (ii) an unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of the United States or any State; or (iii) an unincorporated branch or office located in the United States or any State of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State.
- If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State, no more than 25% (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from: (i) a majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the United States or any State; or (ii) an unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any State.

The safe harbor described above would not be available with respect to any transaction or series of transactions that, although in technical compliance, is part of a plan or scheme to evade the requirements of Section 15G and the Proposed Rules. In such cases, compliance with Section 15G and the Proposed Rules would be required.

VI. Conclusion

The Proposed Rules address in a constructive fashion some of the most controversial elements of the Original Proposal, including rationalizing the basis for measuring retention to be fair value and consequently removing the much criticized PCCRA requirement, harmonizing the QRM and QM definitions and permitting the retained risk to be transferred or hedged after the point in time that the type of underwriting risk that the risk retention rules are designed to mitigate will likely have become manifest through loan defaults. The Proposed Rules also reflect a refined understanding by the Agencies, gleaned through the comment process on the Original Proposal, of the nuances of many types of ABS and a willingness to adapt the rules to make them consistent with common market practices, where appropriate.

Despite the Agencies' efforts, the Proposed Rules still contain some elements that could, if not refined through the upcoming comment process, disrupt certain ABS markets which have re-opened and delay the re-emergence of other ABS markets. However, because the Proposed Rules represent a reproposal after almost 2-½ years of study by the Agencies, we think it unlikely that fundamental changes will result from the current comment period, especially with respect to matters as to which the Agencies rejected industry comments on the Original Proposal. Nevertheless, we would expect a number of technical corrections to be forthcoming, and the Agencies may well react to market input on the two asset classes they have specifically addressed for the first time in the Proposed Rules, namely Open Market CLOs and tender option bonds.

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