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FINANCE FORUM

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DECEMBER 1, 2016

PANEL MATERIALS

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DECEMBER 1, 2016
Ritz Carlton Charlotte

AGENDA

TIME	Salon II	Salon III	The Den
		Welcome Remarks and Opening Panel	
1:00-2:00 PM		**0A:** Welcome and Opening Remarks Stuart Goldstein, Cadwalader	
		0B: Regulation of the Financial Markets in the Trump Administration: How Far Will the Pendulum Swing? **Moderator:** Patrick Quinn, Cadwalader **Panelists:** Scott Cammarn, Cadwalader James Frazier, Cadwalader Gregory Mocek, Cadwalader Jeffrey Robins, Cadwalader Edward Wei, Cadwalader *CLE accreditation pending*	
		Panel 1	
2:10-2:55 PM	**1A:** Middle Market Lending **Moderator:** Jeffrey Nagle, Cadwalader **Panelists:** Joseph Alala, Capitala Peter Bove, Wells Fargo Frank Byrne, Bank of America Jeffrey Kung, Citizens *CLE accreditation pending*	**1B:** CMBS Risk Retention and the Wall of Maturities… What to look forward to in 2017 **Moderator:** David Burkholder, Cadwalader **Panelists:** Stefanos Arethas, Credit Suisse Larry Brown, Starwood Lainie Kaye, Deutsche Bank Kara McShane, Wells Fargo Kunal Singh, JPMorgan *CLE accreditation pending*	**1C:** Capital Rules: Practical Impacts on Financing to Investment Funds **Moderator:** Brian Foster, Cadwalader **Panelists:** Chris Burke, Barclays Brandon Clar, Two Sigma Nathan Lebioda, Wells Fargo *CLE accreditation pending*

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TIME	Salon II	Salon III	The Den
Panel 2			
3:05-3:50 PM	**2A:** Subscription Finance Market Update **Moderator:** Wesley Misson, Cadwalader **Panelists:** Stephen Arnall, Capitala Brad Boland, Wells Fargo Jeremy Grubb, Citizens Matthew Skurbe, Blackstone Mary Touchstone, Simpson Thacher Robert Wood, Bank of America *CLE accreditation pending*	**2B:** Current Trends in Commercial Real Estate Finance **Moderator:** Bonnie Neuman, Cadwalader **Panelists:** Brad Beelaert, WHI Quentin Fogan, Bank of America Joseph Geoghan, JPMorgan Michael Lascher, Blackstone Dennis Schuh, Starwood	**2C:** AML, OFAC and Cyber Regulatory Developments **Panelists:** Jodi Avergun, Cadwalader John Curran, Stroz Friedberg Maureen Dollinger, Barclays *CLE accreditation pending*
Panel 3			
4:00-4:45 PM	**3A:** Fund Finance: Hybrid and NAV-Based Leverage **Moderator:** Michael Mascia, Cadwalader **Panelists:** Doug Cruikshank, Enhanced Capital Alessandra McKell, Investec Nick Mitra, Natixis Michael Williamson, Clearhaven *CLE accreditation pending*	**3B:** CRE Debt Repo & Warehouse Finance Update **Moderator:** Stuart Goldstein, Cadwalader **Panelists:** Cary Carpenter, Starwood Thomas Cassino, JPMorgan Matthew Cohen, Mesa West Bob Foley, TPG Jonathan Love, Wells Fargo *CLE accreditation pending*	**3C:** Alternative Risk Retention Solutions: Thinking Outside the Box **Moderator:** Gregg Jubin, Cadwalader **Panelists:** Joseph Beach, Cadwalader Jake Jamison, Voya Dan Norman, Voya *CLE accreditation pending*
Panel 4			
4:55-5:40 PM	**4A:** Hot Topics in Residential Mortgage Origination, Finance and Securitization **Moderator:** Chris Gavin, Cadwalader **Panelists:** Robert Durden, Credit Suisse Keith Luedeman, Goodmortgage.com Tim Nabors, TIAA Matthew Nichols, Deephaven Dash Robinson, Wells Fargo *CLE accreditation pending*	**4B:** Women in Finance: Where are They? **Moderator:** Holly Chamberlain, Cadwalader **Panelists:** Julie Caperton, Wells Fargo Catherine Chen, Apollo Laura Parrott, TIAA Dee Dee Sklar, Wells Fargo	

Reception to follow in the Ballroom

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Regulation of the Financial Markets in the Trump Administration: How Far Will the Pendulum Swing?

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Cadwalader, Wickersham & Taft LLP
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Trump Administration Legal Developments

Examining the Impact of the 2016 U.S. Election

The election of Donald J. Trump as the 45th President of the United States, coupled with Republican control of both chambers of Congress, will likely result in significant developments in U.S. financial markets and the laws that govern them. While the most sweeping changes will require legislation, The Trump Administration will also have numerous non-legislative means to reform and reshape financial and economic regulation broadly and within specific industries.

Through our program of memos, webinars, and other thought leadership and analysis, our multi-disciplinary team of experienced attorneys will provide clients with vital insight and practical guidance.

Visit our Trump Administration Legal Developments webpage to find more information about our program and to download materials.

www.cadwalader.com/resources/trump-administration-legal-developments

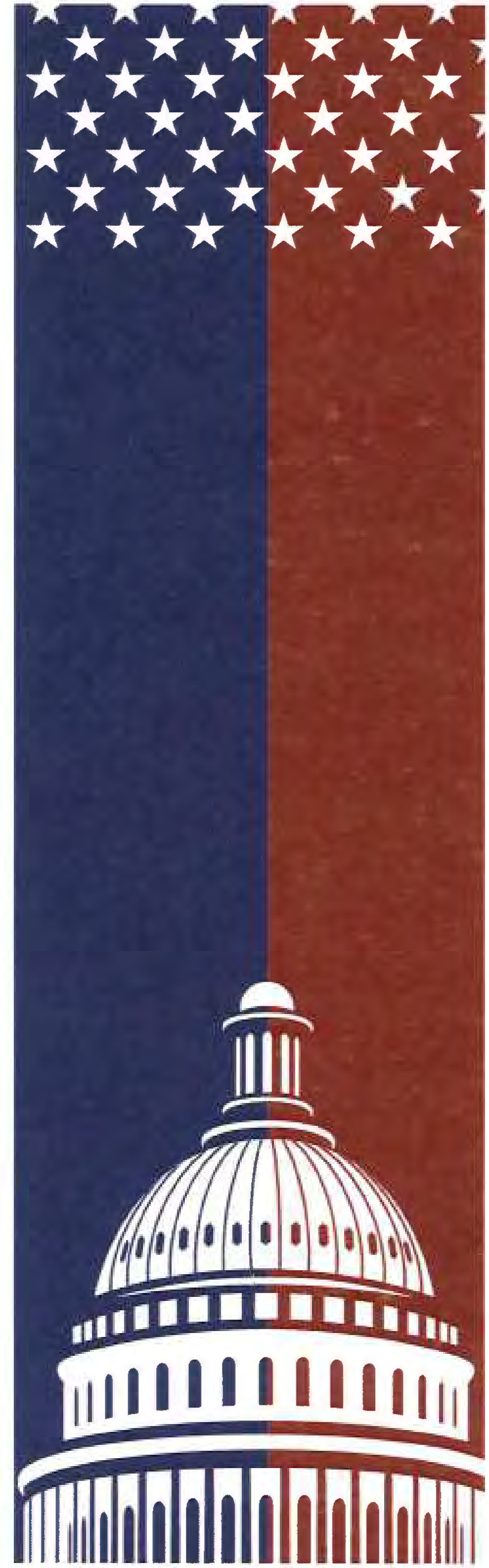
Key areas:

- Capital Markets
- Corporate
- Energy
- Executive Compensation
- Financial Services
- Healthcare
- Tax
- White Collar

The Cabinet Center for Administrative Transition (CCAT)

CCAT is our newest curated repository of policy materials and analysis related to the financial service agenda of the President-elect, the new administration and the new Congress. It will provide all that you need to keep current with relevant legal and regulatory developments affecting you, your company and the U.S. financial markets.

For more information:
www.findknowdo.com/content/cabinet-center-administrative-transition



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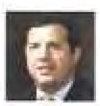
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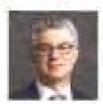
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Clients&FriendsMemo

White Collar Crime Law Enforcement in a Trump Justice Department - 8 Predictions

November 29, 2016

Overview

After a conventional presidential campaign, determining the policy priorities and direction of the incoming administration with respect to the Justice Department's white collar law enforcement responsibilities can be a relatively straightforward process. Confident prediction this election year, however, is tempered by the lack of comprehensive Trump Administration policy releases addressing these issues. And, as history has shown, even a clear articulation of new law enforcement priorities can be overtaken by events – recall Attorney General Ashcroft's pledge to focus the Justice Department on prosecuting pornographic obscenity, which was quickly obviated by the September 11 attacks.

Notwithstanding these challenges, President-elect Trump's announcement of Alabama Senator Jeff Sessions as his choice for Attorney General provides the basis for a forecasting model. We can look to Senator Sessions' public positions in Congress and his previous work as both a federal prosecutor and state Attorney General for guidance as to how he might shape the Justice Department's approach to white collar crime.

The following summarizes positions taken by Senator Sessions as a prediction of how a Justice Department led by him may set law enforcement priorities in eight white collar areas: (1) Foreign Corrupt Practices Act ("FCPA") & International Bribery; (2) Anti-Money Laundering & Asset Forfeiture; (3) Securities Enforcement / Financial Fraud; (4) Cyber & National Security; (5) Pharmaceutical Regulation & Compliance; (6) OFAC & Export Control; (7) False Claims Act ("FCA") & Healthcare Fraud; and (8) Legalized Cannabis.

Biography

Jeff Sessions graduated from the University of Alabama School of Law in 1973. After private practice, Sessions served as an Assistant United States Attorney for the Southern District of Alabama from 1975 to 1977. In 1981, President Reagan appointed Sessions to be the United States Attorney for the Southern District of Alabama, a position he held until 1993. Sessions later served as Alabama's Attorney General from 1995 until 1997, when he was elected to represent Alabama in the United States Senate. In the Senate, he has focused primarily on issues related to immigration, national security, criminal justice and the federal budget. Senator Sessions has served on several committees, most notably as a long-time member of the Judiciary Committee. He was the first Senator to endorse Donald Trump for President and served as the chairman of the Trump campaign's national security advisory committee.

White Collar Crime Generally

A Sessions-led Justice Department is likely to maintain a focus on white collar crime and to build on the Obama Administration's efforts to prosecute individuals responsible for corporate crime. Senator Sessions has expressed support for prosecuting corporations and individuals in white collar cases and has often referenced his own experiences as a federal and state prosecutor. He appears to consider such prosecutions an effective deterrent against future wrongdoing. Some of Senator Session's comments suggest that he might be less inclined to resolve investigations of corporate misconduct through non-prosecution agreements ("NPAs") or deferred prosecution agreements ("DPAs"), and may be more inclined to bring criminal charges in those cases.

- During a 2015 Senate Judiciary Committee hearing on whether the Justice Department should be prohibited from pressuring corporations to waive attorney-client privilege, Senator Sessions argued against any such rule, noting that prosecutors regularly pressure street criminals to waive constitutional rights using the threat of tougher penalties if they do not cooperate. Senator Sessions said the Justice Department should be able to use similar leverage against corporations. Corporate crime "is not easy to prosecute or investigate. They have the best lawyers that you can find, and they utilize all the legitimate tools that they have," Senator Sessions said. "[Y]ou have to be strong . . . a prosecutor cannot be a weak-kneed person going up against a major corporation in a fraud case."
- In 2010, during Senate Judiciary Committee confirmation hearings for Deputy Attorney General James Cole, Senator Sessions appeared to question whether the Justice Department should consider the collateral consequences of a criminal conviction for a corporation (e.g., Arthur Anderson's dissolution) in determining whether to bring a case. Senator Sessions said "I was taught if they violated a law, you charge them. If they didn't violate the law, you don't charge them." In a reference to the Justice Department's investigation into BP over the Deepwater Horizon oil spill, he stated that BP "should be held liable for their responsibilities to the extent of their existence."

- At a 2002 Judiciary Committee hearing regarding white collar crime, Senator Sessions stated, "I was a United States Attorney during the Savings and Loan fraud cases. I prosecuted [f]ederal land bank fraud cases. My office prosecuted those cases that I supervised, and I am going to tell you there is a lot better behavior in banking today because people went to jail over those cases in the past. They lost everything they had, their families were embarrassed, and a lot of people started checking to make sure they were doing their banking correctly."

FCPA & International Anti-Bribery

President-elect Trump has in the past expressed skepticism regarding the FCPA and international anti-bribery enforcement. In a 2012 interview with CNBC, Mr. Trump said that "this country is absolutely crazy" to prosecute alleged FCPA violations in places like Mexico and China. He went on to say that the FCPA is a "horrible law and it should be changed," adding that it puts U.S. business at a "huge disadvantage."

With respect to Senator Sessions, it is unclear whether he would maintain the Justice Department's current high level of FCPA prosecutions, as there is little evidence of his views on international anti-bribery enforcement. Senator Sessions has not commented extensively on the FCPA or the Justice Department's enforcement of international anti-bribery laws, although he once sought information as to whether enforcement of the FCPA has had a negative impact on the ability of American businesses to compete in foreign countries. Domestically, however, Sessions has sought to expand the Justice Department's ability to combat bribery and corruption in the United States.

- In a 2011 Judiciary Committee hearing, Senator Sessions expressed concern over the DPAs and NPAs used to settle FCPA cases. Senator Sessions asked Acting Associate Attorney General Tony West whether DPAs and NPAs "undermine the rule of law by depriving the [Justice Department's] legal arguments of meaningful testing in a judicial forum." In the same hearing, he asked whether the Justice Department's increased FCPA enforcement had an impact "on the competitiveness of American business overseas relative to that of other countries."
- In 2010, the Department of Justice asked Congress to restore prosecutors' power to bring cases against public and private sector officials who conceal conflicts of interest for personal gain. Senator Sessions agreed that a revised statute was needed but argued for the legislation to define specifically what constitutes honest services fraud. "'Undisclosed self-dealing.' That's a pretty broad statute. Give me a break," Senator Sessions said. However, in 2007 he also co-sponsored the Public Corruption Prosecution Improvements Act, which amended the federal criminal code to revise and expand prohibitions against bribery, theft of public money, and other public corruption offenses.

Anti-Money Laundering & Asset Forfeiture

Senator Sessions is likely to consider anti-money laundering prosecutions a law enforcement priority, particularly in cases where potential terrorism or national security issues are implicated. He has sought to expand the federal RICO statute to include the operation of illegal money transmission businesses as a predicate act. Senator Sessions has also expressed his opposition to, and may scale back, the Justice Department's recent reforms to its asset forfeiture program, which had the effect of limiting local law enforcement asset sharing in cash and vehicle seizures. Additionally, Senator Sessions has expressed his opposition to the Justice Department's prohibition of the forfeiture of bank accounts for structuring offenses until after a defendant has been criminally charged.

- Senator Sessions co-sponsored the Combating Money Laundering and Terrorist Financing Act of 2004, which provided for civil forfeiture of the assets of those who plan or perpetrate terrorist acts against international organizations or foreign governments. The act also sought to combat money laundering by amending RICO to cover acts involving illegal money transmission businesses, embezzlement and fraud in the purchase of securities. The act was incorporated into the Tools to Fight Terrorism Act of 2004, which ultimately was not enacted.
- During a 2015 Judiciary Committee hearing on the issue of asset forfeiture, Senator Sessions said that "taking and seizing and forfeiting, through a government judicial process, illegal gains from criminal enterprises is not wrong . . . 95 percent [of forfeitures involve people who have] done nothing in their lives but sell dope." He indicated that it would be "unthinkable that we would make it harder for the government to take money from a drug dealer than it is for a businessperson to defend themselves in a lawsuit." Furthermore, Senator Sessions opposed any reform to the Justice Department's Equitable Sharing Program, stating that he has heard from police groups across the country who have said that civil asset forfeiture is an important law enforcement tool. Ending the sharing of seized cash with local departments, Sessions said, "would be a huge detriment to law enforcement."

Securities Enforcement / Financial Fraud

Senator Sessions has expressed support for both the Justice Department and the Securities and Exchange Commission in their policing of U.S. financial markets. Under Senator Sessions, the Justice Department would be likely to continue to prosecute significant cases involving securities or financial fraud

- Senator Sessions co-sponsored the SAFE Markets Act in 2009, which authorized the Director of the Federal Bureau of Investigation to hire an additional 500 agents to investigate violations of the law relating to U.S. financial markets. The act also authorized the Attorney General to hire an additional 50 Assistant United States Attorneys and the Securities and Exchange Commission to hire 100 additional enforcement staff members dedicated to prosecuting such violations. Ultimately, however, the legislation was not enacted.

Cyber & National Security

With respect to cybersecurity defense, President-elect Trump's transition website states that he plans to "order an immediate review of all U.S. cyber defenses and vulnerabilities, including critical infrastructure, by a Cyber Review Team of individuals from the military, law enforcement, and the private sector." The scope of this critical infrastructure review is likely to include large private financial institutions (i.e., banks and funds). President-elect Trump has also indicated that he will instruct the Justice Department to "create Joint Task Forces throughout the U.S. to coordinate Federal, State, and local law enforcement responses to cyber threats."

Senator Sessions is likely to direct the FBI and Justice Department to maintain or increase their use of electronic surveillance methods in criminal investigations, even in areas where courts have identified potential constitutional infirmities. As a Senator he supported broad surveillance powers for use by both domestic law enforcement agencies and U.S. intelligence services; as Attorney General, Sessions might roll back a number of the restrictions on surveillance imposed by the Obama Administration.

- In 2016, Senator Sessions proposed an unsuccessful amendment to the Electronic Communications Privacy Act, which would have required technology companies to turn over sought-after data without a warrant if federal, state or local law enforcement agencies declared that an emergency existed.
- Senator Sessions harshly criticized Apple's recent refusal to unlock iPhones connected to the San Bernardino terrorism case, stating, "coming from a law enforcement background, I believe this is a more serious issue than [Apple CEO] Tim Cook understands." Senator Sessions said that accessing phones is critical to law enforcement. "In a criminal case, or could be a life and death terrorist case, accessing a phone means the case is over. Time and time again, that kind of information results in an immediate guilty plea, case over," Senator Sessions said.

- In 2013, Senator Sessions opposed reforms to the Foreign Intelligence Surveillance Act, which included increasing transparency in the Foreign Intelligence Surveillance Court and halting bulk metadata collection, commenting that he believed that "everything in the Patriot Act that [Congress] passed was consistent in principle to the very things that have been done by law enforcement for years and decades in terms of the ability to issue subpoenas and obtain records." Senator Sessions also supported the Cybersecurity Information Sharing Act of 2015 to enable companies and the government to share information on cyber threats.
- Senator Sessions criticized Attorney General Holder during a 2009 Judiciary Committee hearing because he "failed to weigh in on dangerous legislation such as the State Secrets Act and the media shield law" opposed by prior Attorneys General, and "stood silent on bills that need to be passed . . . such as the reauthorization of the PATRIOT Act." Senator Sessions also defended the warrantless surveillance of U.S. citizens' phone calls and emails when contacting foreign citizens who were the subject of an intelligence-gathering operation.

Pharmaceutical Regulation & Compliance

From a law enforcement standpoint, Senator Sessions appears to be most focused on prescription drug abuse, rather than the technical, regulatory issues implicated in, for example, off-label promotion cases. His legislative efforts in this area have centered on increasing penalties for violations of federal laws that criminalize the use of fraud or deception in obtaining pharmaceutical products, and prohibiting the internet sale of controlled substances without a prescription. Senator Sessions supports improving treatment for addiction but believes that tougher prosecution of drug traffickers, as well as pharmacists and doctors, is more important in stopping the current epidemic of opioid abuse. He has criticized "Big Pharma" in statements on the floor of the Senate during debates surrounding the Affordable Care Act ("ACA").

- In 2016, Senator Sessions supported the Comprehensive Addiction and Recovery Act and its measures to address the current opioid epidemic. Upon its passage, however, Senator Sessions released a statement arguing that the act fell short by not addressing the larger problem of heroin trafficking, particularly over the Mexican border.
- In a Judiciary Committee hearing that same year on the issue of heroin and prescription drug abuse, Senator Sessions stated that as a prosecutor in Alabama he sought to investigate the sources of prescription drugs, which he found to be a small number of doctors and pharmacists. Senator Sessions explained his enforcement policy as follows: "If somebody goes to jail, that sends a message to the other doctors and pharmacists, does it not?"
- In 2012, Senator Sessions co-sponsored the Safe Doses Act, which enhanced federal penalties for those who steal, embezzle or obtain pharmaceutical products through fraud or deception. The act also enhanced penalties for those who knowingly resold stolen medical products and pharmaceuticals, and provided restitution to victims injured by stolen medical products.

- In 2009, Senator Sessions made a speech on the Senate floor opposing the ACA. Quoting an article written by former Labor Secretary Robert Reich, Senator Sessions argued that the Obama Administration had signaled to "Big Pharma" that the government would not use its purchasing power to negotiate lower drug prices, in an effort to induce the pharmaceutical industry to support the ACA. Senator Sessions said that, in return, "Big Pharma" budgeted $150 million in TV ads for promoting universal health insurance.
- In 2008, Senator Sessions co-sponsored the Ryan Haight Online Pharmacy Consumer Protection Act of 2008, which amended the Controlled Substances Act to prohibit the delivery, distribution, or dispensing of controlled substances over the Internet without a valid prescription and imposed registration and reporting requirements on online pharmacies.

OFAC & Export Control

Senator Sessions seems likely to continue efforts by the Justice Department to prosecute companies that engage in transactions with sanctioned individuals, companies or governments. Senator Sessions has co-sponsored legislation aimed at continuing or enhancing sanctions against Iran to promote U.S. foreign policy objectives. He has also supported efforts on export control to prevent foreign countries from unfairly benefiting from trade with the United States and has opposed foreign militaries obtaining U.S. exports. In addition, Senator Sessions has argued that the Commerce Department's primary goal of promoting American business should disqualify it from enforcing export control restrictions.

- Senator Sessions has been a vocal critic of China's allegedly unfair trade practices. He authored a January 2015 op-ed that praised the U.S. International Trade Commission for penalizing Chinese tire producers that had flooded the U.S. market with low-cost products to drive out competition.
- In 2013, Senator Sessions co-sponsored the Iran Sanctions Loophole Elimination Act, which directed the President to impose sanctions on any foreign bank that knowingly engaged in certain types of transactions with the Central Bank of Iran or any entity within the blacklisted Iranian energy, shipping, shipbuilding and port-operator sectors. The legislation was not enacted.
- In 2009, Sessions supported a "Sense of Congress" motion, which held that diplomatic efforts to address Iran's nuclear program are likely to be more effective if the President is empowered with explicit authority to impose additional sanctions on the government of Iran.
- In 2003, Senator Sessions joined four Senators who called on the Bush Administration to strengthen export controls on products that may be used against the United States during armed conflict. Specifically, the Senators were concerned that exports of aluminum tubes were used by Iraq to assist its missile program and that China may have used fiberglass from the

United States to help Iraq rebuild its air defense system. The Senators also said that the Department of Commerce should not be in charge of export control, arguing that "[t]here is an inherent conflict of interest in resting the protection of our national security in the hands of a department that is charged with the promotion of U.S. business interests."

False Claims Act & Health Care Fraud

Senator Sessions has shown general interest in the False Claims Act and public health care fraud, but has not been actively involved in proposing legislation or engaging in public policy debates with respect to these subjects. Accordingly, the public record does not provide a firm basis for predicting how these issues would be prioritized in a Sessions-led Justice Department.

- In a 2011 Judiciary Committee hearing, Senator Sessions asked Acting Associate Attorney General Tony West to reconcile the Justice Department's increase in recoveries in FCA cases while the number of FCA cases declined. Senator Sessions also asked West to explain the decline in FCA cases and whether the Justice Department's "emphasis on health care fraud diverted disproportionate amounts of time and resources from other types of False Claims cases."
- In a 2009 Judiciary Committee hearing on effective strategies for preventing health care fraud, Senator Sessions acknowledged the massive number of fraud claims and "the Government's inability to monitor these claims . . .". Senator Sessions said that "[i]f [the] Government has difficulty combating fraud in the current program, we know that if we expand those programs, it will be even greater." Senator Sessions added that "whistleblowers can be a critical part of discovering frauds that may be of a massive nature . . . and I think it is a legitimate part of our enforcement effort."
- In a 2009 Judiciary Committee hearing, Senator Sessions expressed interest in the Health Care Fraud Prevention and Enforcement Action Team ("HEAT"). Senator Sessions asked Attorney General Eric Holder questions about HEAT and indictments filed, defendants charged, guilty pleas negotiated, and convictions won since commencing the HEAT initiative.

Legalized Cannabis

Senator Sessions has been a vocal opponent of the legalization of marijuana, which he considers a dangerous drug. Senator Sessions has criticized the Obama Administration for its decision (articulated in the 2013 "Cole Memorandum") to decline enforcing federal marijuana laws in states in which medical marijuana is permitted. Because the Cole Memorandum is a guidance document that reflects the Obama Administration's enforcement policies, it can be immediately rescinded by the incoming Attorney General. Given Sessions' vocal opposition to legalized marijuana, the Cole Memorandum, and the policies it reflects, may be in jeopardy.

- During a 2016 hearing of the Senate Caucus on International Narcotics Control, Senator Sessions said that "we need grown-ups in charge in Washington to say marijuana is not the kind of thing that ought to be legalized, it ought not to be minimized, that it's in fact a very real danger." He also spoke of the need to foster "knowledge that this drug is dangerous, you cannot play with it, it is not funny, it's not something to laugh about . . . and to send that message with clarity that good people don't smoke marijuana."
- In October 2015 prepared remarks to the Senate, Senator Sessions labeled the States' legalization of marijuana as a "mistake" and lamented the Obama Administration's decision not "to enforce federal drug laws regarding marijuana in Colorado, Washington, and Oregon." Senator Sessions referenced the America Medical Association, which "issued an unequivocal report . . . about the danger and ramifications of the use of marijuana."

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Clients&FriendsMemo

The Trump Administration: Change By Appointment

November 18, 2016

The Trump Administration: Instituting Change

The election of Donald J. Trump as the 45th President of the United States, along with the Republican control of the majority of both the House of Representatives and the Senate, will likely result in significant changes in U.S. financial services, energy, and commodities laws and markets. The most sweeping changes may require legislation and may generate controversy within Congress – in particular in the U.S. Senate. This is due to differences in views between the Democrats and Republicans regarding economic regulation; these differences are amplified by the very narrow majority held by Senate Republicans and the Senate's existing rules that allow the minority to "filibuster" (or block) a bill absent 60 votes necessary for "cloture" to override the filibuster. However, even in the absence of legislation, President-elect Trump and the Republican Congress will have numerous means to reform and reshape economic regulation.

Many experts are engaged in educated speculation about the regulatory priorities of the now-forming Trump Administration. One way to analyze the likelihood (and timing) of various regulatory developments is through the lens of process: What is required for the new Administration and Republican-controlled Congress to implement various possible initiatives? This memorandum focuses on the ability of the President and the Republican Congress to reshape policy through the appointment process with respect to certain key agencies responsible for financial, commodities, and energy markets in the U.S. Subsequent memos in this Series will discuss other non-legislative means by which the new President can act, both directly and indirectly, to effect regulatory change, as well as certain limiting factors.

Less Through Legislation; More Through Regulation

There has been much speculation regarding the impact the Trump Administration will have on the 2010 legislation adopted on the heels of the financial crisis, the Dodd-Frank Act. Given the strong support for the Dodd-Frank Act by certain Democratic Senators, any attempt to significantly scale back or repeal the Dodd-Frank Act (or those aspects of the Dodd-Frank Act most favored by the Democrats) will almost certainly trigger an attempt by Senate Democrats to block that effort. Given the other priorities announced by the Trump Administration (including health care, tax, energy, and immigration reform), it seems unlikely that Mr. Trump would seek a heated Senate battle over large-scale Dodd-Frank Act reform early in his term as that could scuttle or delay his other priorities, especially since Mr. Trump's pre-election positions about Wall Street and the major banks were decidedly mixed. Moreover, while the Trump Administration has vowed to "dismantle" the Dodd-Frank Act, it has also indicated that it intends to replace it with something new, which would of course take time to develop (although existing legislation, such as Republican House Financial Services Committee Chairman Jeb Hensarling's Financial CHOICE Act, can serve as a starting point). In any case, simply repealing the Dodd-Frank Act in its entirety is not feasible; too much of the Dodd-Frank Act has become ingrained in U.S. financial services law, meaning that a complete repeal would create a gaping void in U.S. law and result in significant operational and regulatory disruption.

Thus, it seems more likely that the Trump Administration will adopt a targeted approach to economic regulation, seeking to repeal certain aspects of the Dodd-Frank Act, amend other aspects, and leave intact the remainder. Legislative efforts to change existing financial services law, therefore, are likely a more long-term and deliberative process. (In upcoming Clients & Friends Memos we will discuss the prospects for legislative change to the Dodd-Frank Act in more detail.)

This is not to say that the Trump Administration cannot have an immediate and significant impact on U.S. financial services, energy, and commodities regulations. The Trump Administration can, and will, fairly quickly reconstitute a number of federal agencies by appointing agency leaders that will advance the Trump Administration's policies. These changes in policy could be effectuated by slowing the pace of proposed or pending regulations, revising existing regulations, or altering the agency's interpretive, supervisory and enforcement positions.

In this regard, it is important to note that financial services, energy, and commodities laws in the U.S. are largely driven by complex and detailed agency regulations. The regulations of the four principal federal banking agencies alone – the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System (the "Fed"), the Federal Deposit Insurance Corporation ("FDIC"), and the Consumer Financial Protection Bureau ("CFPB") – span more than 7,000 pages covering eight volumes of the Code of Federal Regulations. These massive regulations are supplemented by an even more voluminous amount of orders, interpretations, no-action letters, guidance, and pronouncements.

The Appointment Power

In a very real sense, Mr. Trump's best ability to make an immediate impact on financial services, energy, and commodities laws, without triggering heated (and public) disputes in Congress, is through his ability to reconstitute certain federal agencies through appointment and direction. Below we summarize the composition of these critical agencies and the ability of the Trump Administration to alter the regulatory landscape through prompt changes to the agencies' leadership.

CFPB

The most watched change may be at the CFPB. The CFPB was created by the Dodd-Frank Act and is controversial due to its sweeping mandate and powers with respect to consumer financial services, its method of funding that is wholly outside traditional appropriations processes, and its unique structure whereby the single CFPB Director is, by statute, immunized from control or removal by the President. In a very recent decision, the D.C. Circuit ruled that the CFPB's structure was unconstitutional and that the CFPB Director therefore must be subject to control and removal at-will by the President. This decision, if upheld, would subject the CFPB Director to removal by Mr. Trump. See *PHH Corp. v. Consumer Financial Protection Bureau*, No. 15-1177, at 10. While the CFPB indicated prior to the election that it was considering an appeal of the D.C. Circuit's decision, it is unclear whether that appeal will continue (given that the Trump Administration would not have any reason to support the appeal). If such an appeal is filed, it is also unclear whether the D.C. Circuit's decision will be stayed. The CFPB is the product of Senator Elizabeth Warren, a Massachusetts Democrat and an outspoken critic of Mr. Trump.

The CFPB Director is appointed by the President and serves for five years. Currently Richard Cordray serves as the CFPB Director. Director Cordray's term expires in July 2018. Of course, if the D.C. Circuit decision is not stayed or upheld, Director Cordray can be removed at will by Mr. Trump immediately after inauguration in January. While the CFPB has rulewriting and supervisory authority, the CFPB also has sweeping enforcement authority that has been liberally used in recent years. Thus, a change in the CFPB Director may have enormous and immediate impact on consumer financial services.

OCC

The most immediate change may be felt at the OCC, the regulator of national banks and federal thrifts. The OCC, the oldest of all financial regulators and established in 1863, is an office of the U.S. Treasury Department, a traditional executive agency. The OCC is headed by a Comptroller, who is appointed by the President and serves five years in office. The current Comptroller is Thomas J. Curry, formerly the Commissioner of the Division of Banks of Massachusetts. While the President has the power to remove the Comptroller only upon "reasons to be communicated by the President to the Senate," Comptroller Curry's term ends in April 2017, just three months following Mr. Trump's inauguration (unless Comptroller Curry decides to resign, or is removed, prior to that date).

Given that virtually all of the largest U.S. banks are national banks regulated by the OCC, a change in leadership at the OCC will have widespread impact across the banking industry.

SEC

The Securities and Exchange Commission ("SEC") operates pursuant to the Securities Exchange Act ("SEA"); its reach extends over initial securities offerings and secondary market trading, registered investment companies under the Investment Company Act ("ICA") and private funds under the Investment Advisers Act ("IAA"). It is primarily responsible for administration and enforcement of various statutes, including: the Securities Act, the SEA, the ICA, the IAA, the Trust Indenture Act of 1939, the Sarbanes-Oxley Act, and the JOBS Act. SEC authority over U.S. securities markets encompasses securities, including security options, security futures (jointly with the CFTC), and security-based swaps.

The SEA provides for the Commission to be led by up to five Commissioners appointed by the President, with the advice and consent of the Senate, to serve staggered five-year terms so that one Commissioner's term ends on June 5th of each year. Terms end at the later of (i) five years or (ii) when a successor has been appointed and qualified.

The President names one Commissioner as Chairman. An SEC Commissioner, as a member of an "adjudicatory body," may be removed by the President only for "inefficiency, neglect of duty or malfeasance in office." While the Chairman has only a single vote, the Chairman in fact controls the agenda as well as most of the resources of the agency (the other Commissioners are allocated little resources individually). No more than three Commissioners at any one time may be from the same political party.

When there is a vacancy in the Commission, SEC action is governed by common law and statutorily authorized quorum and voting rules. Under those rules, two out of three Commissioner votes are sufficient to adopt rules in the absence of all five positions being filled. However, when there are three or fewer sitting Commissioners, all sitting Commissioners are necessary to form a quorum unless a Commissioner has been disqualified from the matter at hand.

Currently there are only three SEC Commissioners: Mary Jo White (Chairman, Democrat, 2013-2019), Kara Stein (Democrat, 2013-2017), and Michael S. Piwowar (Republican, 2013-2018). President Obama had nominated Lisa Fairfax (Democrat) and Hester Peirce (Republican) to fill the current Commission vacancies but the Senate Democrats had placed a "hold" on the confirmation of both of the President's nominees. It would seem unlikely that the Republican Senate will confirm the two pending nominees during the lame duck session; thus the new Administration will have the ability to appoint two Republican Commissioners. In addition, current Chairman Mary Jo White has already announced her plans to step down from the Commission when President Obama exits the Oval Office. Note that, when a vacancy exists in the position of Chairman, the President will designate a Commissioner to serve as acting Chairman until a permanent Chairman is selected. Thus, Mr. Trump will likely have the ability to nominate Commissioners for the three vacancies (at least one of which will need to be a Democrat) and designate one Commissioner as Chairman.

At least until the new Commissioners are named, it is expected that the President would name Commissioner Piwowar as Chairman.

CFTC

The Commodity Futures Trading Commission ("CFTC" or "Commission") gained enhanced authority over U.S. financial markets following the Dodd-Frank Act, which expanded the CFTC's jurisdiction over U.S. swaps markets (in addition to its pre-existing regulatory authority over commodity futures and options contracts and market participants). The Dodd-Frank Act also expanded the CFTC's enforcement authority over the broader commodities markets and market participants. The CFTC's swaps rulemaking process following Dodd-Frank was controversial; the CFTC was criticized by the industry and Congressional Republicans due to the rapid manner in which it issued regulations implementing the Dodd-Frank Act, and then "clarified" flawed rules through hundreds of no-action letters. This process was characterized by some as unnecessarily disruptive. The CFTC's efforts to regulate aggressively cross-border or extraterritorial swaps transactions and foreign institutions was also met with stiff criticism abroad.

The CFTC was established in 1975 as an independent agency that is run by five Commissioners, each appointed by the President and confirmed by the Senate. A Commissioner serves a five-year term that is staggered from the other Commissioners, and can only be removed for cause. No more than three Commissioners may be from the same political party. The President appoints one of the Commissioners as the Chairman of the CFTC. The Chairman serves at the pleasure of the President. Should the Chairman be removed from his or her position by the President, the removed Chairman may continue to serve as a Commissioner for the remainder of their unexpired term. If the position of Chairman becomes vacant, then the remaining Commissioners must elect one among them to be the Acting Chairman of the CFTC, who serves until the President appoints, and the Senate confirms, a new Chairman.

Commissioner vacancies do not limit the remaining Commissioners from exercising any and all of the powers of the CFTC. There is no minimum quorum requirement, and only a bare majority of the quorum must reach consensus for the CFTC to take actions that require the approval of the Commission. In the past, the CFTC has acted with as few as two Commissioners.

Currently there are only three CFTC Commissioners: Timothy G. Massad (Chairman, Democrat, term expires April 13, 2017); Sharon Y. Bowen (Democrat, term expires April 13, 2018); and J. Christopher Giancarlo (Republican, term expires April 13, 2019). Two of President Obama's Commissioner nominations are still pending before the Senate: Christopher Brummer (Democrat, a Georgetown University Law Center professor) and Brian D. Quintenz (Republican, a commodity pool hedge fund founder). Even with the impending transition to the new Administration, it is possible that the Republican-controlled Senate could move forward with the existing nominations.

Assuming that Chairman Massad tenders his resignation – which is not unexpected – Mr. Trump may appoint two new Republicans and one new Democrat as Commissioners, and may name one of the Republicans as Chairman. The Republican Chairman will control the executive and administrative functions of the Commission, and the Republican majority – the Chairman and the other two Republican Commissioners – likely will work together to implement Mr. Trump's financial regulatory agenda.

FDIC

The FDIC, formed in 1933, serves multiple roles — it administers the Deposit Insurance Fund, it oversees the resolution of failed FDIC-insured depository institutions, and it supervises state-chartered banks that are not members of the Federal Reserve System as well as state-chartered thrifts.

The FDIC is a bi-partisan agency headed by a board of directors. The FDIC Board comprises five directors: three appointed by the President; the Comptroller; and the CFPB Director. Not more than three of the directors of the FDIC Board may be from the same political party, and each director serves for a six-year term. One of the directors of the FDIC Board serves as its chairperson for a five-year term and is appointed to that role by the President. Members of the FDIC Board can be removed by the President only for cause.

Currently, the FDIC Board comprises Richard Cordray (the CFPB Director, a Democrat), Thomas J. Curry (the Comptroller, a Democrat), Martin J. Gruenberg (the chairman of the FDIC Board, a Democrat), and Thomas M. Hoenig (the Vice Chairman, a Republican). This composition leaves one vacancy that could be filled immediately by a presidential appointment. Chairman Gruenberg's term as a director expires in early 2018 (although his term as chairperson expires in November 2017). Vice Chairman Hoenig's term as a director also expires in early 2018. Accordingly, not only can Mr. Trump fill the existing vacancy, and refill the seats allocated to the Comptroller and CFPB Director by making changes to those agency heads, but Mr. Trump also will have the ability to replace the chairmanship as early as 2017 and Hoenig's and Gruenberg seats in 2018, if he so chooses.

The Fed

The Fed, established in 1913, has the dual role of managing U.S. monetary policy as well as supervising bank holding companies, savings and loan holding companies, and state banks that chose to join the Federal Reserve System. Given that virtually all significant U.S. banking organizations are in holding company form, the Fed is perhaps the most powerful of the U.S. banking agencies.

The Fed is headed by a Board of Governors, comprising up to seven members (each a "Governor"), to be appointed by the President from a different district of the Federal Reserve System. Each

Governor serves for 14 years, from February 1 of the closest even-numbered year, and cannot be reappointed after serving a full term. Each Governor can be removed only for cause by the President. This restriction on removal is by design, in order to keep the Fed somewhat independent from political influence of the Executive Branch due to the Fed's critical role in establishing U.S. monetary policy.

From these existing Governors the President chooses one to serve as Chair. The Chair serves for four years and is the Fed's executive officer. Currently Janet Yellen serves as the Chair. Her term as Chair expires February 3, 2018, but her term as a Governor expires in 2024.

There are only five Governors currently serving: Stanley Fischer (term expires January 31, 2020); Daniel Tarullo (term expires January 31, 2022); Janet Yellen (term expires January 31, 2024); Lael Brainard (term expires January 31, 2026); and Jerome H. Powell (term expires January 31, 2028).

Two vacancies remain on the Board of Directors. One vacancy is particularly noteworthy. The Dodd-Frank Act requires that the Board have a "Vice Chairman of Supervision," to "develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board, and [to] oversee the supervision and regulation of such firms." This position was never filled by President Obama. While Mr. Trump is largely unable to reconstitute the Fed, he can influence the direction of the Fed through by filling the remaining seats on the Board, including the crucial Vice Chairman of Supervision and naming the Chair in 2018.

FHFA

The Federal Housing Finance Agency ("FHFA") serves a critical financial role due to its supervision of the government sponsored enterprises — Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The FHFA is headed by a single director. The FHFA Director serves for a term of five years and is subject to removal by the President only for cause. Currently Mel Watt, a former Democratic member of the House of Representatives, serves as the FHFA Director. Director Watt's term expires early 2019.

FSOC

The Financial Stability Oversight Council ("FSOC") is a body created by the Dodd-Frank Act. Most notably, the FSOC was given the authority to determine whether the potential failure of a nonbank entity poses significant risk to the U.S. financial system and thus to designate the entity as a "nonbank financial company," subject to Fed oversight in many respects as if the entity were a bank holding company. The FSOC is comprised of ten voting members, nine of which consist of the agency heads of many of the agencies discussed above – the Fed, OCC, FDIC, CFPB, SEC, CFTC, and FHFA – along with the Secretary of the Treasury (who acts as the FSOC Chair), the Chairman of the National Credit Union Administration, plus one independent member selected by the President. The FSOC largely will be re-constituted automatically as the President makes appointments to these other agencies.

DOL

The U.S. Department of Labor ("DOL") is a Cabinet-level department responsible for administering and enforcing numerous employment and labor-related laws. The DOL carries out its mission through several agencies and offices, including the Employee Benefits Security Administration ("EBSA"). EBSA is responsible for administering, regulating and enforcing Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended, including the fiduciary responsibility and prohibited transaction rules applicable to the investment of ERISA plan assets. The DOL recently issued the final regulation redefining the term "fiduciary" in connection with the provision of investment advice, which regulation is slated to become applicable on April 10, 2017. The DOL is headed by the Secretary of Labor and EBSA is headed by the Assistant Secretary of Labor of the Employee Benefits Security Administration. The Secretary of Labor and the Assistant Secretary are nominated by the President and subject to Senate confirmation. The Trump Administration has not yet indicated who will be appointed to these positions.

FERC

The Federal Energy Regulatory Commission ("FERC") regulates various interstate transactions involving the sale of electric energy and natural gas, certain mergers of public utilities and the licensing of hydroelectric facilities, among many other things. The Commission comprises five Commissioners appointed by the President, with the advice and consent of the Senate. The President names one of these Commissioners as the Chairman, who generally sets the regulatory agenda of the agency.

A Commissioner serves a five-year term that is staggered from the other Commissioners and can be removed only for cause by the President. No more than three Commissioners may be from the same political party. The minimum quorum for FERC to take "Commission action" is three Commissioners. Commission action includes issuing proposed and final regulations and initiating enforcement proceedings.

There are currently three Commissioners: Norman C. Bay (Chairman, Democrat, term expires June, 2018); Cheryl A. LaFleur (Democrat, term expires June, 2019); and Colette D. Honorable (Democrat, term expires June, 2017).

Assuming that Chairman Bay tenders his resignation – which is not unexpected – Mr. Trump may appoint possibly one Republican and one Democrat as Commissioners, and may name one of the Republican Commissioners Chairman. Mr. Trump may then replace Commissioner Honorable after her term expires in June of 2017. These changes would represent a shift, giving FERC a Republican majority that could advance Mr. Trump's financial regulatory agenda.

All of the above-mentioned positions in all of the above agencies would be subject to Senate confirmation proceedings, and thus it is difficult to know precisely when new leadership will begin within the agencies.

Conclusion

President-elect Trump, directly or through appointees, and perhaps with the assistance of a Republican-controlled Congress, will now have available those levers of power that, for the last eight years, have been in the hands of President Obama. This memorandum reviewed Mr. Trump's appointment powers as to a number of the agencies most significant to the economy. In a series of memoranda to come, we will discuss other non-legislative means by which a President can act, both directly and indirectly. We will also discuss limiting factors on the power of the President, indeed even on the power of the President with the co-operation of Congress, such as treaties and other international agreements to which the United States is a party, as well as likely changes in legislation or agency rulemakings and policies.

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Clients&FriendsMemo

The Trump Administration: Tools to Modify Current Tax Guidance

November 30, 2016

The election of Donald J. Trump as the 45th President of the United States, along with the Republican control of the majority of both the House of Representatives and the Senate, has raised the possibility that current Treasury regulations may be modified or nullified. The Trump Administration can consider one of two methods to do so:

1. The IRS/Treasury may issue new, and simultaneously withdraw existing, Treasury regulations, or

2. Congress can act under the Congressional Review Act ("CRA") to strike down Treasury regulations.

The easier of the two methods for the IRS/Treasury to modify or nullify current Treasury regulations would be to withdraw existing temporary and/or final Treasury regulations and issue new proposed Treasury regulations. In doing so, the IRS/Treasury, similar to other administrative agencies, must satisfy the current interpretations of the Administrative Procedure Act. Typically, this requires a notice and comment period for new proposed Treasury regulations prior to finalization of the Treasury regulations. In addition, the IRS/Treasury generally needs to acknowledge that it is changing its policy when withdrawing the Treasury regulations and state the reasons for the change, though it does not need to prove that its new policy is better than its old policy.

As an alternative, Congress can act under the CRA to strike down Treasury regulations. Under the CRA, Congress may act by passing a joint resolution to disapprove Treasury regulations, although the President can veto the disapproval. From the time a CRA report is submitted, Congress has 60 legislative days to review the rule (60 session days in the case of the Senate and 60 legislative days in the case of the House of Representatives). If an agency rule is promulgated when there are 60 or fewer legislative days remaining in the legislative session, the rule is also subject to review under the CRA in the following Congressional session. Congress may be hesitant to use this approach because once a Treasury regulation has been disapproved, the agency generally cannot issue a rule that is substantially the same. Because of these procedural difficulties, it should not be surprising that the CRA has rarely been used to override administrative regulations.

We can expect the Trump Administration to consider the modification of numerous Treasury regulations, including the recently issued debt-equity regulations under I.R.C. section 385 (view our previous memo here) and the anti-inversion regulations under I.R.C. section 7874 (view our previous memo here), and we would generally expect that it would issue new, and withdraw existing, Treasury regulations to achieve its objectives.

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Clients&FriendsMemo

The Trump Administration: The Future of Health Care

November 30, 2016

The election of Donald J. Trump as the 45th President of the United States, along with the Republican control of the majority of both the House of Representatives and the Senate, will likely set in motion a major overhaul of the nation's health care system. As a candidate, President-elect Trump strongly echoed calls to "repeal and replace" the Affordable Care Act ("ACA") and also called for other reforms that would potentially affect Medicaid funding, pharmaceutical regulation, and the health insurance industry. Given the relative lack of detail in his policy proposals, it remains to be seen what specific health care policy changes the Trump Administration will present when President-elect Trump takes office in January 2017. However, a number of sources provide guidance as to potential policy proposals, including: (i) the Health care page on the GreatAgain.gov website, (ii) the Health care page on the Donald J. Trump campaign website, (iii) the 2016 Republican Party Platform adopted by the delegates to the Republican National Convention, (iv) House Republican's "A Better Way" heath care reform plan, (v) H.R. 3762, 114th Cong. (2016), a reconciliation bill that would have, had it not been vetoed by President Barack Obama, effectively repealed certain provisions of the ACA, and (vi) the Empowering Patients First Act, a bill put forward by Congressman Tom Price, President-elect Trump's designated nominee for Secretary of Health and Human Services ("HHS"). This memorandum covers the various areas of potential change within the nation's current health care system that may be brought about by the Trump Administration, as well as the potential implications of such change.

The Affordable Care Act

The Current Law

The ACA, enacted by President Obama on March 23, 2010, was designed to increase access to quality and affordable health care by (i) providing subsidies to help low and middle income individuals to purchase private health insurance, and (ii) expanding Medicaid coverage to individuals under 65 with incomes up to 133 percent of the federal poverty level who were previously ineligible. In order to facilitate a market for the purchase of health insurance by low and middle income individuals, the ACA mandated the creation of health insurance exchanges offering qualifying health plans in each state (and federal default exchanges). Individuals who met a certain income threshold yet chose to remain uninsured faced a tax penalty.

In 2012, in response to legal challenges to the ACA, the United States Supreme Court upheld the individual mandate but made Medicaid expansion voluntary. Thirty-one states and the District of Columbia expanded Medicaid voluntarily, with those states that declined to do so citing cost concerns as a primary factor. Under the ACA, the federal government covers the entire cost of Medicaid expansion through 2016, decreasing to 97 percent in 2017 and 90 percent in 2020 and thereafter. Nonetheless, numerous states continue to decline the Medicaid expansion under the ACA.

The Proposed Changes to the Law

Republicans have been nearly unanimous in their opposition to the ACA, especially with regard to eliminating the individual mandate provision. The proposal articulated by President-elect Trump with respect to the ACA on the Donald J. Trump campaign website is to "Completely repeal Obamacare." However, reflecting the preference of many Republican lawmakers, President-elect Trump has indicated that he is in favor of keeping certain aspects of the ACA, including both the requirement that insurers offer coverage to people with existing health conditions and the provision allowing parents to keep children up to age 26 as dependents on their health insurance. He has not, however, stated whether he would be in favor of preserving other insurance-related consumer protection provisions of the ACA, such as the community-rating regulations that allow insurers to set premiums based only on age, smoking, and geography without considering sex or health status, and minimum standards for covered benefits.

The success of any repeal requires the Trump Administration to put forth a workable alternative that takes into account the difficulty in unwinding a major law in its sixth year of existence that currently provides insurance coverage for millions of Americans who may not be insured otherwise. Specifically, since its passage, approximately 22 million additional people have gained health insurance, 10 million of whom purchased health insurance on the state health insurance exchanges.

President-elect Trump's specific proposals to "replace" the ACA are aimed at promoting consumer choice, stimulating competition, and enabling a wider range of health coverage options. His campaign platform contains the following proposals:

1. Removing the borders traditionally constraining health insurance markets by allowing insurers and consumers to market and purchase insurance across state lines;

2. Providing premium assistance in the form of a full tax deduction of premium costs; and[1]

3. Expanding the use of flexible, tax-free health savings accounts.

Repeal Strategy – Budget Reconciliation

While Republican control of the majority of both the House of Representatives and the Senate makes major revisions to the ACA possible, Senate Republicans do not hold the "super-majority" of 60 seats in the Senate necessary to override any potential filibuster of legislation by Senate Democrats. Accordingly, a full repeal of the ACA is unlikely.

However, many of the central aspects of the ACA, including the individual mandate, are subject to the budget reconciliation process requiring only a simple majority in the Senate to pass. The budget reconciliation process enables Congress to effect substantive changes to law that affect spending, revenues, and the federal debt limit under strict procedural rules. Specifically, reconciliation can be used to address most entitlement programs, such as Medicare and Medicaid, but not Social Security.

Budget reconciliation would require the House and Senate to first agree on a budget resolution containing "reconciliation directives" to specified committees. Each committee that receives a directive prepares and adopts proposed legislation through a committee vote. If a committee fails to meet its budget targets, special procedures enable each chamber of Congress to fill any gaps before the bill goes to the full House or Senate for vote. However, provisions of reconciliation bills that are extraneous to the purpose of implementing budget changes may be blocked in the Senate. If it passes both the House and the Senate, the reconciliation measure is then presented to the President for signing.

In 2016, Congress unsuccessfully attempted to undo portions of the ACA using budget reconciliation.[2] That bill, which passed both houses of Congress, but was vetoed by President Obama, would have eliminated: (i) the expansion of Medicaid coverage for adults up to 138 percent of the federal poverty level, (ii) subsidies for middle-income Americans to buy insurance in the state marketplaces, (iii) tax penalties for the uninsured,[3] and (iv) many of the taxes created to fund the ACA program, including the "Cadillac" tax. The bill provided for a two-year period before such

[1] The House Republicans' plan also looks to the tax code to aid consumers in affording health insurance, and such plan may possibly be adopted as a stronger alternative. Instead of a tax deduction, the House Republicans proposed in "A Better Way" to provide an advanceable, refundable tax credit adjusted for age to be used for purchasing health insurance. Any funds leftover after premium costs would automatically be applied to a health savings account.

[2] H.R. 3762, 114th Cong. (2016).

[3] While not a repeal of the "individual mandate" and the "employer mandate," the bill eliminated the penalties associated with non-compliance.

provisions were repealed. This attempt ostensibly provides a blueprint for the Trump Administration, should it decide to dismantle the ACA through budget reconciliation.

Potential Impact

If the Trump Administration follows through with its plan to repeal major portions of the ACA, without replacing them with measures that would preserve health care insurance for those currently covered, the market impact of millions of people losing insurance would be significant. Hospitals and insurance companies would likely be affected negatively. For hospitals, increased insurance under the ACA has led to greater demand for care, increased revenue, and lower uncompensated care provided to the uninsured. In addition, insurers could lose millions of customers, both from the individual market and under state Medicaid programs.

The problem of "adverse selection" may become more pronounced without an individual mandate provision, as it is likely that some individuals may not purchase insurance unless and until they need it. If the Trump Administration remains committed to eliminating the individual mandate but chooses to maintain the requirement that insurers offer coverage to people with pre-existing conditions, significant risk-pool problems could arise, with insurers being forced to cover a sicker and more costly population without attracting enough healthy enrollees. Indeed, the ACA's coupling of the individual mandate and the pre-existing condition rule was meant to address this problem.

<u>Changes Outside of the ACA</u>

President-elect Trump's campaign platform also includes proposals addressing Medicaid, Medicare, and pharmaceutical regulation and pricing.

Medicaid Policy

Currently, federal Medicaid funding to the states is determined by the federal Medical Assistance Percentages ("FMAP"), which use measures such as per capita income to determine the amount of federal matching funds provided to the states. According to this guideline, for every $1 in state funds spent on Medicaid, states can draw at least $1 additional from the federal government based on the FMAP minimum, up to as much as $2.85 in certain states. As a result, there is no ceiling on federal Medicaid expenditures. Because the current system for financing Medicaid concerns budget outlays and appropriations, numerous Congresses have attempted to alter it through the budget reconciliation process.

The Republicans, President-elect Trump included, envision shifting more control to the states in order to maximize "state flexibility." President-elect Trump proposes to "block-fund" Medicaid, pursuant to which states would be required to administer their Medicaid programs with a fixed amount of federal funding. The intended result is to make states more prudent in the administration of Medicaid and create a greater incentive to eliminate fraud, a perennial concern of many Republicans. House Republican's "A Better Way" proposal is broader and offers the states a choice between a per capita allotment or a block grant to fund care provided under Medicaid. These reforms could have a significant budget impact on states. The states that have expanded Medicaid under the ACA generally stand to see a negative impact, which may require such states to restrict eligibility and/or limit benefits within their respective Medicaid programs.

Medicare Policy

President-elect Trump's campaign website and his GreatAgain.gov transition website are largely silent with respect to addressing Medicare, with references to "modernizing Medicare." Because the Republican Party Platform and the House Republican's proposals are intended to expand consumer choice, also a dominant feature in President-elect Trump's proposals, it is possible that the Trump Administration would closely consider such proposals or adopt them entirely.

Payment Structure

Currently, Medicare provides two general options for beneficiaries: traditional Medicare or Medicare Advantage. In traditional Medicare, reimbursement is made to providers through a fee-for-service system. Medicare Advantage, on the other hand, allows beneficiaries to enroll in private insurance plans approved by Medicare. Medicare pays the private insurance plan a monthly capitated fee. The Republican platform broadly calls for introduction of an alternative option to traditional Medicare, a "premium-support model designed to strengthen patient choice, promote cost-saving competing among providers, and better guard against fraud and abuse . . ." Although Medicare has been partly privatized through the Medicare Advantage Program, the House Republicans' proposal clarifies that this option would offer a range of different coverage plans, unlike Medicare Advantage, which requires identical benefits be offered to all beneficiaries regardless of differences in health status.

Value-Based Care

The ACA included a series of reforms to the way in which Medicare reimburses health care providers, which were designed to decrease utilization and increase quality through broader provider integration, capitated payments and coordination of care. A shift to value-based reimbursement models is unlikely to be reversed by the Trump Administration given the wide consensus over the need to tie Medicare and Medicaid reimbursement to quality measures. Medicare Advantage, for example, is looked upon favorably by most Republicans and is lauded as a successful model of promoting value based care in the House Republicans' reform plan. However, because of the interplay between the ACA and its emphasis on accountable care, a complete repeal of the law would also mean ending important initiatives to promote and develop successful models for value-based care, a key example of which is the ACA-funded CMS Innovation Center which was created by the ACA for the purpose of testing innovative payment and service delivery models to decrease expenditures while preserving or enhancing the quality of care for beneficiaries of Medicare, Medicaid or Children's Health Insurance Program. The House Republican's proposal contemplates eliminating the CMS-Innovation Center and shifting the role of developing innovative payment and service delivery models to the states by promoting state innovation grants. Notwithstanding any repeal of the ACA, it is likely that the regulatory and market-place drivers of value-based care and pay-for-performance will continue to push the health care payors, public and private, in this direction.

Drug Regulation and Pricing

Similar to President-elect Trump's proposals related to health insurance, it is likely that the Trump Administration will also seek to remove barriers to open competition in the pharmaceutical market. Specifically, the President-elect has called for allowing the importation of drugs from abroad, and the first 100 day plan includes "cutting the red tape at the FDA" in order to speed up the process for "over 4000 drugs awaiting approval." President-elect Trump has also called for allowing Medicare to take advantage of its market power and negotiate directly with pharmaceutical companies for lower rates.

Appointment of Tom Price

On November 29, 2016, the Trump Administration stated that it would appoint Congressman Tom Price as Secretary of HHS and Seema Verma, a health-care consultant, to run the Centers for Medicare and Medicaid Services ("CMS").

HHS is an executive level agency responsible for administering federal health care programs and executing laws under its authority. It oversees over 100 programs nationwide and implements parts of the ACA that deal with private and public health insurance. HHS also regulates and enforces laws related to health information privacy, clinical research, and civil rights. HHS is headed by the Secretary. It is the overseeing agency of a number of sub-agencies, including the Food and Drug Administration and CMS, which administers the Medicare program and along with the states, Medicaid and Children's Health Insurance Program. Both the Secretary of HHS and the Administrator at CMS are appointed by the President and confirmed by the Senate and serve without fixed terms.

Congressman Price is the U.S. Representative for Georgia's 6th congressional district, serving since 2005. He currently serves as chairman of the House Budget Committee and was previously chairman of the Republican Study Committee and the Republican Policy Committee. A former physician and veteran lawmaker, he has been a staunch critic of the ACA. Price has proposed legislation that, if passed, would have replaced the ACA.

First introduced in the 111th Congress, the Empowering Patients First Act sponsored by Price has as its first provision the repeal of the ACA.[4] In its place the bill would provide for a tax credit and deductions to offset the cost of insurance. In addition, the bill would allow individuals to opt out of Medicare, Medicaid, and other government payment programs and instead receive a tax credit to purchase health insurance, without losing Social Security benefits. The legislation also calls for the promotion of state-based high-risk insurance pools and the creation of individual and small employer membership associations and association health plans. Other aspects of the bill are similar to proposals put forth by House Republicans, including the "A Better Way" proposal.

As Secretary of HHS, Congressman Price will have significant influence in shaping the administrative agenda of the agency. Congressman Price would be in a position as Secretary to exert significant input in developing the legislation to replace of the ACA. It would then fall to HHS to draft most of the rules needed to implement whatever legislation is passed. We anticipate that any replacement to the ACA, like the ACA itself, would require significant regulatory input to address the numerous detailed aspects of insurance regulation, Medicare, Medicaid, and other elements.

Centers for Medicare and Medicaid Services

CMS has responsibility over the administrative simplification standards under the Health Insurance Portability and Accountability Act, quality standards in long term care facilities and laboratories, and oversight over HealthCare.gov, the website operated by the federal government to facilitate the health insurance exchanges under the ACA. CMS is authorized to formulate rules through notice and comment and has thereby implemented numerous significant administrative rules impacting many facets of health care. Importantly, CMS works with states in connection with the expansion of Medicaid under the ACA.

Seema Verma is the CEO of a health policy consulting firm who has worked in designing Medicaid expansion in a number of Republican leaning states including Indiana and Kentucky. As head of CMS, Verma would be in position to set the policy agenda of the agency in line with the Trump Administration. In particular, CMS would be in charge of implementing reforms to Medicare and Medicaid such as switching to a block grant system, which the Trump Administration has proposed. If the ACA were to remain, CMS would have significant control over the waiver process pertaining to the expansion of Medicaid.

[4] H.R. 3400, 111th Cong. (2009).

Takeaways

While the election of Donald J. Trump as the 45th President of the United States, along with the Republican control of the majority of both the House of Representatives and the Senate, will result in changes to ACA, a full repeal of such legislation is unlikely and any changes will likely be phased in over at least a two year period. This is in part due to the complexity of drafting an alternative that addresses the concerns of individual consumers, health care providers, and insurance companies. We will continue to monitor changes in legislation or agency rulemakings and policies that will impact the health care marketplace.

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CWT: Focus on Trump's appointments

Edward Price | Published: 28 Nov 2016

Donald Trump's election victory has caused the market to seek out answers regarding the regulatory implications of his appointment. And according to a research memo from partners at Cadwalader, Wickersham & Taft, the key is studying not Trump himself, but his appointments.

Anthony Mansfield, Cadwalader, Wickersham & Taft

Trump is a disruptive force – but inconsistent. He's often on record contradicting his own policy pledges, or firing out controversial tweets today only to row back on his statements tomorrow.

Nonetheless, in the area of financial regulation some key themes have emerged: deregulation is a broad aim of the nascent Trump administration, and the man has tended to attack the regulators. With an eye on infrastructure spending, Trump has thus indicated his distaste at Federal Reserve independence (in return, Fed Chair Janet Yellen has reminded US lawmakers of a potential increase in national debt). Plus the controversial Consumer Financial Protection Bureau (CFPB) – long derided for perceived overreach by a concerned GOP – is widely expected to come under fire after January.

Yet those are only broad brush themes. To really dig into the implications of the Trump administration, the partners at Cadwalader, Wickersham & Taft are studying the president-elect's actions.

"The most expeditious way President-elect Trump can change many of the financial regulators' policies is by taking his foot off the gas pedal and by changing who's in charge," said Scott Cammarn, partner at Cadwalader, Wickersham & Taft.

Changes at the top

President-elect Trump has repeatedly said he'll aim for a de-regulated US environment. High on his list is a repeal of the 2010 Dodd-Frank act, a law many Republicans (and no small number of Democrats) associate with the most cumbersome regulatory aspects of the Obama years. But a wholesale repeal of Dodd-Frank is far easier said than done, which leads to the question: how exactly will Trump deregulate?

Beginning in January, and absent immediate legislative changes, the new president will have a wild card – changes at the top of the main US regulators.

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KEY TAKEAWAYS

- **Partners at Cadwalader, Wickersham & Taft are studying Trump's likely regulatory appointments;**
- **Trump has a stated aim of financial sector deregulation;**
- **The repeal or replacement of Dodd-Frank will, however, take time, so Trump's short-term approach to deregulation will be making changes at US regulators;**
- **The CFTC and OCC will likely be the first to see changes, with the CFPB soon to come under fire.**

"On the Commodity Futures Trading Commission [CFTC] side, there's an opportunity to see these changes playing out potentially very immediately," said Anthony Mansfield, partner at Cadwalader, Wickersham & Taft.

Even at this late stage in the US political calendar, the CFTC has been considering three potential rules that would apply to derivatives: the regulation of automated trading, position limits and certain capital requirements. And for months, incumbent chairman Timothy Massad has been working at pace. "Now, there's a question about whether during a transition to the Trump administration that agenda will continue to go ahead," said Mansfield.

Instead, House Republicans are encouraging US agencies to stand down on further rule-making pending the new administration. The chairman of the House Agriculture Committee, Mike Conaway, for example, recently urged the CFTC to stand down, in particular on position limits, automated trading and registration rules for institutions that trade in derivatives.

In this climate, it may be that chairman Massad stands down before the end of his term, which ends in April 2017, making way for Republican commissioner Christopher Giancarlo. The Republican might be positioned, in turn, to serve as acting chairman. According to Mansfield, if that happens, it may well impact the CFTC's willingness to press forward with rule-making under the new Trump administration.

And Trump has another card to play, one that reflects how he may treat the other US regulators too: the CFTC is comprised of five commissioners, but currently, only three serve. As long as he maintains party balance, the new US president will be at liberty to select less regulation-minded commissioners and – in effect – prime the commission with the new, trumpian view of rule-making: less is more.

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OCC, CFPB

The new Trump administration will also be able to change the direction of the Office of the Comptroller of the Currency (OCC). Incumbent Comptroller Thomas Curry's term also expires in April. Trump can ask for his resignation or his term will otherwise expire a mere three months after the inauguration. According to Cammarn, such a change would be significant; the OCC is the regulator for the vast majority of bank assets in the US and the six largest banks in the US are all national banks.

Scott Cammarn, Cadwalader, Wickersham & Taft

But the real fireworks are likely to occur with any changes at or to the CFPB. The DC circuit and its recent court decision decided that the CFPB needs to be re-construed as an executive agency, one where the director is capable of being removed at will.

"Change by appointment could be Mr Trump's low-hanging fruit"

"Mr Trump could easily remove and replace CFPB Director Cordray with someone who perhaps might take a more balanced approach at the CFPB. That can occur fairly swiftly," said Cammarn. Of course, there may be a battle over the confirmation of any suggested replacement – the CFPB has been treated as a controversial topic for a long time. But Cordray can be removed at speed.

Fed, FDIC

As 2017 unfurls, they should be aware that changes in the other US bank sector agencies will likely take more time than those described above. Both the Fed and Federal Deposit Insurance Commission (FDIC) are designed to be more immunised from political influence. Fed governors can't be removed at will, but there are still two open seats, including the critical Vice Chair of Supervision. "Mr. Trump could add two Fed governors with a different perspective on bank regulation," said Cammarn.

Which leaves the FDIC. Its board is derived to a large extent of the other agencies, so changes at FDIC tend to occur after changes at regulators such as the OCC and CFPB have been made. Cammarn expects that, later in 2017 and 2018, Trump will be able to change the other members of FDIC board, subject to the limit that no more than three of its five members can come from the same party.

"In the end, change by appointment could be Mr Trump's low-hanging fruit," said Cammarn.

CADWALADER

FINANCE FORUM

Middle Market Lending

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I. Introduction to Middle Market Lending

A. *What is Middle Market Lending?*

The corporate debt market is generally divided into three categories: the broadly syndicated market, middle market, and small cap market. The exact definition of what is "middle market" is hard to pin down, however, traditionally an extension of credit is generally understood to be middle market when either (1) the size of the loan is less than $500 million but more than $75 million or (2) the borrower has annual revenues of less than $500 million or an annual EBITDA of less than $50 million.[1]

Other factors generally considered include the borrower's industry and geographic location, as well as the size of the lender. However, the lines between the broadly syndicated and middle markets have become increasingly blurred in recent years—especially for loans of $250 million or more.

B. *Who makes Middle Market Loans and Why?*

Middle market loans are made by a wide variety of lenders, including national banks, community banks, regional banks, business development companies, and other financial institutions. Traditionally, middle market lenders (particularly community and regional banks) are likely to have existing relationships with borrowers. Middle market lenders often leverage these relationships to cross-sell additional services to borrowers. For this reason, middle market lenders are less likely to sell a large portion of their loans on the secondary debt market and instead tend to buy-and-hold their positions.

Because middle market lending—particularly traditional deals—remains relationship-driven, loans in this area are often made by a single lender or a small group of lenders arranged by a lead lender (called "club deals"). However, some large deal middle market loans are made by larger groups of lenders organized into a small syndicate. Large deals tend to be less relationship-driven than traditional deals and focus more on return, valuation, and liquidity.

However, as is true in the broader debt market, non-bank lenders are becoming more common in middle market financings largely due to the issuance of the Interagency Guidance on Leveraged Lending by the Federal Reserve, the FDIC, and the Comptroller of Currency. Further, the middle market is seeing an influx of lenders that have traditionally restricted their lending activities to the more broadly syndicated loan market.

C. *What does the Deal Process Look Like for a Middle Market Loan?*

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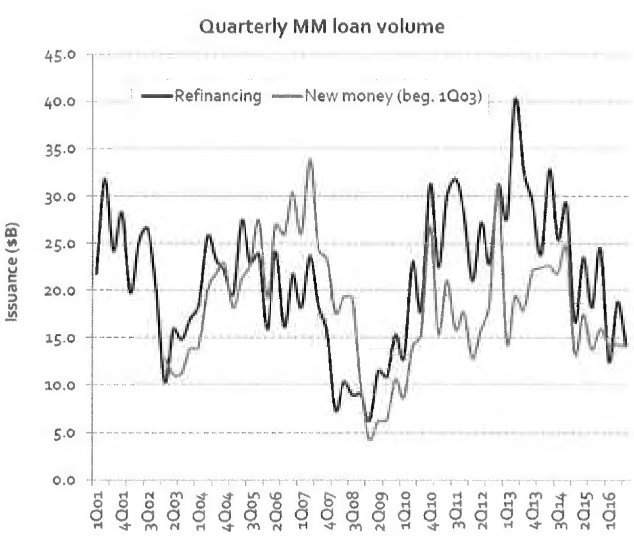
[1] Middle market loans are often further classified as either "large deals" or "traditional deals" depending on whether the amount of the loan is more or less than $100 million, respectively.

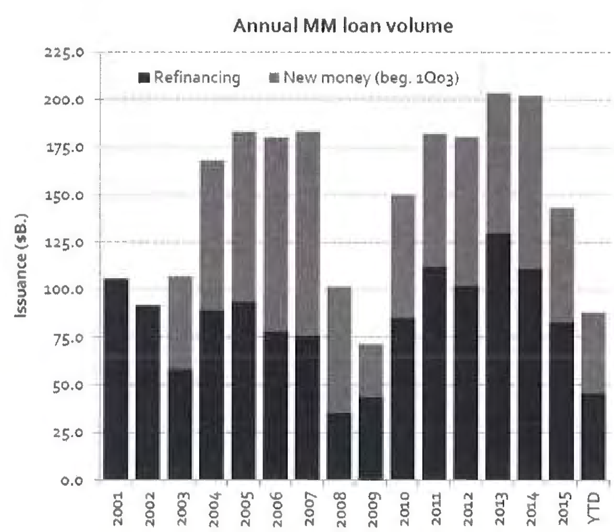
Middle market loans are made through a process quite similar to that of large syndicated bank loans. First, a borrower and the lenders agree on a financing structure and begin due diligence. After negotiating the commitment or proposal letter, term sheet, fee letter, and any applicable intercreditor terms, the parties negotiate the principal finance documents. However, unlike in the more broadly syndicated market and as discussed below, the terms of these documents are often driven less by larger macroeconomic and market forces than by borrower and industry fundamentals.

II. The Market

A. *How's Business?*

As a result of the increase in the number of lenders in the market and a decrease in the volume of quality lending opportunities, competition for deals in the middle market has increased. Lenders have responded to this by increasing their hold-levels, which reduces opportunities for other lenders to join syndicates and for borrowers to develop relationships with a larger group of lenders.





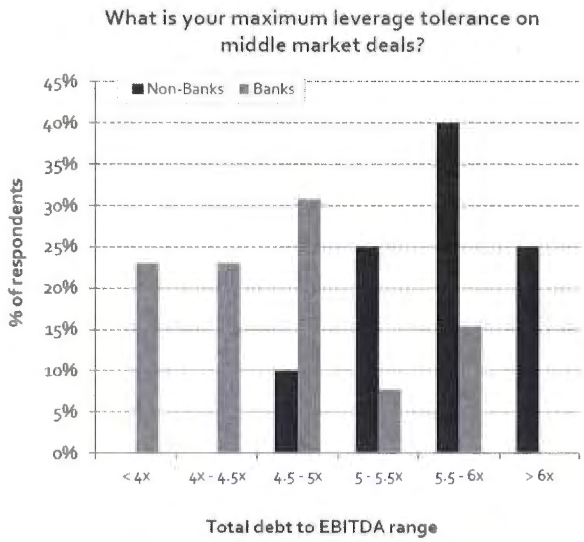
SOURCE: THOMPSON REUTERS LPC

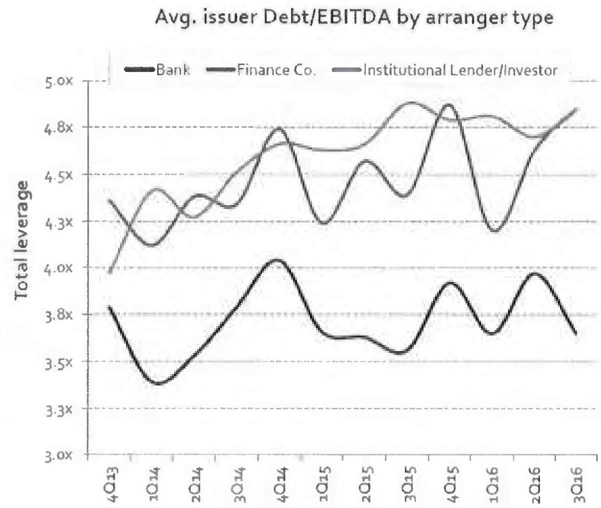
III. Regulatory Issues

A. *Impact of Leveraged Lending Guidance on Middle Market Lending*

In 2013, the Federal Reserve, FDIC, and Comptroller of Currency issued guidance that strongly discouraged banks from holding or arranging loans in an amount more than six times a company's EBITDA. Because this guidance typically restricts only bank lenders, who are also subject to regulations imposing increased capital restrictions, banks are increasingly being excluded from middle market financings despite their traditional prevalence in the market.

The gap left by banks has not gone unfilled. Non-bank lenders, free from many of the regulatory restrictions to which banks are subject, have stepped up to make the middle market loans with which traditional banks are no longer comfortable.





SOURCE: THOMPSON REUTERS LPC

IV. Deal Structures & Terms

A. *What Drives Middle Market Loan Terms?*

Terms of middle market financings—particularly traditional middle market loans—tend to be driven more by the borrower and industry fundamentals rather than macroeconomic issues and market fluctuations. Middle market loans are less sensitive to issues in the general loan markets—like Brexit. However, the influx to the middle market of lenders traditionally engaged in the more broadly syndicated loan market is impacting this characteristic. Such lenders tend to negotiate the same terms in middle market loans as they do in their deals with larger corporate borrowers.

B. *How do Middle Market Loans Tend to be Structured?*

Senior financings generally provide revolving and term loan facilities, and often include a letter of credit facility. Unlike loans in the broadly syndicated market and because middle market companies are perceived to be riskier, middle market loans are almost always secured. Generally, senior portions of middle market financings include a security and guarantee package from the borrower, its parent, and certain subsidiaries. Middle market financings often combine lending structures, including senior, second-lien, Term B, unitranche, and mezzanine debt. Middle market loans also tend to feature higher yields than broadly syndicated loans, due in large part to the perceived risk of investing in smaller companies and the less-active secondary market for middle market loans.

V. Summary

Middle market loans comprise a large portion of the overall corporate debt market. Although regulatory and market pressures have blurred the lines between the middle and more broadly syndicated loan markets, middle market loans maintain many of their distinctive characteristics.

ATTACHMENTS

I. *Interagency Guidance on Leveraged Lending Activities*, Dept. of the Treasury, Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys. & the Fed. Deposit Ins. Corp. (Mar. 21, 2013), available at https://www.federalreserve.gov/bankinforeg/srletters/sr1303a1.pdf.

ADDITIONAL INFORMATION & EXAMPLES

II. *OCC Bulletin 2014-55, Subject: Leveraged Lending*, Office of the Comptroller of the Currency (Nov. 7, 2014), available at https://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-55.html#.

III. *Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending*, Dept. of the Treasury, Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys. & the Fed. Deposit Ins. Corp. (Nov. 7, 2014), available at https://www.occ.gov/news-issuances/news-releases/2014/nr-ia-2014-153c.pdf.

IV. An example of a Middle Market Credit Agreement can be found at: https://1.next.westlaw.com/Xhtml/I7f7ea566e56211e598dc8b09b4f043e0?originationContext=document&transitionType=PLDocumentLink&contextData=(sc.Search)#N/A.

A. ***Summary***. This single-lender credit agreement features a secured $100 million revolver loan with a $10 million letter of credit sublimit to borrowers in the retail industry. The credit agreement is a borrowing base facility. The borrowing base includes certain eligible credit card receivables and inventory. The interest rate is set at L+ 1.25% to 1.75%, determined according to the average daily availability pricing grid, unless an event of default exists, in which case the applicable margin is increased to the highest level. The borrower must consent to assignments by lenders to entities other than lenders, lender affiliates and approved funds (although consent is deemed to have been given after the passage of ten business days). Guarantees are required from certain subsidiaries of the borrowers.

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

Interagency Guidance on Leveraged Lending

March 21, 2013

Purpose

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively the "agencies") are issuing this leveraged lending guidance to update and replace the April 2001 Interagency guidance[1] regarding sound practices for leveraged finance activities (2001 guidance).[2] The 2001 guidance addressed expectations for the content of credit policies, the need for well-defined underwriting standards, the importance of defining an institution's risk appetite for leveraged transactions, and the importance of stress-testing exposures and portfolios.

Leveraged lending is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure they do not unnecessarily heighten risks by originating poorly underwritten loans.[3] For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system. This guidance is designed to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner.

Since the issuance of the 2001 guidance, the agencies have observed periods of tremendous growth in the volume of leveraged credit and in the participation of unregulated investors. Additionally, debt agreements have frequently included features that provided relatively limited lender protection including, but not limited to, the absence of meaningful maintenance covenants in loan agreements or the inclusion of payment-in-kind (PIK)-toggle features in junior capital instruments, which lessened lenders' recourse in the event of a

[1] OCC Bulletin 2001-18; Board SR Letter 01-9, "Interagency Guidance on Leveraged Financing" April 9, 2001; and, FDIC Press Release PR-28-2001.

[2] For the purpose of this guidance, references to leveraged finance, or leveraged transactions encompass the entire debt structure of a leveraged obligor (including loans and letters of credit, mezzanine tranches, senior and subordinated bonds) held by both bank and non-bank investors. References to leveraged lending and leveraged loan transactions and credit agreements refer to all debt with the exception of bond and high-yield debt held by both bank and non-bank investors.

[3] For purposes of this guidance, the term "financial institution" or "institution" includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor.

borrower's subpar performance. The capital structures and repayment prospects for some transactions, whether originated to hold or to distribute, have at times been aggressive. Moreover, management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, with many institutions holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly.

This guidance updates and replaces the 2001 guidance in light of the developments and experience gained since the time that guidance was issued. This guidance describes expectations for the sound risk management of leveraged lending activities, including the importance for institutions to develop and maintain:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending that facilitates consistent application across all business lines;
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- A credit limit and concentration framework consistent with the institution's risk appetite;
- Sound MIS that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and,
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Applicability

This guidance updates and replaces the existing 2001 guidance and forms the basis of the agencies' supervisory focus and review of supervised financial institutions, including any subsidiaries or affiliates. Implementation of this guidance should be consistent with the size and risk profile of an institution's leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions should consider all aspects and sections of the guidance.

In contrast, the vast majority of community banks should not be affected by this guidance as they have limited involvement in leveraged lending. Community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator the implementation of cost-effective controls appropriate for the complexity of their exposures and activities.[4]

Risk Management Framework

Given the high risk profile of leveraged transactions, financial institutions engaged in leveraged lending should adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework should have as its foundation written risk objectives, risk acceptance criteria, and risk controls. A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices. This guidance outlines the agencies' minimum expectations on the following topics:

- Definition of Leveraged Lending
- General Policy Expectations
- Participations Purchased
- Underwriting Standards
- Valuation Standards
- Pipeline Management
- Reporting and Analytics
- Risk Rating Leveraged Loans
- Credit Analysis
- Problem Credit Management
- Deal Sponsors
- Credit Review
- Stress-Testing
- Conflicts of Interest
- Reputational Risk
- Compliance

[4] The agencies do not intend that a financial institution that originates a small number of less complex, leveraged loans should have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions should follow applicable supervisory guidance provided in the "Participations Purchased" section of this document.

Definition of Leveraged Lending

The policies of financial institutions should include criteria to define leveraged lending that are appropriate to the institution.[5] For example, numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.[6]
- A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.[7]

A financial institution engaging in leveraged lending should define it within the institution's policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. A financial institution's definition should describe clearly the purposes and financial characteristics common to these transactions, and should cover risk to the institution from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

General Policy Expectations

A financial institution's credit policies and procedures for leveraged lending should address the following:

- Identification of the financial institution's risk appetite including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The institution's designated risk appetite should be supported by an analysis of the potential

[5] This guidance is not meant to include asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor. Asset-based lending is a distinct segment of the loan market that is tightly controlled or fully monitored, secured by specific assets, and usually governed by a borrowing formula (or "borrowing base").

[6] Cash should not be netted against debt for purposes of this calculation.

[7] The designation of a financing as "leveraged lending" is typically made at loan origination, modification, extension, or refinancing. "Fallen angels" or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged would not be included within the scope of this guidance, unless the credit is modified, extended, or refinanced.

effect on earnings, capital, liquidity, and other risks that result from these positions, and should be approved by its board of directors;

- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The limit framework should identify the related management approval authorities and exception tracking provisions. In addition to notional pipeline limits, the agencies expect that financial institutions with significant leveraged transactions will implement underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk;[8]
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses;
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors;
- Expected risk-adjusted returns for leveraged transactions;
- Minimum underwriting standards (see "Underwriting Standards" section below); and,
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds.[9] They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for:

[8] Flex terms allow the arranger to change interest rate spreads during the syndication process to adjust pricing to current liquidity levels.

[9] Refer to other joint agency guidance regarding purchased participations: OCC Loan Portfolio Management Handbook, http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf, Loan Participations, Board "*Commercial Bank Examination Manual*," http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf, section 2045.1, Loan Participations, the Agreements and Participants; and FDIC Risk Management Manual of Examination Policies, section 3.2 (Loans), http://www.fdic.gov/regulations/safety/manual/section3-2.html#otherCredit, Loan Participations, (last updated Feb. 2, 2005).

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- Carefully monitoring the borrower's performance throughout the life of the loan; and,
- Establishing appropriate risk management guidelines as described in this document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. A financial institution should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, an institution's underwriting standards should consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute. The entirety of a borrower's capital structure should reflect the application of sound financial analysis and underwriting principles;
- A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period. As a general guide, institutions also should consider whether base case cash flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term.[10] Also, projections should include one or more realistic downside scenarios that reflect key risks identified in the transaction;
- Expectations for the depth and breadth of due diligence on leveraged transactions. This should include standards for evaluating various types of collateral, with a clear definition of credit risk management's role in such due diligence;
- Standards for evaluating expected risk-adjusted returns. The standards should include identification of expected distribution strategies, including alternative strategies for funding and disposing of positions during market disruptions, and the potential for losses during such periods;

[10] In general, the base case cash flow projection is the borrower or deal sponsor's expected estimate of financial performance using the assumptions that are deemed most likely to occur. The financial results for the base case should be better than those for the conservative case but worse than those for the aggressive or upside case. A financial institution may make adjustments to the base case financial projections, if necessary. The most realistic financial projections should be used when measuring a borrower's capacity to repay and de-lever.

- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values;
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors. Institutions looking to rely on sponsor support as a secondary source of repayment for the loan should be able to provide documentation, including, but not limited to, financial or liquidity statements, showing recently documented evidence of the sponsor's willingness and ability to support the credit extension;
- Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;
- Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6X Total Debt/EBITDA raises concerns for most industries;
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies. Standards for asset-based loans that are part of the entire debt structure also should outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and,
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Nothing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured, standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which a financial institution should consider separate underwriting and risk rating guidance.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and, (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The "capitalized cash flow" method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The "discounted cash flow" method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the "discount rate") that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a lender should reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets should be tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress tests of enterprise values and their underlying assumptions should be conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The institution should perform its own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral should have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the institution should establish limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise-value estimates should be clearly documented, well supported, and understood by the institution's appropriate decision-makers and risk oversight units. Further, an institution's valuation methods should be appropriate for the borrower's industry and condition.

Pipeline Management

Market disruptions can substantially impede the ability of an underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses. Accordingly, financial institutions should have strong risk management and controls over transactions in the pipeline, including amounts to be held and those to be distributed. A financial institution should be able to differentiate transactions according to tenor, investor class (for example, pro-rata and institutional), structure, and key borrower characteristics (for example, industry).

In addition, an institution should develop and maintain:

- A clearly articulated and documented appetite for underwriting risk that considers the potential effects on earnings, capital, liquidity, and other risks that result from pipeline exposures;
- Written policies and procedures for defining and managing distribution failures and "hung" deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from transaction closing). The financial institution's board of directors and management should establish clear expectations for the disposition of pipeline transactions that have not been sold according to their original distribution plan. Such transactions that are subsequently reclassified as hold-to-maturity should also be reported to management and the board of directors;
- Guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic and market conditions on the institution's asset quality, earnings, liquidity, and capital;
- Controls to monitor performance of the pipeline against original expectations, and regular reports of variances to management, including the amount and timing of syndication and distribution variances, and reporting of recourse sales to achieve distribution;
- Reports that include individual and aggregate transaction information that accurately risk rates credits and portrays risk and concentrations in the pipeline;
- Limits on aggregate pipeline commitments;
- Limits on the amount of loans that an institution is willing to retain on its own books (that is, borrower, counterparty, and aggregate hold levels), and limits on the underwriting risk that will be undertaken for amounts intended for distribution;
- Policies and procedures that identify acceptable accounting methodologies and controls in both functional as well as dysfunctional markets, and that direct prompt recognition of losses in accordance with generally accepted accounting principles;
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures, which should address acceptable types of hedges and the terms considered necessary for providing a net credit exposure after hedging; and,

- Plans and provisions addressing contingent liquidity and compliance with the Board's Regulation W (12 CFR part 223) when market illiquidity or credit conditions change, interrupting normal distribution channels.

Reporting and Analytics

The agencies expect financial institutions to diligently monitor higher risk credits, including leveraged loans. A financial institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the institution's board of directors. Policies and procedures should identify the fields to be populated and captured by a financial institution's MIS, which should yield accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs;
- Amount of impaired assets and the nature of impairment (that is, permanent, or temporary), and the amount of the ALLL attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu treatment for all lenders and, thus, dilute the secondary support from the sale of collateral;
- Secondary market pricing data and trading volume, when available;
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures;
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Pipeline definitions should clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed;

- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative;
- Borrower and counterparty leveraged lending reporting should consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the institution should consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Risk Rating Leveraged Loans

Previously, the agencies issued guidance on rating credit exposures and credit rating systems, which applies to all credit transactions, including those in the leveraged lending category.[11]

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, the agencies believe that it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual status.

[11] Board SR Letter 98-25 "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations;" OCC Comptroller's Handbooks "Rating Credit Risk" and "Leveraged Lending", and FDIC Risk Management Manual of Examination Policies, "Loan Appraisal and Classification."

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. A financial institution's policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, whether

- Cash flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- Liquidity analyses include performance metrics appropriate for the borrower's industry; predictability of the borrower's cash flow; measurement of the borrower's operating cash needs; and ability to meet debt maturities;
- Projections exhibit an adequate margin for unanticipated merger-related integration costs;
- Projections are stress tested for one or more downside scenarios, including a covenant breach;
- Transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status. From inception, the credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance;
- Enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- Collateral liquidation and asset sale estimates are based on current market conditions and trends;
- Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity; and,
- The borrower is adequately protected from interest rate and foreign exchange risk.

Problem Credit Management

A financial institution should formulate individual action plans when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment should develop guidelines for evaluating the qualifications of financial sponsors and should implement processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include the following:

- The sponsor's historical performance in supporting its investments, financially and otherwise;
- The sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;
- Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance);
- Consideration of the sponsor's contractual investment limitations;
- To the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals;
- Consideration of the sponsor's dividend and capital contribution practices;
- The likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio; and,
- Guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance.

Credit Review

A financial institution should have a strong and independent credit review function that demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to their senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, the institution's credit review function should assess the performance

of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. Such assessments should be performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews should generally be conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate more frequent reviews.

A financial institution should staff its internal credit review function appropriately and ensure that the function has sufficient resources to ensure timely, independent, and accurate assessments of leveraged lending transactions. Reviews should evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Internal credit reviews should include the review of the institution's leveraged lending practices, policies, and procedures to ensure that they are consistent with regulatory guidance.

Stress-Testing

A financial institution should develop and implement guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital.[12] The sophistication of stress-testing practices and sensitivity analyses should be consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

Conflicts of Interest

A financial institution should develop appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential

[12] *See* interagency guidance "Supervisory Guidance on Stress-Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets," Final Supervisory Guidance, 77 FR 29458 (May 17, 2012), at http://www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm, and the joint "Statement to Clarify Supervisory Expectations for Stress-Testing by Community Banks," May 14, 2012, by the OCC at http://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76a.pdf; the Board at www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf; and the FDIC at http://www.fdic.gov/news/news/press/2012/pr12054a.pdf. See also FDIC Final Rule, Annual Stress Test, 77 FR 62417 (Oct. 15, 2012) (to be codified at 12 CFR part. 325, subpart. C).

conflicts of interest arise between the financial institution and its customers. Policies and procedures should clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, management should have an established training program for employees on appropriate practices to follow to avoid conflicts of interest, and provide for reporting, tracking, and resolution of any conflicts of interest that occur.

Reputational Risk

Leveraged lending transactions are often syndicated through the financial and institutional markets. A financial institution's apparent failure to meet its legal responsibilities in underwriting and distributing transactions can damage its market reputation and impair its ability to compete. Similarly, a financial institution that distributes transactions which over time have significantly higher default or loss rates and performance issues may also see its reputation damaged.

Compliance

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure potential conflicts are avoided and laws and regulations are adhered to, an institution's independent compliance function should periodically review the institution's leveraged lending activity. This guidance is consistent with the principles of safety and soundness and other agency guidance related to commercial lending.

In particular, because leveraged transactions often involve a variety of types of debt and bank products, a financial institution should ensure that its policies incorporate safeguards to prevent violations of anti-tying regulations. Section 106(b) of the Bank Holding Company Act Amendments of 1970[13] prohibits certain forms of product tying by financial institutions and their affiliates. The intent behind Section 106(b) is to prevent financial institutions from using their market power over certain products to obtain an unfair competitive advantage in other products.

In addition, equity interests and certain debt instruments used in leveraged transactions may constitute "securities" for the purposes of federal securities laws. When securities are involved, an institution should ensure compliance with applicable securities laws, including disclosure and other regulatory requirements. An institution should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.

[13] 12 U.S.C. 1972.

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Finance Forum

December 1, 2016

Moderator: **David Burkholder**, Partner, Cadwalader, Wickersham & Taft LLP

Panelists: **Stefanos Arethas**, Head of Origination, Credit Suisse
Larry Brown, President, Starwood Mortgage Capital
Lainie Kaye, Managing Director, Deutsche Bank
Kara McShane, Managing Director & Head of Commercial Real Estate Capital Markets & Finance, Wells Fargo
Kunal Singh, Managing Director, Head of CMBS Capital Markets, JPMorgan

Credit Risk Retention for CMBS: Introduction

- On October 22, 2014, the federal regulatory agencies responsible for implementing regulations under Dodd-Frank finalized the risk retention rules (the "*Final Rules*") for ABS transactions, including CMBS transactions.
- The Final Rules come more than three years after risk retention rules were originally proposed, and more than a year after the rules were re-proposed. The Final Rules contain a few clarifications and revisions to the re-proposed rules, but for the most part the Final Rules are substantially the same as the re-proposed rules.
- The regulations will become effective on December 24, 2016 with respect to CMBS.

Introduction

Notable Revisions Made in Final Rules

- The controversial "projected cash flow rate test" feature of the re-proposed rules has been removed. This feature would have prevented the holder of a horizontal risk retention interest from receiving principal and interest at a rate that is faster than the rate at which the issued CMBS recover their principal.
- The B-piece buyer definition is expanded to include a "majority-owned affiliates," which opens up various structuring possibilities.
- Non-economic residual interests are excluded from the definition of "Asset Based Security" and therefore not included in any risk retention requirement.
- Maximum quorum that securitization documents can require for purposes of replacing the Special Servicer upon an operating advisor's recommendation was raised to 20% (proposal called for 5%), with such quorum requiring at least 3 investors that are not affiliated with each other. This provision makes it more difficult to replace the special servicer.
- The definition of Qualifying Commercial Real Estate Loan was modified to include (1) loans secured by a fee interest in a ground leased property, (2) floating rate loans that have the benefit of an interest rate cap and (3) loans with "level payments of principal and interest" as opposed to straight line amortization.

Notable Requested Revisions That Were Not Made

- No relief for single-borrower/single-asset securitizations.
- No relief granted to allow senior/sub structuring within the horizontal risk retention held by a B-piece buyer.
- No relief granted to allow for more than two *pari passu* B-piece buyers.
- No relief granted regarding disclosure of purchase price of B-piece.
- No relief granted regarding the use of subordinate or *pari passu* participation interests as an acceptable form of risk retention.

Party to Retain Risk

Sponsor

- 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.
  - "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.

Originator

- A sponsor is allowed to allocate a portion of its risk retention obligation to an originator (or a majority-owned affiliate of an originator) that contributes at least 20% of the underlying assets in the pool.
- Risk allocated to an originator must be at least 20% of the risk retention amount but cannot exceed the percentage, by unpaid principal balance, of securitized assets it originated.
- Originator will be subject to the same requirements for holding the risk retention amount as the sponsor and must hold its share of risk retention in the same manner (as between vertical and horizontal interests) as the sponsor.
- The sponsor remains obligated to monitor compliance by the originator with the risk retention requirements.
- The risk retained by an originator must relate to the entire pool of securitized assets, not just the assets originated by such originator.

Form and Amount of Risk Retention

B-Piece Buyer

- For CMBS transactions only, the Final Rules permit a third party purchaser to retain all or a portion of the risk retention if certain conditions are satisfied. See "CMBS B-Piece Buyer Retention" below.

- Unlike the proposed rules, the Final Rules also allow a majority-owned affiliate of a B-piece buyer to hold risk retention.

Majority-Owned Afiliate

- "Majority-owned affiliate" is an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

Forms of Risk Retention

There are generally two structures for retaining risk: vertical and horizontal:

- Vertical Risk Retention
  - An "eligible vertical interest," in which the sponsor is required to retain 5% of the face value of each class of securities issued in the transaction (excluding the REMIC residual)
- Horizontal Risk Retention
  - an "eligible horizontal interest," in which the sponsor is required to retain the most subordinate class or classes of securities issued in the CMBS transaction (excluding the REMIC residual) in an amount equal to 5% of the "fair value" of all of the CMBS issued (determined by using a "fair value" measurement framework under U.S. GAAP).

CMBS B-piece Buyer Retention

  - the horizontal residual interest may be comprised of multiple classes as long as they are the most subordinate classes in the capital stack.
  - The B-piece buyer option, described below, is a form of horizontal risk retention.

- *Horizontal Cash Reserve Account.* In lieu of holding all or any part of an eligible horizontal residual interest, a sponsor may 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.
- *Combination of Vertical and Horizontal.* A sponsor may satisfy its risk retention requirements by retaining a combination of vertical and horizontal retention if the fair value of the horizontal risk portion and the percentage of the vertical risk portion are at least equal to 5%.
- For CMBS transactions only, the Final 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 B-piece buyer retention option may be used 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.
- When combined with vertical risk retention, the vertical portion needs to run through the entire capital stack, including the classes that are also being held by the B-piece buyer.
- 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.
- The Rules allow a majority-owned affiliate of a B-piece buyer to hold the required risk retention.

CMBS B-piece Buyer Retention (cont'd)

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.

- A "commercial real estate loan" is defined as a loan that is secured by (i) a property with 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 from the property or (ii) a fee interest in land that is leased to a third-party that owns the improvements on such land, which must be non-residential or residential with five or more single family units.

- Excluded from the definition of "commercial real estate loan" is a (i) development and construction loans (including one-to-four family residential or commercial construction loans), (ii) any other land loans and (iii) any unsecured loans to a developer.

General Requirements for B-Piece Risk Retention:

- 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 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 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.

- No B-piece buyer may be affiliated with any party to the securitization transaction 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.

CMBS B-piece Buyer Retention (cont'd)

- 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;
  - when the horizontal residual interest is reduced to 25% or less of its initial principal balance (whether by payments, realized losses or appraisal reduction amounts), the special servicer is required to consult with the operating advisor in connection with material servicing decisions;
  - the operating advisor is responsible for reviewing the actions of the special servicer, reviewing the reports of the special servicer, reviewing the calculations made by the special servicer for accuracy and consistency with the transaction documents 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 has the right 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. The required quorum for such vote (i) may not exceed 20% of the outstanding principal balance of CMBS and (ii) must require at least 3 investors that are not affiliated with each other.

CMBS B-piece Buyer Retention (cont'd)

Disclosure. The Final 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;
- any other information regarding each B-piece buyer that is material to investors in light of the circumstances of the transaction;
- the fair value (expressed as a percentage of fair value and face 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.

Exception to Transfer Restriction. 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.

Responsibility for Compliance. The sponsor remains responsible for compliance by each B-piece buyer and each subsequent B-piece buyer with the risk retention rules.

- The sponsor is required to maintain and adhere to policies and procedures to monitor each B-piece buyer's compliance (although the rules do not specify what such policies and procedures should be).
- If the sponsor determines that a B-piece buyer no longer complies with the risk retention requirements it must notify investors in the related CMBS holders.

CMBS Backed by QCRE Loans

The risk retention requirements would not apply or would be reduced for an issuance of CMBS if all or a portion of the assets backing the transaction are qualifying commercial real estate (QCRE) loans.

- For pools that are comprised entirely of QCRE loans, the risk retention percentage would be zero.
- For pools that are partially comprised of QCRE loans, the risk retention percentage would be reduced, but not by more than 50%, by the ratio that the unpaid principal balance of the QCRE loans bear to the total unpaid principal balance of the loans that are included in the pool (i.e., risk retention cannot be less than 2.5% in a deal that has both QCRE loans and non-QCRE loans).

Requirements for QCRE Exemption/Reduction.

- *Commercial Mortgage Loans*. The securitization transaction has to be collateralized solely by a static pool of commercial mortgage loans (and related servicing assets);
- *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.

CMBS Backed by QCRE Loans (cont'd)

- *DSCR*. The originator must determine that, based on the previous years of actual performance, the borrower would have had, and based on two years of projections, the borrower will have, the following debt service coverage ratio:
  - a DSCR of 1.5 or greater, if the loan is a qualifying leased CRE loan (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; or
  - a DSCR of 1.7 or greater, if the loan is any other type of CRE loan (all hotel loans would fall into this category).

  Note: Properties without a minimum of two years of operating history cannot qualify as a QCRE.
- *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%.

    If the appraisal used a direct capitalization rate and that rate 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%.
- *Loan Terms*. A QCRE must have the following terms:
  - monthly payments;
  - level monthly payments of principal and interest that fully amortize the loan over a term that does not exceed 25 years, or 30 years in the case of a qualifying multifamily loan;
  - minimum term of ten years;

CMBS Backed by QCRE Loans (cont'd)

- no ability to defer principal or interest payments;
- no interest reserves;
- one of (i) a fixed rate of interest, (ii) a floating rate that is swapped into a fixed rate or (iii) a floating rate and the borrower has obtained an interest rate cap contract for the term of the loan.

Buy-Back Requirements

If a sponsor relied on the qualification of a CRE 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.

Additional Exemptions

- *Resecuritizations.* Resecuritization of ABS issued in a securitization transaction for which risk was retained under the Final Rules will be exempt from the risk retention requirements if it involves the issuance of only a single class of ABS interests.
- *Seasoned Loans.* Any securitization transaction that is collateralized solely by servicing assets, and by “seasoned loans” that (i) have not been modified since origination and (ii) have not been delinquent for 30 days or more.

Restrictions on Hedging, Transfer and Financing

Restrictions on Hedging, Transfer and Financing

- *Transfer.* The Final Rules prohibit a sponsor from transferring any risk retention interest that it is required to retain to any person other than a majority-owned affiliate.
- *Hedging.* Under the Final Rules, sponsors and their affiliates would be prohibited from hedging the credit risk of the CMBS interests it is required to retain.
  - Hedge positions that are not materially related to the credit risk of the retained CMBS interests are not prohibited by the Final Rules. Examples offered by the Agencies are:
    - hedges related to interest rates (but not spread risk), and
    - hedge related to currency exchange rates.
  - Hedges tied to securities that are backed by similar assets originated and secured by other sponsors also would not be prohibited.
  - The Final 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 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 (or any of its majority-owned affiliates) is 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 of all instruments included in the index.

Restrictions on Hedging, Transfer and Financing (cont'd)

Financing. The Final Rules 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.

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

- In the case of securitizations of assets other than residential mortgages, on or after the date that is the **latest** of:
  - 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 cut-off date;
  - 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 closing date; or
  - Two years after the date of the closing of the securitization transaction.
- A sponsor that retained a horizontal residual interest can transfer the interest after five years to a B-piece buyer.
- In addition, a B-piece buyer will not be restricted from hedging, transferring or financing its retained interest after all of loans in the pool have been defeased with cash or cash equivalents (which can include obligations backed by the full faith and credit of the United States).

Regulation AB II

- On August 27, 2014, the SEC adopted final rules relating to ABS, known as Regulation AB II.
- "Regulation AB II" is short hand. The final rules relate to registration and disclosure requirements. The final rules amend not just Regulation AB but other sections of the Securities Act and the Exchange Act as well.
- The final rules were adopted more than 4 years after the original proposal was made in early 2010.
- In response to questions presented by the SEC and comments submitted by industry participants, portions of the original proposal were subsequently re-proposed in 2011 for further comment.
- For the most part, the final rules implement the re-proposal, with a few notable exceptions.

Comparison to the Proposed Rules

- **<u>The SEC Did Not Adopt Certain Portions of the Proposed Rules</u>**
  - Issuers were not required to make available the same information in private offerings as is in registered offerings
    - ➢ The SEC stated that it may consider taking such action in the future, especially if there is evidence that ABS transactions are shifting into the private markets to avoid the final rules.
  - Issuers were not required to file a waterfall program reflecting the contractual cash flow of the ABS
    - ➢ In the 2011 re-proposal, the SEC stated that it would address this requirement separately.
  - Asset-level disclosure was brought into greater alignment with the CREFC Investor Reporting Package

Revisions to Registration and Offering Procedures

- <u>Overview of Changes</u>
  - New registration forms specifically tailored for ABS offerings
  - New eligibility requirements for shelf registration
  - Annual evaluation of shelf eligibility
  - New rules relating to preliminary prospectuses for ABS and new delivery and filing requirements

Revisions to Registration and Offering Procedures (cont'd)

- <u>New ABS-Specific Registration Forms</u>
  - New Form SF-1 for non-shelf offerings
  - New Form SF-3 for shelf offerings
    - ➢ Registrants are permitted to pay the registration fee for securities registered on Form SF-3 on a pay-as-you-go basis.
    - ➢ New eligibility requirements to use Form SF-3.
    - ➢ Unitary preliminary prospectus required.
      - ❑ No more base prospectus with accompanying prospectus supplement
- <u>New Eligibility Requirements for Form SF-3</u>
  - The final rules eliminated the investment grade requirement and replaced it with four new transaction requirements

    <u>1. CEO Certification</u>

    <u>2. Asset Review Provision</u>

    <u>3. Dispute Resolution Provision</u>

    <u>4. Investor Communication Provision</u>

  1. <u>CEO Certification</u>
     - ➢ I have reviewed the prospectus and am familiar with, in all material respects, the characteristics of the securitized assets, the securitization structure and all material underlying transaction agreements as described in the prospectus.
     - ➢ Based on my knowledge, the prospectus does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading.

Revisions to Registration and Offering Procedures (cont'd)

1. <u>CEO Certification (cont'd)</u>
   - Based on my knowledge, the prospectus and the registration statement fairly present the characteristics of the securitized assets, the structure of the securitization and the risks of ownership of the securities.
   - Based on my knowledge, taking into account the characteristics of the securitized assets, the securitization structure, and the risk relating to the assets that would affect the cash flows, there is a reasonable basis to conclude that the securitization is structured to produce, but is not guaranteed to produce, expected cash flows at times and in amounts to service scheduled payments of interest and the ultimate repayment of principal on the securities in accordance with their terms as described in the prospectus.
   - The foregoing certifications are given subject to any and all defenses available to me under the federal securities laws.
2. <u>Asset Review Provision</u>
   - The underlying transaction documents must provide for the selection and appointment of an "asset representations reviewer" ("ARR").
   - The ARR cannot be affiliated with any sponsor, depositor, servicer or trustee, or any of their affiliates.
   - The ARR cannot be the same party or an affiliate of any party that performs pre-offering due diligence for the sponsor or the underwriters.
   - The review would be triggered by the satisfaction of a two-prong test consisting of: (1) exceeding a delinquency threshold specified in the underlying transaction documents, followed by (2) an investor vote to direct the review, based on the procedure specified in the underlying transaction documents, requiring (x) not more than a 5% quorum for the investor vote, and (y) a simple majority of investors casting a vote to direct a review.

Revisions to Registration and Offering Procedures (cont'd)

2. Asset Review Provision (cont'd)
   - The ARR must, at a minimum, review all 60+ delinquent assets for compliance with representations and warranties.
   - The ARR's findings and conclusions are submitted to another party for follow-up and enforcement.
   - Form 10-D requires filing of disclosure of a review-triggering event and a summary of the ARR's findings and conclusions.
3. Dispute Resolution Provision
   - For asset repurchase demands that are not resolved within 180 days, the transaction documents must permit the party requesting repurchase to refer the dispute to either mediation or arbitration.
   - If arbitration is chosen, the arbitrator will determine the allocation of the costs and expenses of the dispute resolution. If mediation is chosen, the parties will determine expenses allocation as part of the mediation.
4. Investor Communication Provision
   - The underlying transaction documents must allow investor communication requests to be included in Form 10-D.
   - The substance of the matter that the requesting investor wishes to discuss is not required to be disclosed.
   - The underlying transaction documents may not require verification of ownership by a record holder, but may provide that the party obligated to file the Form 10-D may require a person who is not a record holder to provide a written certification of beneficial ownership together with one other form of documentation of ownership.

Revisions to Registration and Offering Procedures (cont'd)

- New Registrant Requirement
  - Depositor must timely file all CEO certifications and transaction documents containing the required independent asset review, dispute resolution and investor communication provisions (the "New Shelf Eligibility Filings")
- Annual Shelf Eligibility Evaluation
  - The new rules require the depositor to annually assess whether all Exchange Act filings and all New Shelf Eligibility Filings are timely made in the 12 months preceding the 90th day after the end of its fiscal year.
    - ➢ Depositor's failure of any required timely filing during the 12-month period means depositor is ineligible to offer securities on a shelf basis for 12 months, unless such failure was with respect to a New Shelf Eligibility Filing and was cured 90 days after the filing is made.
- New Rule 430D and Rule 424(h): Preliminary Prospectus Required
  - These new rules are exclusive to ABS transactions.
  - In an offering using a shelf registration statement on Form SF-3, the issuer must file a complete single preliminary prospectus under new Rule 424(h), with all required information in the final prospectus other than pricing-related information (offering price, offering syndicate, underwriting and deal discounts, amount of proceeds, etc.).
  - Preliminary prospectus must be filed at least three business days before the first sale in the offering, or the second business day after first use, if used earlier.
  - Any material change requires the filing of a prospectus supplement at least 48 hours before the first sale in the offering.

Enhanced Disclosure Requirements for ABS

- **<u>Disclosure of Asset-Level Information</u>**
  - The final rules require asset-level disclosure both at time of offering and in ongoing reporting on Form 10-D.
  - Asset data required includes general fields, applicable to all ABS, and asset-specific fields.
  - Specific data requirements are included in the new Schedule AL (new Item 1125 of Regulation AB).
  - General data disclosure requirements include:
    - ➢ Asset-level data must be in machine-readable XML language.
    - ➢ Data to be filed on new Form ABS-EE through EDGAR and incorporated by reference into Form SF-1, Form SF-3 or Form 10-D.
    - ➢ All fields must be disclosed—no issuer discretion for materiality.
  - CMBS disclosure:
    - ➢ Based on CREFC Investor Reporting Package.
    - ➢ Examples of new CMBS-specific data fields are: the identities of three (3) largest tenants and lease expirations, most recent appraisals or valuations, and source and date of such valuations.

Enhanced Disclosure Requirements for ABS (cont'd)

- **Other Changes to Disclosure Requirements**
  - Identification of each originator of pool assets if the total amount of assets originated by parties other than the sponsor or its affiliates exceeds 10% of the pool.
  - Disclosure of any interest retained in the transaction by the sponsor, any servicer or any originator of 20% or more of the asset pool.
  - Financial information about the sponsor or other originator if they are obligated to repurchase or replace assets for breach of a representation and warranty, and if there is a material risk that their nonperformance will materially impact the pool.
  - Information regarding the ARR.
  - Explanation as to why static pool information is not material.
- **Other Changes to Exchange Act Reporting**
  - Form 10-Ds will also include the following information:
    - Requests for investor communications, information regarding the ARR reviews and information regarding any change of the ARR.
    - Delinquency and loss information in distribution reports.
    - Material changes in the sponsor's or an affiliate's interest in the transaction.
  - Form 10-Ks must include servicer assessments of compliance with servicing criteria that identify whether material noncompliance affects the specific transaction and discuss steps taken to remedy the issue.

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Capital Rules: Practical Impacts on Financing to Investment Funds

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Capital Rules: Practical Impacts on Financing to Investment Funds

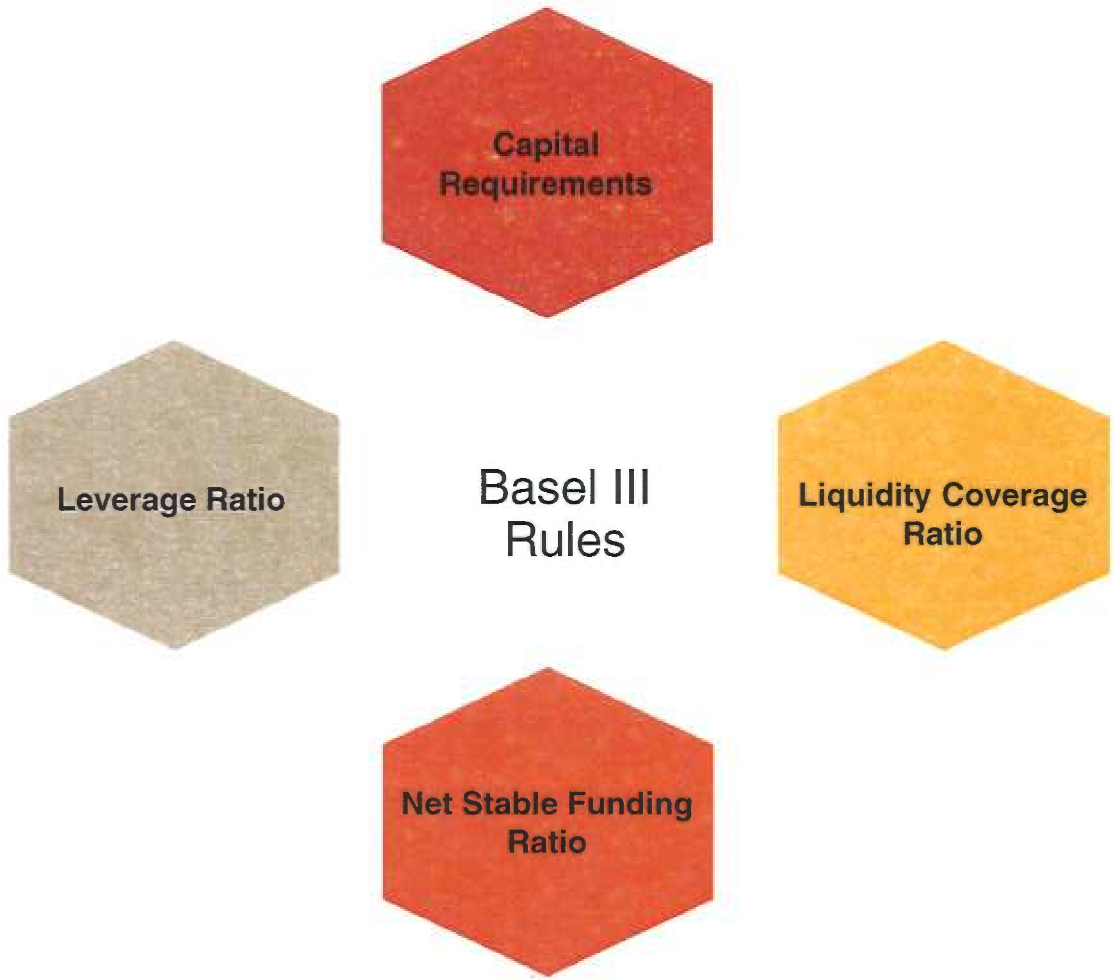
Finance Forum

December 1, 2016

Moderator: **Brian Foster**, Partner, Cadwalader, Wickersham & Taft LLP

Panelists: **Chris Burke**, Director, Barclays
Brandon Clar, Vice President, Counsel, Two Sigma Investments
Nathan Lebioda, Capital Markets Counsel, Wells Fargo

Key Basel III Rules



Additional Relevant Restrictions

- Stress Tests
- Supervisory Limits
- Volcker Rule
- Structural Reforms (ring-fencing, intermediate holding companies)
- Resolution regimes (bail-in, moratorium, automatic stay, TLAC)
- Central Clearing
- Margin Requirements

Impact on Finance Providers

- Allocation of Resources to Most Profitable Clients
- Focus on RWA
- Emphasis on Return on Equity/Return on Balance Sheet
- Importance of Classification of Counterparties/Borrowers
- Need for Netting Opinions
- Increased Compliance Costs
- Higher Funding Costs
- Competition from Alternative Lenders

Impact on Investment Funds

- Reversal of Post-Lehman Diversification
- Optimization of Balances to Fit Lender/Prime Broker Metrics
- Attention to Total Wallet Share
- Loss of Dry Powder
- More Frequent Repricing
- Termination Provisions Linked to Borrower Credit Events
- Increased Costs for Sec Lending/Repo Transactions
- Use of Alternative Lenders

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Subscription Finance Market Update

Fund Finance Insight

November 2016

The Impact of EU Bail-In Provisions on Fund Finance Transactions

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Fund Finance Insight | November 2016

The Impact of EU Bail-In Provisions on Fund Finance Transactions

Welcome to the first issue of Cadwalader's *Fund Finance Insight*, which aims to provide an in-depth analysis of important developments affecting the fund finance market in the US and Europe.

Our first issue covers the impact of EU Bail-In provisions on fund finance transactions. We hope you find *Fund Finance Insight* useful and we would welcome any feedback.

Contents

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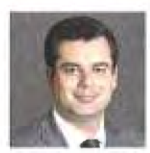

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Section 1: The Context

- Following the Financial Crisis in 2008 and the fallout from that crisis, it became apparent that existing available procedures (based largely on various insolvency-related measures applicable in The European Union ("EU") / European Economic Area ("EEA") member states) for failing or failed EU/EEA Credit Institutions and Investment Firms whose failure could have a systemic impact on the wider financial system were it not adequate either to prevent the insolvency of such institutions or, when insolvency occurred, to minimize negative repercussions by preserving the systemically important functions of the institutions concerned, and that, as a result, a number of those institutions had to be preserved or saved using taxpayers' money.
- In particular, existing insolvency regimes (i) differ and are differently applied across each EU/EEA member state; (ii) could not be applied speedily enough or early enough; (iii) do not ensure the continuation of the critical functions of institutions; and (iv) do not ensure that financial stability is preserved.
- Mechanisms additional to and outside the existing insolvency regimes were therefore required (i) to ensure continuity of a failing institution of its critical financial and economic functions and (ii) to minimize the impact of any such failure on the economy and broader financial system.
- EU-wide Bail-In tools for European Credit Institutions and Investment Firms were introduced into Europe (along with a number of other measures) by the EU Banking Regulation Recoveries Directive 2014/59/EU ("the Directive"). A number of the contents of the Directive had already been introduced into national legislation independently by a number of individual EU and EEA states prior to the entry into force of the Directive, but others, including Bail-In, have been extended or are new.
- The Directive has now been transposed into national law by all 28 EU Member States (in the UK effective January 2015 with the Article 55 requirements – see below – taking effect on January 1, 2016 with implementation of "impracticability" exceptions effected on August 1, 2016) and will likely be adopted shortly into the laws of the EEA states which are not EU states (Norway, Liechtenstein and Luxembourg).
- The Directive is designed to enhance (and harmonize) many of these mechanisms across all EU/EEA member states. The Bail-In tool is only one of the mechanisms introduced, but is the most directly relevant for counterparty creditors of a relevant institution.

Section 2: The Bail-In Provisions

- Bail-In impacts all agreements to which the relevant institution is a party which "create a liability" on that institution, so in the Fund Finance context this would include unsecured liabilities as a Creditor/Lender in Credit and Security Agreements and Swap and other "treasury" type instruments and as an Investor in Partnership Agreements, Subscription Agreements, Side Letters and other related "Fund" agreements (e.g., Co-Investment Agreements).
- The Bail-In tools can be applied by the relevant national regulator to a relevant institution that is "failing or likely to fail" and where other remedies are not available or will not be effective.
- The Directive (in many, but not all, cases by supplementing pre-existing national legislation) effectively implements

Section 2: The Bail-In Provisions (continued)

a "pre insolvency" set of potential actions which can be applied to restructure any or all of the operations, assets, structure or liabilities of a relevant institution. Any implementation of some or all of those steps in respect of a relevant institution which is (among other things) either a Lender or other Finance Party under Facility Arrangements, a Counterparty under a Swap arrangement or an Investor / Limited Partner in a Fund could operate to significantly affect the ability of that relevant institution to continue to fulfil its obligations under those Facility or Treasury Arrangements or under the relevant Partnership Documents.

- With limited exceptions, Bail-In tools can be applied to all liabilities of a relevant institution, but there is a "waterfall" contained in the legislation which requires bail-in of Tier 1 and Tier 2 and non-regulatory capital to be effected first before bail-in of other liabilities under other agreements (referred to as "eligible liabilities" such as those under Credit or Fund Agreements).
- Where a contract or agreement to which a relevant institution is a party is governed by the laws of an EU/ EEA member state, the Bail-In provisions are incorporated into that contract or agreement automatically. Where the contract or agreement is governed by non EU law (e.g., US law and potentially if the UK went for a "hard Brexit" UK law), specific Bail-In provisions have to be incorporated into that contract or agreement under Article 55 of the Directive. A number of industry bodies (including the LMA, ISDA, AFME and the LSTA) have prepared sample wording / provisions to be included to cover this in Finance documentation.
- Where the Bail-In provisions are required to be written into a contract under Article 55, it is a matter of the relevant applicable law of the contract whether and to what extent these provisions will be enforceable.
- The provisions have to be incorporated not only into "new" agreements, but also into "material amendments" to existing agreements made since the provisions came into effect.
- Failure by a relevant institution to include the relevant wording where required can lead to penalties on that institution in the form of fines and restrictions on licensing / authorizations of that institution.
- In the UK, the Prudential Regulatory Authority has settled on some exceptions to the above requirement where the inclusion of the wording would be "impractical". It is anticipated that the test of what is "impractical" will be based on legal or quasi legal constraints, not simply on "convenience" or commercial practicality.
- The Bail-In tools must be applied within certain guidelines, the most relevant of which are (i) shareholders bear losses first and creditors second; and (ii) creditor losses should be no greater than they would have been if the relevant institution had been subject to insolvency proceedings.
- While there has been a significant focus by industry bodies on the practical application and implementation of the requirement of Article 55 into Credit and Facility documentation, there has been much less formal consideration of its application in other agreements under which relevant implications might incur liability (including Fund and Fund related documentation).

Section 3: Recommended Actions

- Review any Facility, Swap or Fund Documentation entered into on or after January 1, 2016 (or any material amendment or accession to that documentation entered into after that date) to determine whether any party to that document is or might be a "relevant institution" for the purpose of the Directive.
- To the extent that any such party is subject to liabilities under that documentation, then consider the inclusion in the documentation of sufficient provisions (in particular representations, undertakings and events of default or termination or close-out events, as applicable, in Facility Agreements or Swap Agreements and relevant "Default", "Exclusion" and "Transfer" provisions in an LPA or Subscription Agreement) sufficient to cover such relevant institution's inclusion in the Directive.
- Note that in any Facility Agreement or Treasury Agreement a number of the items covered by the Directive and a number of the "tools" which may be employed will or should be covered by existing representations, undertakings, events of default or termination events or close-out (for example asset transfers or changes in ownership imposed by the Directive), and that the same will be true to some extent for an LPA. However, others may not be, and it is unlikely (unless the document has been drafted and executed on or after January 1, 2016) that drafting specific to the Bail-In Provisions section of the Directive (which are "new") will have been included.
- Where any relevant agreement (Facility Agreement, Swap Agreement, Fund Document (including LPA or Subscription Agreement) or any accession or material amendment to any such document) is governed by the laws of a "third country" (i.e., non EU / EEA) and a relevant institution is or may become a party to it, then consider whether either (i) in the case of a Facility Agreement or Treasury Agreement entered into after the introduction of Article 55 (in the UK 1 January 2016), the recommended LMA or ISDA or, if applicable, AFME or LSTA bail-in language is included, and in the case of any Fund Document, including the LPA or Subscription Agreement, whether similar or equivalent language should be included so as to give effect to the provisions of Article 55; or (ii) consider whether the relevant institution may be able to take advantage of any exception – e.g., the "impracticality" exception – to the requirements.
- Ensure that, if necessary and if required under the Directive, any relevant agreement to which Article 55 applies is one in respect of which legal opinions can be given specifically on the enforceability and effectiveness of the contractual bail-in language referred to above. Note that in a Facility or Treasury context this may well be covered in any event by the standard requirements for the provision of legal opinions in such documentation, but that in the context of a Fund LPA or related Subscription Agreement the provision of such a legal opinion may be less of a "normal" or "standard" requirement.

Our Fund Finance Practice

Cadwalader has developed a market leading international team of fund finance lawyers with client relationships that stretch across the global fund finance spectrum.

We advise a broad range of financial entities as both lenders and borrowers, including banks, private equity funds, hedge funds, real estate funds, infrastructure funds, funds-of-funds, investment advisers and public investment companies such as mutual funds, business development companies, closed-end investment companies and UCITS. With lawyers based in the United States and UK, we offer clients unrivalled cross-border capabilities, providing insightful and comprehensive legal analysis and advice, efficient transaction execution and unmatched market knowledge.

A broad practice

Our practice covers a diverse set of international financing structures and transactions, including:

- Capital Call, NAV and Hybrid facilities
- Management fee facilities
- Term financing arrangements such as:
  - prime brokerage
  - securities lending
  - repurchase structures
- Subscription revolving credit lines secured by capital call rights
- Management fee rights
- Leveraged derivative arrangements such as:
  - total return swaps
  - barrier options
  - forward transactions
- Hedge fund and private equity fund interests
- Real estate investments
- All forms of equity, debt and commodity investments

We have assisted more than

36 banks

as lead or syndicate lender during the past two years.

We have represented the lead arrangers and served as lead counsel on many of the **largest and most sophisticated fund credit facilities** ever completed.

In the last two years, we have advised on transactions totalling in excess of

USD 26 billion.

For more information about our fund finance practice, please click here.

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The International Comparative Legal Guide to:

Lending & Secured Finance 2016

4th Edition

A practical cross-border insight into lending and secured finance

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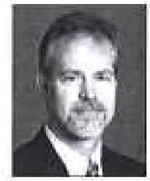
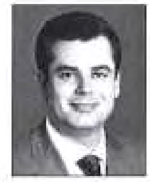
Country Question and Answer Chapters:

The Global Subscription Credit Facility and Fund Finance Markets – Key Trends and Forecasting 2016

Michael C. Mascia





Wesley A. Misson

Cadwalader, Wickersham & Taft LLP

Introduction

Despite numerous headwinds, the Subscription Credit Facility (each, a "Facility") and related Fund Finance markets continued their outpaced growth in 2015, building upon and continuing a market trend in place since at least 2010. Similarly, Facility credit performance remained pristine, and no loan losses or write-downs from last year have become public. This chapter summarizes the key trends in the Facility and Fund Finance markets in 2015 and forecasts developments for the coming year.

Credit Performance

To our knowledge, there were no payment events of default in the Facility or related Fund Finance markets in 2015. None of the Lenders from the 50+ banking institutions in attendance at the 6th Annual Global Fund Finance Symposium hosted by the Fund Finance Association on March 2, 2016 in New York (the "2016 Global Conference") reported a loss or payment event of default last year. Similar to 2014, we were not consulted on any funding delinquencies by limited partners ("Investors") on their capital calls ("Capital Calls"), other than a few by high net worth and family office Investors ("HNW Investors") that were subsequently remedied. While this positive credit performance has to a large extent become a baseline expectation in the Facility market, it does bear noting that this perfect credit performance extended to our hybrid and asset-level facilities last year, which are underwritten at significantly higher risk profiles. Interestingly, however, we have seen a significant rise in technical defaults caused by covenant breaches, predominantly around borrower reporting obligations. While we think this trend is simply a function of portfolio growth and the increase of newer private equity funds (each, a "Fund") borrowing their first Facility, it bears watching. Several active Lenders in the market are adding post-closing Fund training sessions with the aim to reduce these occurrences.

Resilient Growth

The year 2015 included a number of macro challenges to the Facility Market: drastic reductions in oil and commodity prices; significant disruptions and volatility in the public equity markets; a reported 24% drop in the total number of Funds closed in 2015 compared to 2014; and a growing Investor preference for separately managed accounts ("SMAs"), which are more challenging to lend to than traditional commingled fund vehicles.[1] Yet, despite these challenges, the Facility market marched onward, with many of the major lending participants ("Lenders") reporting portfolio growth in the 10% to 30% range for 2015. This growth was driven by the same factors that have been driving the market for some time. There are still Funds being introduced to the Facility product, and market penetration has been and remains a primary growth driver, especially in the middle market buyout space. Further, many Lenders have been upwardly adjusting their maximum hold positions, leading to larger availability for the larger Funds currently being formed. Similarly, Lenders have developed concepts to lend against the uncalled capital commitments of Investors that have historically been excluded from Facility borrowing bases ("Borrowing Bases"). These structural evolutions have extended Borrowing Base availability later into Fund life cycles, further extending the market. Finally, asset-based lending to fund-of-funds and secondary Funds secured only or primarily by their underlying fund interest investments has increased considerably. The fund-of-funds and secondaries sub-market is rapidly maturing to near consistent structures. This growth, combined with the huge fundraising success of secondary Funds in 2014, created extensive leverage financing activity in 2015 as well.

Structural Evolution

Partnership Agreements. Facility structural evolution was more muted in 2015 compared to prior years. The increasing concentration of Funds with the top-tier Fund formation law firms has been a significant positive for the Facility market, as these firms are intimately familiar with lending requirements and tend to produce bankable Fund limited partnership agreements from the outset. This positive trend on the collateral side of Facility structure has somewhat reduced the prevalence of asset-level mitigants, such as net asset value covenants, periodic clean downs and covenants to call capital.

Hurdle Requirements. One structural evolution that appears to be gaining traction across the market is "Hurdle Requirements" for including certain Investors in a Borrowing Base. Despite potential enforcement issues for certain sovereign wealth Fund, Texas and other historically challenging Investors, Lenders are more frequently gaining comfort including such Investors with solid credit profiles where the Fund is managed by a top-tier sponsor and the Investor pool is diverse.[2] The concept, often referring to such Investors as "Hurdle Investors", generally requires the Investor to have net funded at least 50% of its capital commitment before being eligible for inclusion in the Borrowing Base. Although this approach does not solve potential legal enforcement issues, Lenders gain comfort via the funded Capital Calls that the Investor's substantial skin in the game strongly incentivizes its further Capital Call funding.

Shadow Borrowing Bases. Another interesting trend is that of "Shadow Borrowing Bases". Many of the regional banks in the United

States have done an exceptional job of lending to smaller Funds over the years, but the sponsor's new Funds require Facilities larger than the regional bank wishes to deliver bilaterally. The Fund sponsor, valuing the relationship and frequently the perceived simplicity of a coverage ratio-style Borrowing Base afforded by these regional banks, awards them the mandate, tasking them with syndicating material Lender loan commitments. The traditional "subscription" Facility style Lenders, in order to participate, underwrite the Investor pool according to their more traditional included Investor/designated Investor/concentration limit formula, but do it on a shadow basis not conscripted in the credit documentation. In a static pool, this would of course be simplistic. But it does create interesting issues and approval standards with respect to new Investor closings and Investor transfers.

HNW Investor Facilities. During the past two years, we have experienced a notable uptick in the establishment of Facilities for Funds comprised mostly or exclusively of HNW Investors. This trend has emerged not only for middle-market sponsors but also for some of the largest sponsors in the market today. While traditionally challenging for Lenders to include HNW Investors in a Borrowing Base, certain Lenders are now viewing the diversity and granularity of the Investor pool in many cases to be a credit positive. For Funds where the HNW Investors invest indirectly through managed platforms of brand name wealth management institutions, comfort with the managed platform and some level of negotiated look-through rights or bespoke exclusion events related to the platform are often present. Many such Facilities remain bilateral and are generally smaller ($150 million or less) in size. However, we have recently seen some relative "giants" in terms of Facility size, where two or more Lenders have been required to participate. While we expect the overall impact of HNW Facilities to remain small in 2016, we forecast this as an area of continued growth.

Fund Performance

Fund performance in 2015 continued to be a factor driving overall Facility growth. Happy Investors are certainly expected to fund Capital Calls and seek to invest additional capital into new Funds. The most telling trend is that Investors are reaping the benefit of hefty distributions at record rates. The year 2015 marked the fifth consecutive year that Investors received more from Fund distributions than they funded via Capital Calls.[3] The net cash flows to Investors over that five-year period have exceeded $300 billion – equal to more than one-and-a-half years' worth of fund raising during that same period.[4] In fact, according to data presented by Preqin at the 2016 Global Conference, 94% of all Investors today have a positive view of Fund investment.

Legal Updates

Case Law Update. Other than the infrequent dust up that has occurred between an Investor and a general partner,[5] we are not aware of any substantial new case law relevant to Facilities in 2015. In fact, the often-cited *In re LJM2 Co-Investment, L.P.* and *Iridium* cases remain good law in Delaware and stand for the proposition that capital commitment funding obligations are enforceable for debt repayment in spite of a Fund bankruptcy or bad faith modification of Investor funding obligations.[6]

Making Bail-In. In January of 2016, new European "bail-in" rules became law and the ripple effect is making its way into Facility documentation, both in the U.S. and in Europe. Affected financial institutions, including European banks, under the new rules are subject to "bail-in" where certain of their unsecured liabilities could be subject to cancellation, write-downs, or conversion into equity in order to recapitalize the affected institution. Credit agreement language will require other Lenders and the borrowers to acknowledge and accept the potential application of the bail-in legislation.[7] Since banks are infrequent Investors in Fund borrowers today given the current regulatory regime, including the Volcker Rule,[8] we do not anticipate that the new "bail-in" rules will have a significant impact on collateral or the credit outlook for Facilities.

2016 Market Forecast

While we do expect the rate of Facility growth to slow in 2016 as compared to the previous three or four years, we continue to forecast growth in Lender portfolios in the 10% range year-over-year. There are simply too many factors supporting continued growth that outweigh a more pessimistic view. The number of Funds in the market is at an all-time high at 2,651.[9] The record levels of cash distributions made to Investors since 2013 will require them to re-up with Funds at meaningful levels to come close to maintaining their asset allocations, and as a result we are hard pressed to forecast a meaningful decline in 2016 Fund formation. If these Funds come anywhere close to their projected aggregate target for 2016 fundraising of $946 billion,[10] then 2016 could prove to be very solid from a fundraising perspective. But even assuming the recent macro level economic uncertainties materially slow fundraising, we think the Facility market will still show somewhat uncorrelated growth. There is a reported $1.34 trillion in dry powder available at the start of 2016, which is up from the $1.2 trillion level last year and marks the third consecutive annual increase since 2012.[11] Assuming a Facility market size of $300 billion in Lender commitments (our reasoned but unsubstantiated estimate), this still only yields a global advance rate of approximately 23%. Most Lenders have an average blended advance rate of closer to 30% across their portfolios, which suggests there is still ample room for Facility growth via penetration into new Funds. When you combine this likelihood of market expansion with Lenders getting increasingly comfortable lending to SMAs, lending to all HNW Investor Funds, extending Borrowing Bases and lending against Fund net asset value or investment assets, we think 2016 will continue its growth trend. Thus, market growth, while materially more modest than the eye-popping numbers sustained the last few years, should approach double digits once again in 2016.

Conclusion

Despite uncertainties in the macro landscape, the Facility market appears poised for another solid year in terms of portfolio growth in 2016. While Facility structures have been trending moderately in favor of Fund borrowers, we continue to believe that the credit profile of market-structured Facility transactions forecasts well for Facility performance in the coming year and we do not forecast any systematic or widespread default or loss occurrences.

Endnotes

1. *See*, 2016 Preqin Global Private Equity & Venture Capital Report ("2016 Preqin Report"), p. 19. Note: Preqin cautions that data as of the 2016 Preqin Report publish date was preliminary and this percentage is likely to decrease when final reporting has been completed.
2. We note that Texas state Investors are the most common subject of this trend as local law may not provide a complete waiver of contractual immunity.
3. $475 billion was returned to Investors in 2015 alone according to data presented by Preqin at the 2016 Global Conference.

4. *See*, 2016 Preqin Report, p. 43.
5. *See*, *Wibbert Investment Co. v. New Silk Route PE Asia Fund LP et al.*, case number 650437/2013, in the Supreme Court of the State of New York, County of New York. Wibbert sought to avoid making a Capital Call seven times alleging fraud on the part of New Silk, but, according to the last publicly available reports, ultimately funded its capital commitment in order to preserve its status as a limited partner in the Fund.
6. *See*, *In re LJM2 Co.-Investment, L.P.*, 866A. 2d 762 (Del. Super. Ct. 2004) and *Chase Manhattan Bank v. Iridium*, 307 F.Supp 2d 608, 612-13 (D. Del. 2004); local counsel should be consulted for non-Delaware jurisdictions, which often have similar case law: *see Advantage Capital v. Adair* [02 Jun 2010] (QBD) Claim no. HQ10X01837 (Order for breach of contract granted in favor of private equity fund that sued a limited partner for repudiation under English law).
7. Each of the LSTA and LMA have published form language for syndicated credit agreements regarding European "bail-in" acknowledgment.
8. The aggregate level of bank Investor commitments has reduced by an aggregate of nearly 56% since 2011 according to numbers presented by Preqin at the 2016 Global Conference.
9. *See*, Preqin 2015 Fundraising Update ("Preqin 2015 Update"), p. 2.
10. *See*, Preqin 2015 Update, p. 2.
11. *See*, 2016 Preqin Report, p. 13.

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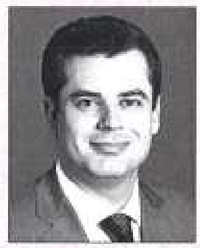
Mike Mascia is a partner in Cadwalader, Wickersham & Taft's Capital Markets Group. He has extensive experience representing a variety of lenders across a range of secured lending transactions, with particular emphasis on the financing of investment funds and financial institutions. He has a globally recognised practice in the subscription credit facility space, having represented both balance sheet and commercial paper conduit lenders in facilities to real estate and private equity funds sponsored by many of the world's preeminent fund sponsors.

Mike has represented the lead arrangers in many of the largest subscription credit facilities ever consummated. He has been lead counsel on numerous hybrid facilities, and is one of the few attorneys in the United States with experience in both subscription credit facilities and CLOs. Mike represents lenders on leverage facilities to secondary funds and other credits looking primarily to fund assets for repayment. Many of his transactions are cross-border in nature, and he is well-versed in the nuances of multi-jurisdictional transactions.

Mike is the founder of the annual Subscription Credit Facility and Fund Finance Symposium and is a founding member and the Secretary of the Fund Finance Association. Mike is recognized as a Leading Lawyer in the area of Banking and Finance in the *International Financial Law Review*'s IFLR1000 Legal Directory in 2015.



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Wes Misson is a partner in Cadwalader, Wickersham & Taft's Capital Markets Group. Wes's practice focuses on fund finance and he has represented financial institutions as lenders and lead agents in hundreds of subscription credit facilities and other fund financings, with his experience encompassing both subscription and hybrid facilities. Wes also works with fund-related borrowers on the negotiation of third-party investor documents with institutional, high net worth and sovereign wealth investors.

Wes has served as lead counsel on many of the largest and most sophisticated fund financings ever consummated, notably having assisted more than 35 banks as lead or syndicate lender during the past two years with transaction values totalling in excess of $25 billion. Many of the transactions he advises on are precedent setting, carrying unique structures and complex international components – whether that be foreign limited partners or funds, multi-currency advances or foreign asset investment.

Wes has been recognized as a "Rising Star" in the US in the area of Banking and Finance in the *International Financial Law Review*'s IFLR1000 Legal Directory, and is also a frequent speaker and an accomplished author in the area of fund finance. He has worked extensively with financial institutions to develop form agreements for fund finance transactions, many of which are the dominant forms used in the market today, and to educate bankers, internal legal counsel and credit officers on hot issues and trends affecting the fund finance market.

CADWALADER

Cadwalader, Wickersham & Taft LLP, founded in downtown New York in 1792, is proud of more than 200 years of service to many of the world's most prestigious financial institutions and corporations. With more than 450 attorneys practicing in New York, London, Charlotte, Washington, Houston, Beijing, Hong Kong and Brussels, we offer clients innovative solutions to legal and financial issues in a wide range of areas. As a longstanding leader in the securitization and structured finance markets, the Cadwalader team features lawyers with a broad range of experience in corporate, securities, tax, ERISA, bankruptcy, real estate and contract law. Consistently recognized by independent commentators and in the league table rankings, our attorneys provide clients unparalleled insight regarding fund finance, asset-backed and mortgage-backed securitization, derivatives, securitized and structured products, collateralized loan obligations, synthetic securities, swap and repo receivables, redundant insurance reserves, and other financial assets.

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AML, OFAC and Cyber Regulatory Developments

Finance Forum

December 1, 2016

Panelists: **Jodi Avergun**, Partner, Cadwalader, Wickersham & Taft LLP
John Curran, Executive Managing Director, Stroz Friedberg, an Aon company
Maureen Dollinger, Vice President, Barclays

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Anti-Money Laundering Update

J

Anti-Money Laundering (AML) / Counter-Terrorist Financing (CTF)

Bank Secrecy Act (BSA) (1970)

- Requires US financial institutions to assist in the detection and prevention of money laundering
- Violations of the BSA can result in civil or criminal penalties

USA PATRIOT Act (2001)

- Enacted in 2001 shortly after the September 11 attacks
- Significant enhancements to US statutory AML/CTF framework
  - Expanded AML program requirements
  - Requires special due diligence for certain correspondent and private banking accounts
  - Prohibition on US correspondent accounts with foreign shell banks
  - Improved cooperation and information sharing among FIs and law enforcement

Key Provisions of USA PATRIOT Act

§ 352: AML Program built around Four Pillars

- Development of internal policies, procedures and controls
- Designation of a compliance officer ("BSA Officer")
- Employee training program
- Independent audit function to test program
- "Fifth Pillar" - Identification and verification of beneficial owners of legal entity customers ("CDD Rule")

§ 326: Customer Identification Program

§ 313 / § 319: Prohibition on Accounts with Foreign Shell Banks/Foreign Bank Correspondent Account Ownership Information and Designation of Agent for Service of Process

Key Provisions of USA PATRIOT Act (cont'd)

§ 311: "Special Measures" for Jurisdictions, Financial Institutions, or International Transactions "of Money Laundering Concern"

- Restrict activities of US persons relating to jurisdictions, entities, or individuals who pose heightened AML risk

§ 312: "Special Due Diligence for Correspondent Accounts and Private Banking Accounts

- Heightened "Know Your Customer" standards for certain types of banking relationships involving non-US individuals or entities

§ 356: Suspicious Activity Reporting

§ 314 Information Sharing Provisions

- Section 314(a) – Information sharing with law enforcement
- Section 314(b) – Voluntary information sharing with other financial

Customer Due Diligence ("CDD") Rule

FinCEN issued final rules in July 2016

Covered Financial Institutions must comply with the rules by May 11, 2018

Major Changes

- Beneficial Ownership
  - Must identify and verify the identity of all beneficial owners of all legal entity customers
- AML Program must include risk-based procedures for conducting ongoing customer due diligence and, on a risk basis, maintaining and updating customer information

CDD - Final Rule

Final Rule sets out the four core elements of CDD

- Customer identification and verification
- Beneficial ownership and verification
- Understanding the nature and purpose of customer relationships to develop a customer risk profile
- Ongoing monitoring for reporting suspicious transactions

NYS Department of Financial Services Rule 504

DFS issued Rule 504 in June 2016

Rule takes effect on January 1, 2017

Requirements:

- Transaction Monitoring
- Watch List Filtering Program
- Annual Certification

NYS Department of Financial Services Rule 504

Transaction Monitoring Program

- Must be based on risk assessment
- Reviewed and updated at risk-based intervals
- Match risks to business/products/services/customers
- Detection scenarios
- Testing
- Documentation on underlying parameters/thresholds of detection
- Protocols for investigating alerts
- Ongoing analysis of detection scenarios

Watch List Filtering Program

- Based on risk assessment
- Be based on technology, processes or tools to match names and accounts
- Testing
- Ongoing analysis

NYS Department of Financial Services Rule 504

"Data Requirements"

- Identification of data sources that contain "relevant data"
- Validation of data
- Processes to ensure complete and accurate transfer of data between systems
- Governance and management oversight
- Adequate funding
- Qualified personnel and periodic training

Annual Certification

- The institutions must annually certify compliance with the DFS regulation beginning on April 15, 2018 by either
  - an annual board resolution
  - senior officer compliance finding
- The proposed rule contained criminal liability, but this was removed.

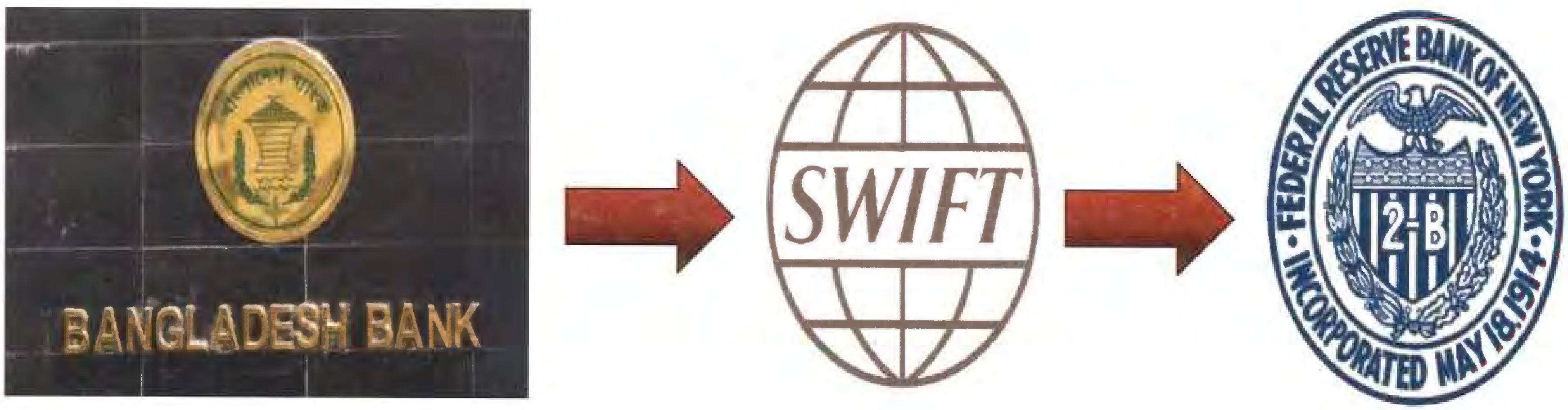
The Convergence of Cyber and AML

John Curran

Executive Managing Director

STROZ FRIEDBERG
an Aon company

Threat to Financial System



When Money Derives from Cyber-attack on the FI itself

The New York Times

In Hours, Thieves Took $45 Million in A.T.M. Scheme

By MARC SANTORA MAY 9, 2013

It was a brazen bank heist, but a 21st-century version in which the criminals never wore ski masks, threatened a teller or set foot in a vault.

In two precision operations that involved people in more than two dozen countries acting in close coordination and with surgical precision, thieves stole $45 million from thousands of A.T.M.'s in a matter of hours.

In New York City alone, the thieves responsible for A.T.M. withdrawals struck 2,904 machines over 10 hours starting on Feb. 19, withdrawing $2.4 million.

When Money Derives from Cyber-attack on the FI itself

Bloomberg Business

Digital Misfits Link JPMorgan Hack to Pump-and-Dump Fraud

by Michael Riley and Jordan Robertson

July 21, 2015 – 1:50 PM EDT *Updated on* July 22, 2015 – 8:09 AM EDT

Authorities arrested four people in Israel and Florida and revealed a complex securities fraud scheme tied to the computer hacks of JPMorgan Chase & Co. and other financial institutions.

Behind the alleged crimes described Tuesday is a remarkable story of unpredictable alliances in modern computer crime involving, if true, a multi-layered organization with tentacles reaching Moscow, Tel Aviv and West Palm Beach.

Cyber-attack on Third Party

theguardian

Fiat Chrysler recalls 1.4m vehicles in wake of Jeep hacking revelation

- Recall includes Dodges, Jeeps, Rams and Chryslers with 8.4in touchscreens
- Company said it will update software to provide protection from hacks

Cyber-attack on Third Party

CNN Money US +

Traders made millions on stocks after hacking press releases

by Chris Isidore @CNNMoneyInvest

August 11, 2015: 2:43 PM ET

A group of stock traders teamed with two Ukrainian-based computer hackers to make $100 million in illegal profits by gaining access to hundreds of press releases of many leading U.S. companies and trading on the stolen news before it became public.

All told 16 individual stock traders, and 14 businesses profited from the illegal trades, according to civil charges from the Securities and Exchange Commission. Nine of those individuals, including the two hackers, also face federal criminal charges. One federal indictment was unsealed in New Jersey and the other in Brooklyn on Tuesday.

Cyber-attack on Third Party

Regulatory Convergence

- Advisory on Cyber-Events and Enabled Crime FIN-2016-A005 (OCT 25, 2016)
- Advisory on E-Mail Compromise Fraud FIN-2016-A003 (September 6, 2016)

- Proposed Cybersecurity Requirements for Financial Services Companies (September 2016)

Convergence of Cyber/AML Compliance?

- Object is similar: detect anomalous activity in data that is deleterious to the Financial Institution and its customers.
- Both areas are heavily regulated, so both need robust compliance programs.
- Collaboration and information sharing are regulatory expectations.
- How far will the two areas converge?
  - Many money laundering schemes have nothing to do with a cyber event.
  - Detection mechanisms very different.
  - Skills in monitoring, investigating, supervising very different.

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About Stroz Friedberg

Stroz Friedberg, an Aon company, is a specialized risk management firm built to help clients solve the complex challenges prevalent in today's digital, connected, and regulated business world. A global leader in the fields of cybersecurity, with leading experts in digital forensics, incident response, and security science; investigation; eDiscovery; and due diligence, Stroz Friedberg works to maximize the health of an organization, ensuring its longevity, protection, and resilience. Founded in 2000 and acquired by Aon in 2016, Stroz Friedberg has thirteen offices across nine U.S. cities, London, Zurich, Dubai, and Hong Kong, Stroz Friedberg serves Fortune 100 companies, 80% of the AmLaw 100, and the Top 20 UK law firms. Learn more at https://www.strozfriedberg.com/.

SANCTIONS

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U.S. Sanctions Programs

Overview

The U.S. Government maintains substantial restrictions on dealings with certain countries, entities, individuals, and other targets through various economic sanctions programs

These programs are enforced primarily through the Treasury Department's Office of Foreign Assets Control ("**OFAC**")

- Some sanctions programs are "comprehensive" and block dealings of almost any kind with particular countries (*e.g.*, Cuba, Iran, North Korea, Sudan, Syria)
- Others are "selective" and prohibit certain transactions or dealings with specific targets
- OFAC maintains a Specially Designated Nationals List ("**SDN**") that identifies individuals and entities with whom U.S. persons may not engage in dealings of any kind (https://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx)
- OFAC may issue licenses authorizing activities otherwise prohibited under the sanctions programs, but such licenses generally must be obtained in advance

U.S. Sanctions Programs (cont'd)

Who is Subject?

The following individuals and entities must comply with U.S. sanctions laws:

- U.S. citizens and permanent resident aliens (*i.e.*, "green card" holders), wherever in the world they are located;
- Entities organized under U.S. law, including their non-U.S. branches; and
- All persons (including entities) located in the United States (even if temporarily)

Under certain sanctions programs (*e.g.*, those dealing with Cuba and Iran), entities owned or controlled by U.S. persons, wherever organized or located (*e.g.*, foreign subsidiaries of a U.S. company), must also comply

U.S. Sanctions Programs (cont'd)

Forms of Sanctions

- **Asset Freezes**. Prohibition on transferring or otherwise dealing in any property (*e.g.*, assets, liabilities, services, securities, or contracts) or interest in property of a sanctions target
- **Trade Embargoes**. Prohibition on importing or exporting any goods, services, or technology from or to particular targets
- **New Investment Restrictions**. Prohibition on contributing or committing funds, loans, or credits to, or developing economic resources for, a target
- **Sectoral Sanctions**. Prohibition on specific kinds of dealings (*e.g.*, dealings in certain kinds of debt or equity) with targets in a particular economic sector
- **Other Prohibitions**. Additional prohibitions may include, for example, travel bans or restrictions on the facilitation or brokering of commercial or financial transactions

Types of Assets/Property Subject to Blocking/Freezing

Funds/Cash

Funds, Cash, Securities, Debt

Goods and technology

Physical property

Lines of credit

Blocked property includes “any property, tangible or intangible, or any interest therein, including present, future or contingent interests.” Includes both direct and indirect interests in property.

Blocked property includes any property in which a blocked party owns a 50% or greater interest. Less than 50% interest needs to be carefully scrutinized.

Background – Sanctions Programs

Cuba

Iran

Sudan

Syria

Counter Narcotics Trafficking

Counter Terrorism

Cyber-related

Non-proliferation

Rough Diamond

Transnational Criminal Organizations

Burma

Ukraine / Russia-related

North Korea

Venezuela

- Balkans-Related Sanctions
- Belarus Sanctions
- Central African Republic
- Cote d'Ivoire (Ivory Coast)
- Democratic Republic of Congo
- Iraq
- Lebanon
- Former Liberian Regime
- Libya
- Magnitsky
- Somalia
- South Sudan
- Yemen
- Zimbabwe

OFAC Sanctions Penalties & Enforcement: *Enforcement Principles*

Strict liability

- Civil penalties may be imposed on a strict liability basis
- In the matter of: Aluminum Company of America, 64 FR 42641-02 (Aug. 5, 1999) (finding that "liability and administrative sanctions are imposed on a strict liability basis once the Respondent commits the proscribed act")
- Iran Air v. Kugelman, 996 F.2d 1253 (D.C. Cir. 1993) (knowledge is not an "essential element of proof for the imposition of civil penalties").

Risk-based compliance

- "OFAC agrees that financial institutions should take a risk-based approach when considering the likelihood that they may encounter OFAC issues." - www.treasury.gov/resource-center/sanctions/Documents/matrix.pdf
- OFAC will consider "an institution's risk-based compliance program in assessing the appropriate enforcement response" – 74 FR 57593 at 57597 (Nov. 9, 2009)

Legal Authorities - Penalties

Penalties:

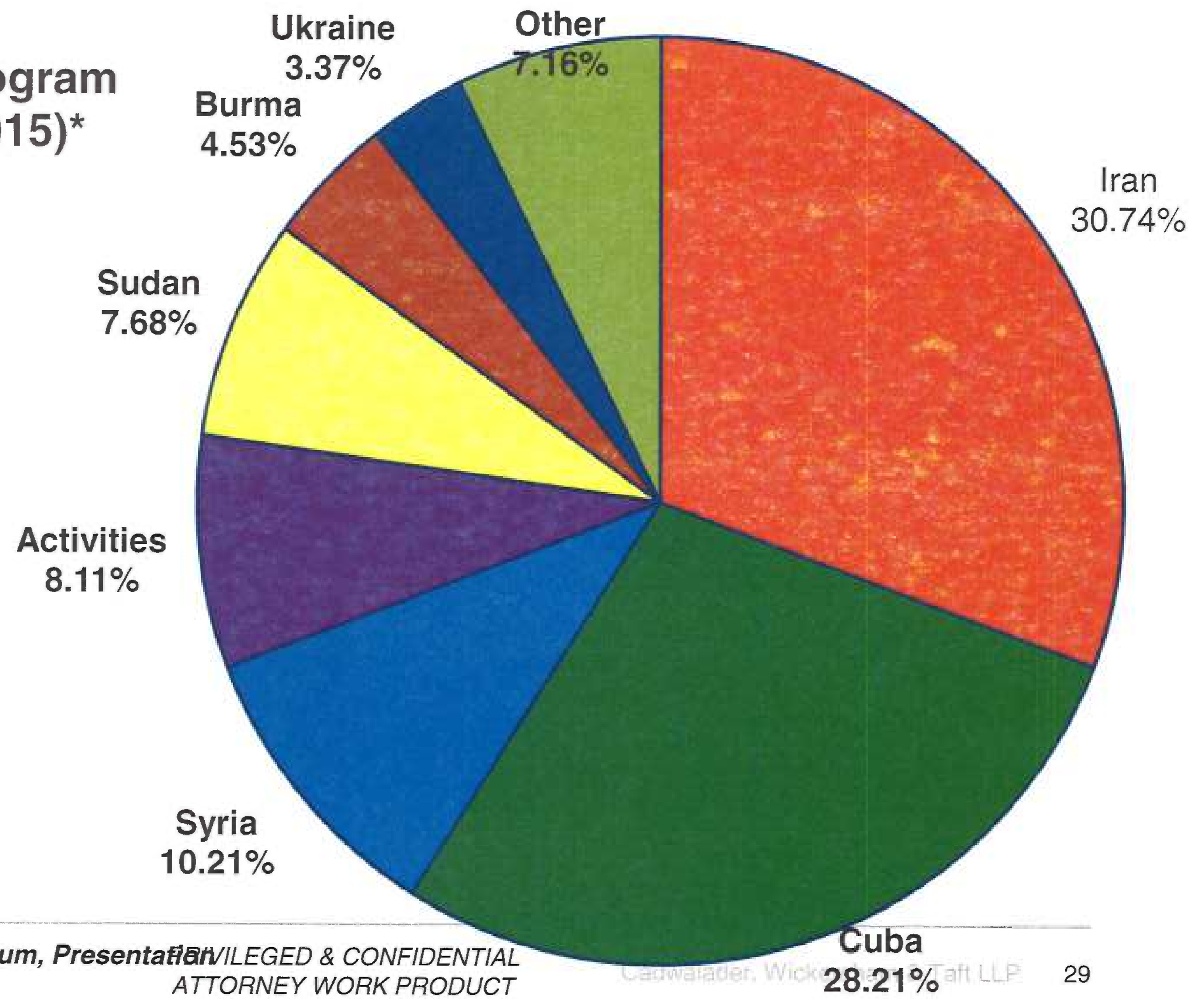
- Trading with the Enemy Act - $65,000
- International Emergency Economic Powers Act (IEEPA) - $250,000 or 2x the value of the transaction
- Foreign Narcotics Kingpin Designation Act - $1,075,000
- Criminal Penalties
    - $1 million or 2x value; imprisonment
    - Larger penalties under Kingpin Act

Other Consequences:

- Revoked licenses
- Debarment
- Liability for related violations
- Reputational risks

OFAC Sanctions Penalties & Enforcement:
OFAC Investigation Trends

Investigations by Program
(Jan. 2014 - Aug. 2015)*



** Source: OFAC 2015 Fall Symposium, Presentation*

U.S. Sanctions Programs

Iran Sanctions Update

Sanctions Relief

- The Joint Comprehensive Plan of Action ("**JCPOA**") of July 14, 2015, created a framework for phased sanctions relief in exchange for the curtailment of Iran's nuclear program
- Sanctions relief—mainly limited to non U.S. persons—would apply to major sectors of the Iranian economy, including the energy, financial, shipping, shipbuilding, and automotive industries
- Once implemented, OFAC will also remove certain individuals, entities, vessels, and aircraft from the SDN List

Current Status

- The U.S. trade embargo against Iran remains intact
- Sanctions related to Iran's human rights abuses, WMD proliferation, and support for terrorism remain in place

U.S. Sanctions Programs

Russia & Ukraine Program

Crimea Region of Ukraine Sanctions

- Comprehensive sanctions imposed on the Crimea Region of Ukraine in December 2014 in response to Russia's occupation of the territory

SDN List Designations

- Beginning in March 2014, a number of Russian, Ukrainian, and other individuals and entities have also been added to OFAC's SDN List, effectively prohibiting U.S. persons from engaging in any transactions with them

Current Status

- U.S. persons generally prohibited from engaging in virtually all direct and indirect transactions (*e.g.*, financial, trade, and other commercial transactions) to or from the Crimea Region of Ukraine

U.S. Sanctions Programs

Cuba Program

- The Cuba embargo remains in place.
- Most transactions between the United States, or persons subject to U.S. jurisdiction, and Cuba continue to be prohibited, and OFAC continues to enforce the prohibitions of the CACR.
- The regulatory changes, effective in January, June, and September 2015, as well as in January, March, and October 2016, respectively, are targeted to further engage and empower the Cuban people by facilitating authorized travel to Cuba by persons subject to U.S. jurisdiction; certain authorized commerce and financial transactions; and the flow of information to, from, and within Cuba

Trump Administration and OFAC

- **Iran: Mr. Trump campaigned on the reversal of JCPOA ("That horrible deal.")**
- Sanctions easing on Iran was strictly be executive order. It is in jeopardy.
- Senator Sessions would be likely to continue Justice Department efforts to prosecute companies that engage in transactions with sanctioned individuals, companies, or governments.
  - Senator Sessions has co-sponsored legislation aimed at continuing or enhancing sanctions against Iran to promote U.S. foreign policy objectives.
- In 2013, Senator Sessions tried to introduce a bill eliminating what he called loopholes that allowed foreign banks to facilitate transactions on behalf of the Central Bank of Iran.
- **Cuba: Mr. Trump did not criticize the easing during the election season.**
- Cuban sanctions are a function of law, not regulation – so, while regulations can be eased and changed, the Cuban embargo is still in place and Congress must repeal TWEA for all restrictions to disappear.
- But easing continues – PPD in October, that puts in place milestones and guidelines for continued engagement with Cuba.

Planning Your Deal To Prevent AML and Sanctions Violations

Good planning starts with good due diligence.

Know your customer and the business.

Search for connections to sanctions targets/countries.

Identify direct and indirect sanctions risks early in the transaction.

Sanctions vary considerably depending on the target/country.

Which country's sanctions law and regulations apply?

How to deal with cross-border deals?

Issues/exposure for US investors (individuals, pension plans, states).

How to deal with conflicts of laws – e.g. Cuba?

Devise a strategy to minimize and deal with risks.

What about reputational risk?

Build in contractual protections.

Engage sanctions lawyers and compliance personnel early to avoid last minute crisis.

Consider getting guidance from US or EU authorities.

QUESTIONS?

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Fund Finance:
Hybrid and NAV-Based Leverage

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Fund Leverage: Hybrids and NAV-Based Lending

Finance Forum

December 1, 2016

Moderator: **Michael C. Mascia**, Partner, Cadwalader, Wickersham & Taft LLP

Panelists: **Michael Williamson**, Chief Executive Officer, Clearhaven Capital
Nicholas Mitra, Executive Director, Natixis Capital Markets
Douglas A. Cruikshank, Managing Partner – Credit Supported Loan Fund, Enhanced Capital Partners
Alessandra McKell, Managing Director, Investec Bank PLC

Fund Leverage: Hybrids and NAV-Based Lending

TOPICS

- Introductions
- Hybrid Facilities
- Lending to Fund of Funds and Secondary Funds
- Lending to Loan and Debt Funds
- Pure NAV-Based Lending to Buyout and other Private Equity Funds

Fund Leverage: Hybrids and NAV-Based Lending

Hybrid Facilities – Key Characteristics

- A hybrid facility looks at a combination of both a Fund's uncalled capital commitments and investments as the source of repayment for the loans
- Hypothetical Borrowing Base = [65]% of the uncalled capital commitments of the [included] investors plus [35]% of the net asset value of the Fund's [eligible] investments
- Eligibility criteria for Investors and Investments often relaxed compared to Subscription Facilities or Asset Level financings
- Often capped such that loans never exceed 100% of uncalled capital commitments
- Full recourse to the Fund

Fund Leverage: Hybrids and NAV-Based Lending

Hybrid Facilities – Collateral Package

- Uncalled Capital Commitments and Capital Contributions
- Collateral Account
- Investment Cash Flow and Liquidation Proceeds
- Operating Account
- [Investments Themselves] [Equity in Holding Vehicles]

Fund Leverage: Hybrids and NAV-Based Lending

Hybrid Facilities – Key Considerations

- Rely on uncalled capital commitments early in the Fund life cycle; investments later on
- Often capped at 100% of uncalled capital to enable only Subscription Facility type underwriting and due diligence by the lender
- True Hybrids:
  - Great utility for a Fund
  - Require lending competence in both Subscription Facilities and, depending on the advance rate for Investments, the underlying assets
  - Longer tenor to be cost efficient: Need to replace two facilities with one
  - Due diligence on enforceability of uncalled capital commitments

Fund Leverage: Hybrids and NAV-Based Lending

Lending to Fund of Funds and Secondary Funds – Key Characteristics

- Mature market with consistent structures
- Typically based exclusively on NAV
- Borrowing Bases have eligibility criteria and concentration limits on the investments
- Due diligence on underlying Fund partnership agreements for restrictions on indirect pledges
- Competitive Financing: seller offering a Deferred Purchase Price

Fund Leverage: Hybrids and NAV-Based Lending

Lending to Fund of Funds and Secondary Funds – Collateral Package

- Typically Limited to the Equity of the Holding Vehicle
  - → Does create transfer issues if title is at the Fund
  - → Often legal ambiguity as to intent of negative pledge language
- Collateral Account
  - → Typically at a third-party account bank, so UCC perfection accomplished by a Deposit Account Control Agreement
- May be limited recourse to a portion of the portfolio
  - → Certain Facilities finance the purchase of a single Investment

Fund Leverage: Hybrids and NAV-Based Lending

Lending to Loan and Debt Funds – Key Characteristics

- Often in tandem with a Subscription Facility
- Can be a CLO and/or CLO warehouse
  - → As hurdle expectations for debt Funds have come down, traditional asset level financing is more likely
- Mezzanine Funds and other higher yielding debt funds need special situation financing
  - → Smaller market
  - → Limited Capital Markets options

Fund Leverage: Hybrids and NAV-Based Lending

Lending to Loan and Debt Funds – Deal Structures

- Borrowing Base structure with advance rates tiered based on credit quality of underlying loans
- Individual and aggregate concentration limits (CLO Style)
- Collateral Package: All loans
  - → Perfection: UCC (But beware of Investments that are certificated)
- Due Diligence: Representations that underlying loans do not prohibit pledge to the Lender
- Collateral Account
  - → All underlying Obligors directed to make payments to the Collateral Account
- Typically full recourse to the Fund

Fund Leverage: Hybrids and NAV-Based Lending

Pure NAV-Based Lending to Buyout and other Private Equity Funds – Key Considerations

- Emerging market with no consistent structure
- Structures and covenants driven by underlying asset class
- Uses: Pure leverage, dividend recaps, follow on investments, liquidity
- Bank, Fund and capital markets solutions
- Full recourse loans
- Moderate growth forecasted

  → Growth drivers: IRR Enhancement, Leverage Limits, Late Stage Liquidity, New Funds being Raised

  → Growth headwinds: LPAs have trouble forecasting financing innovations six years out, just different, perceptions around leverage

Fund Leverage: Hybrids and NAV-Based Lending

Pure NAV-Based Lending to Buyout and other Private Equity Funds – Collateral Package

- Typically secured, but not perfectly
    - → Perfection driven by type of asset class
    - → Certificated equity by possession?
- Typically the equity of the holding vehicle subsidiary is pledged
- Collateral Account
- Full recourse to the Fund

Fund Leverage: Hybrids and NAV-Based Lending

Pure NAV-Based Lending to Buyout and other Private Equity Funds – Challenging Issues

- NAV Marks: Reliance on the Fund? Third Party Appraisals? Time Lag in Financials?
- Equity Cures
  - → Lenders have differing views over whether they are an acceptable way to remedy Investment performance breaches
- Source of Repayment in a Borrowing Base Deficiency
- Remedies in a Borrowing Base Deficiency: Cash Sweep? Time Period for Liquidation? Payment of Management/Servicing Fee?

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CRE Debt Rep & Warehouse Finance Update

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CRE Debt Repo & Warehouse Finance Update

Finance Forum

December 1, 2016

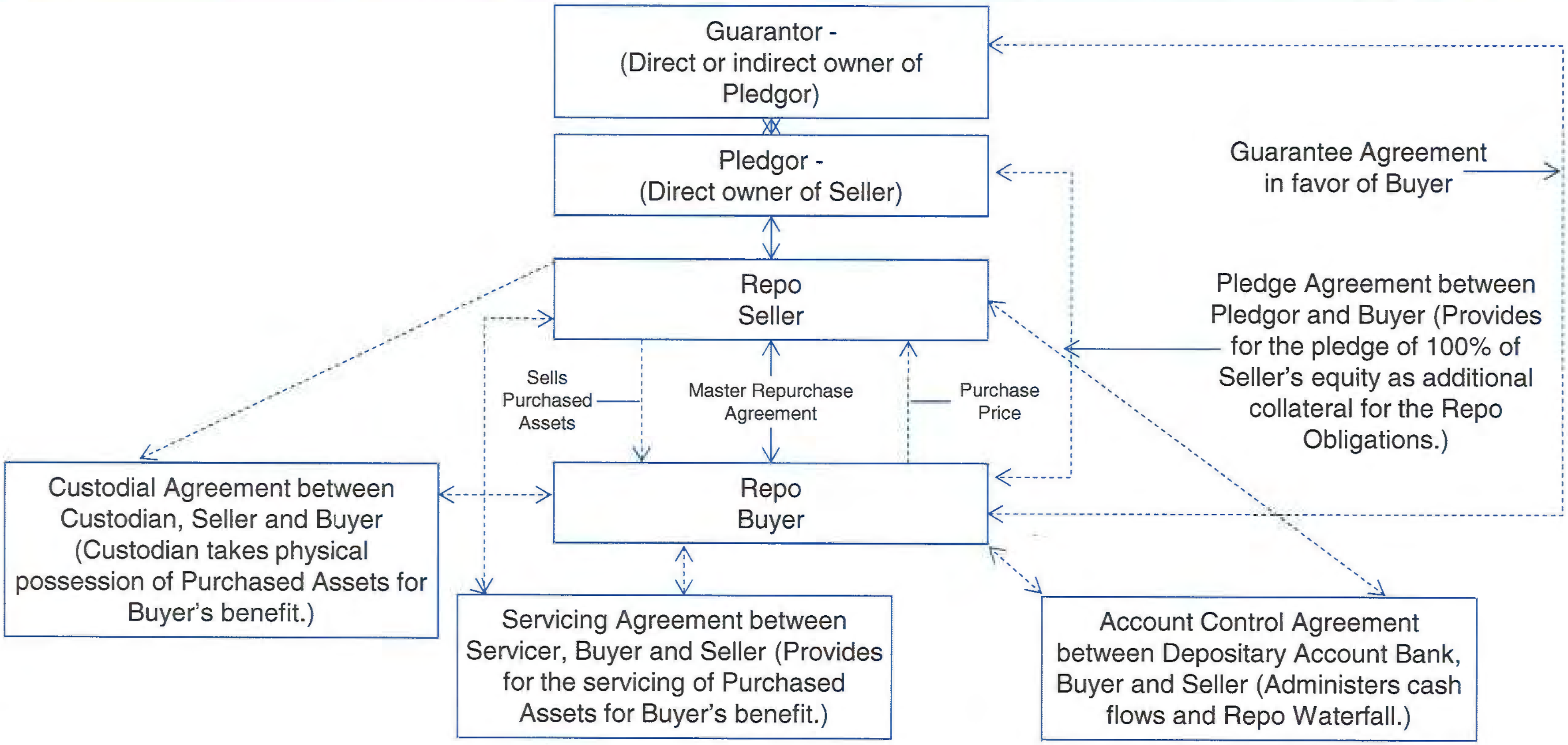
Moderator: **Stuart Goldstein**, Partner, Cadwalader, Wickersham & Taft LLP

Panelists: **Cary Carpenter**, Managing Director, Starwood Capital
Thomas Cassino, Executive Director, JPMorgan
Matthew Cohen, Principal, Mesa West Capital
Bob Foley, Managing Director, Chief Financial and Risk Officer, TPG Real Estate Finance Trust
Jonathan Love, Managing Director, Wells Fargo

What is a Repurchase Agreement?

- A lending arrangement documented as a sale and buyback transaction
- Buyer agrees to purchase commercial real estate loans or a portfolio of commercial real estate loans from a Seller
- Seller agrees to pay price differential on a monthly basis
- Seller agrees to repurchase the loans on the repurchase date against repayment of the purchase price of the loan, plus accrued and unpaid price differential, plus any other fees and expenses due and payable to Buyer.

Structure Chart for a Typical Master Repurchase Agreement[1]



[1] Seller's counsel provides legal opinions on enforceability of Repo Documents, validly granted and perfected security interest and Bankruptcy Code Safe Harbor.

Pricing

- Buyer purchases the loans at a discount off the market value of the loan, which provides over-collateralization
- Buyer charges an interest rate on the aggregate purchase price of the loans, called "Price Differential"
- Since Buyer owns the assets (subject to the Seller's repurchase rights and obligations), following a default Buyer can realize on the loans and sell/dispose of them
- There is a risk that the transaction could be recharacterized as a loan, instead of a repo. In practice, repo Buyers are still advised to sell collateral in compliance with Article 9 of the UCC

Bankruptcy Safe Harbor Protection

- Safe harbor protection against the automatic stay in bankruptcy
  - Repurchase Agreement Safe Harbor
  - Securities Contract Safe Harbor
- Legal opinions are required on the availability of the safe harbor to the transaction and the assets.

Buyer Mark-to-Market Rights

- Buyer allowed to determine the market value of the loans on any business day

- If the market value of a loan is less than the product of the advance rate on that loan multiplied by the purchase price of the loan, a margin deficit exists

- Buyer is allowed to call margin to rebalance the advance on purchase price to the market value of the loan

Documentation

- Master Repurchase Agreement
- Custodial Agreement
- Pledge Agreement
- Guaranty Agreement
- Account Control Agreements
- Servicing Agreement

Benefits of a Repo versus a secured lending

- Why a Repo instead of a secured financing?
  - Buyer incurs less market exposure in the case of Seller's bankruptcy if Buyer has the ability to immediately terminate and liquidate the forward repurchase transaction (as opposed to being a secured creditor in a bankruptcy proceeding)
  - Assets not subject to automatic stay in bankruptcy
  - Buyer gets mark-to-market rights on a daily basis

Recharacterization Risk: What is it?

- Recharacterization Risk
  - The risk that a sale under a Repo will be recharacterized by a bankruptcy court as a financing/loan.
    - Bankruptcy Courts have an equitable right to "recharacterize" a transaction.
    - ". . .the bankruptcy court is permitted to look beyond the form to the substance of a transaction in order to determine the true nature of a transaction as it relates to the rights of parties against a debtor's estate." See In re. Corporate Financing, Inc. et al 22 BR 671, 672 (E.D.N.Y. 1999)

Recharacterization: Mitigating the Risk

- Certain aspects of the transaction pose recharacterization risk:
  - Buyer retains recourse against the Seller with respect to the loans
  - The repurchase price reflects an implied interest rate
  - The Buyer advances less than fair market value to "purchase" the loans

Mitigating the Risk -- Perfection

- Repurchase Agreement contains a back-up grant of a security interest
- Buyer (or, most likely, a Custodian on behalf of Buyer) has possession of the Mortgage Note as well as a full set of assignment documents, in blank, signed by the Seller
- UCC-1 Filing
- Possession of the Mortgage Note ensures priority in the related loan.

Recharacterization Risk: Why Does it Matter?

- If a court recharacterizes the transaction, the Buyer will be reduced to a secured creditor.
- The Buyer will be stayed from exercising remedies until the bankruptcy court resolves the bankruptcy filing, during which time, the assets may decline in value.
- "Owners" and "secured creditors" have very different rights in the assets.

Representations and Warranties

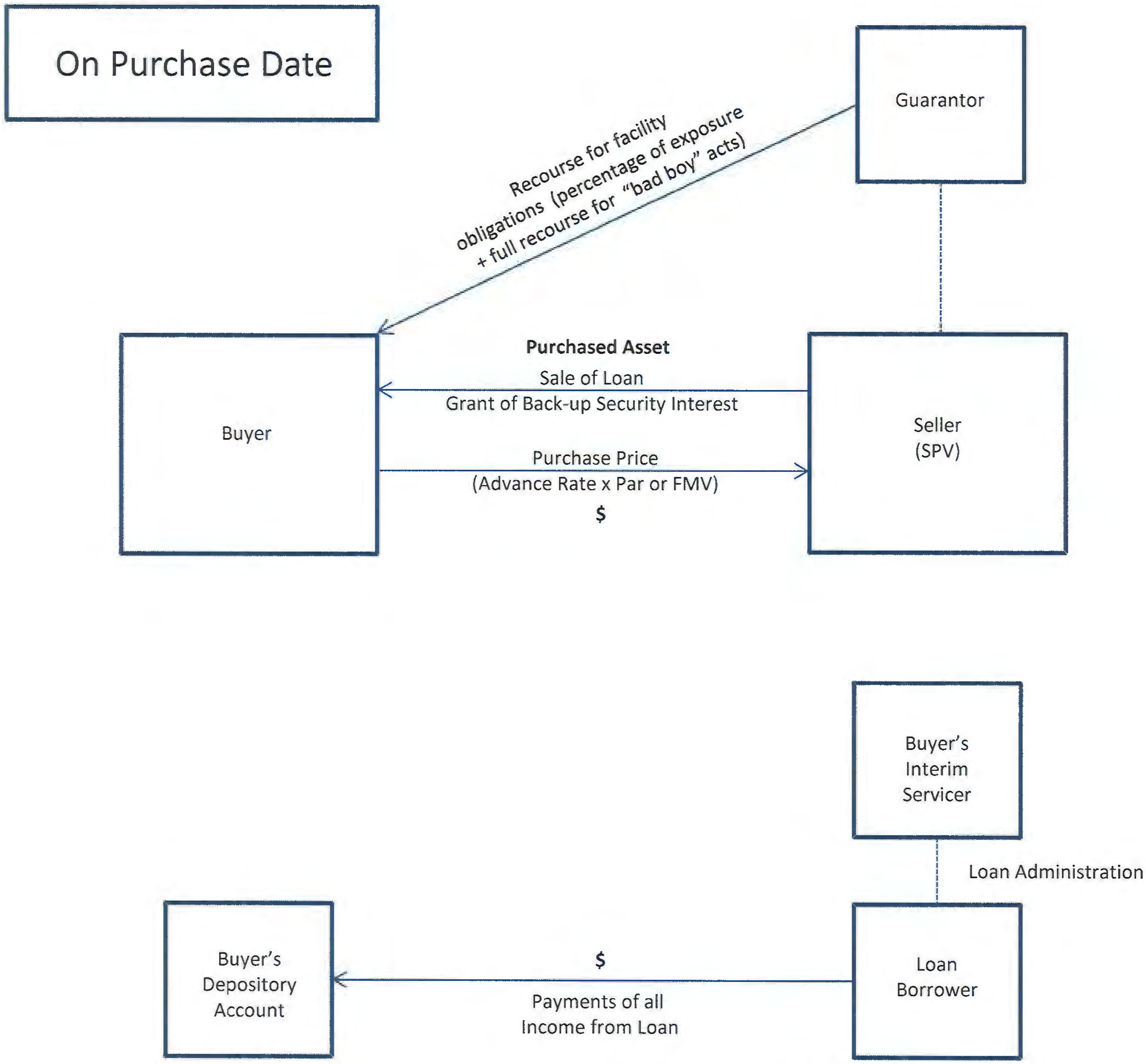
- Typically two types
- Seller level representations (corporate housekeeping, financial covenants, etc.). Breach of reps is an Event of Default.
- Asset level representations
- Remedy for a breach of asset level representations and warranties
  - asset value is reduced to zero
  - Seller must repurchase the asset for the full Repurchase Price

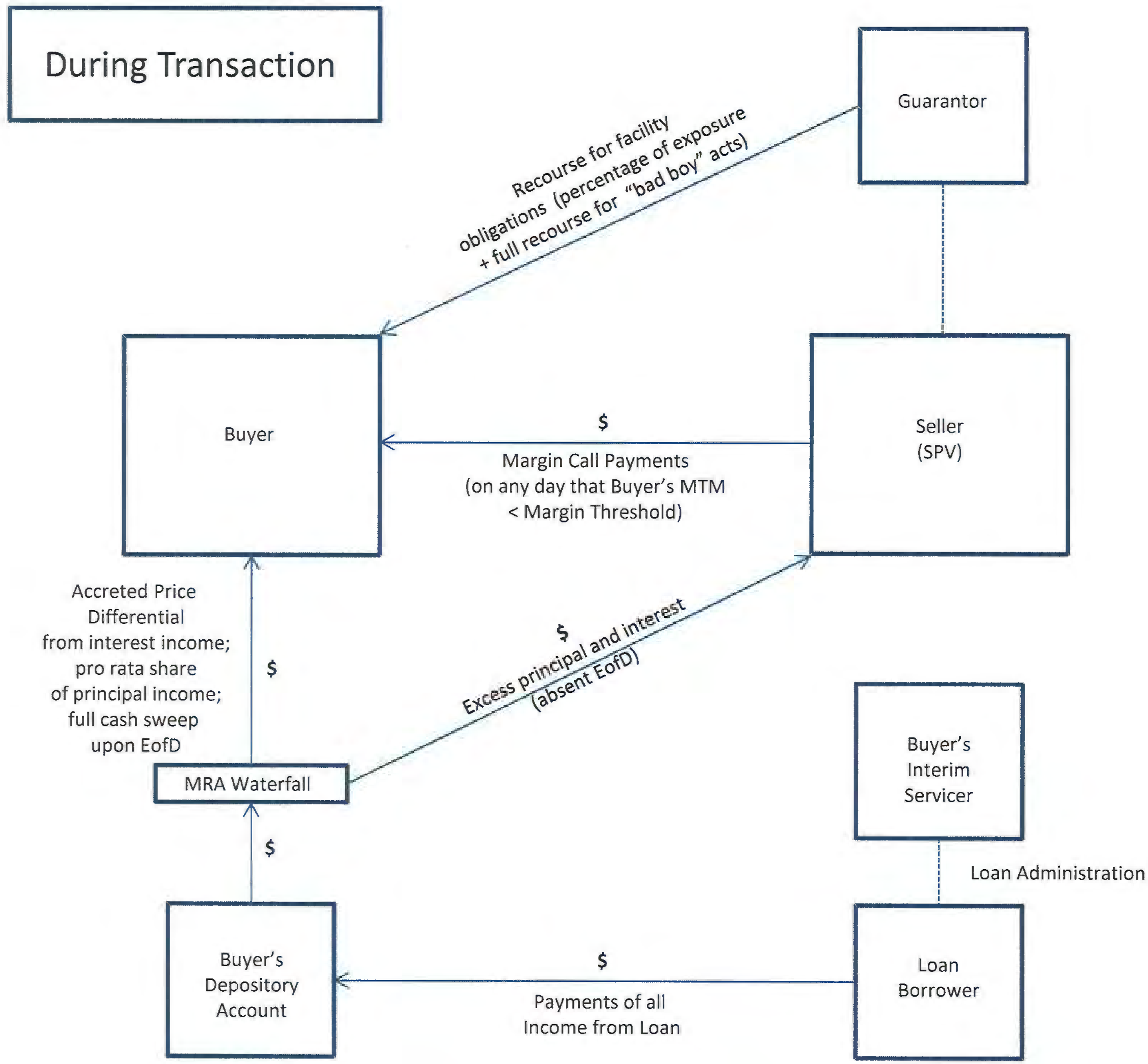
Covenants and Events of Default

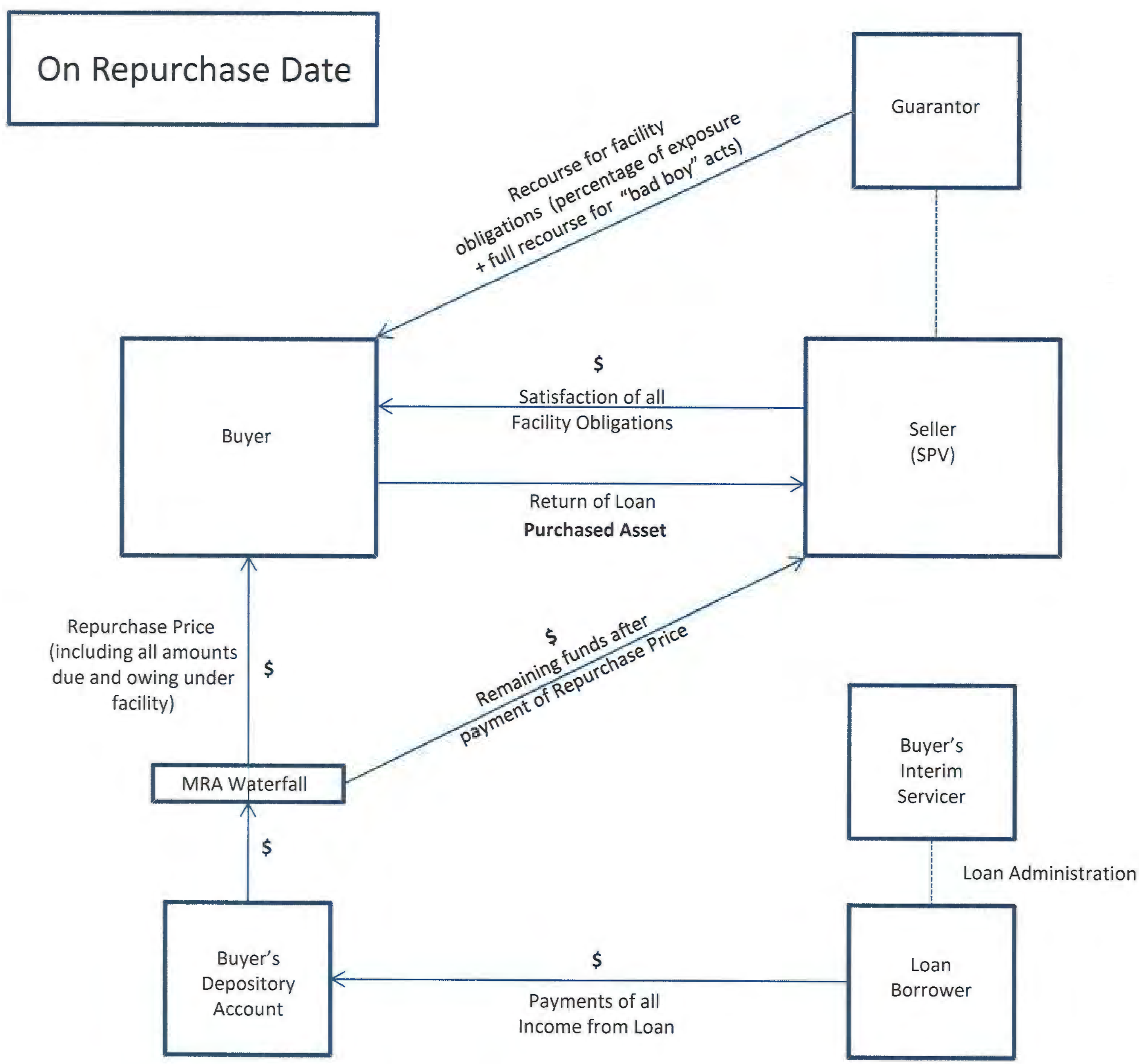
- Financial Covenants
- Restrictive/Negative Covenants
- Affirmative Covenants
- Types of Events of Default
- Cure Periods
- Remedies

Conclusion: Advantages of Repo Structure

- Advantages:
  - Structure suitable for various commercial real estate loans
  - Seller: Allows better pricing and flexibility
  - Buyer:
    - Alternative to lending, less bankruptcy risk due to availability of the bankruptcy safe harbor
    - Allows for mark-to-market to mitigate market volatility risks
    - May allow for quicker and easier foreclosure as Buyer owns the loans outright and has mechanisms in place for quick enforcement, BUT Buyer has to be mindful of recharacterization risk when exercising remedies.


On Purchase Date
Guarantor
Recourse for facility obligations (percentage of exposure + full recourse for "bad boy" acts)
Buyer
Purchased Asset
Sale of Loan
Grant of Back-up Security Interest
Purchase Price
(Advance Rate x Par or FMV)
$
Seller
(SPV)
Buyer's
Interim
Servicer
Loan Administration
Buyer's
Depository
Account
$
Payments of all
Income from Loan
Loan
Borrower


During Transaction
Guarantor
Recourse for facility obligations (percentage of exposure + full recourse for "bad boy" acts)
Buyer
Seller (SPV)
$
Margin Call Payments (on any day that Buyer's MTM < Margin Threshold)
Accreted Price Differential from interest income; pro rata share of principal income; full cash sweep upon EofD
$
$
Excess principal and interest (absent EofD)
MRA Waterfall
$
Buyer's Interim Servicer
Loan Administration
Buyer's Depository Account
$
Payments of all Income from Loan
Loan Borrower


On Repurchase Date
Guarantor
Recourse for facility obligations (percentage of exposure + full recourse for "bad boy" acts)
Buyer
$
Satisfaction of all Facility Obligations
Seller (SPV)
Return of Loan
Purchased Asset
Repurchase Price (including all amounts due and owing under facility)
$
$
Remaining funds after payment of Repurchase Price
MRA Waterfall
$
Buyer's Interim Servicer
Loan Administration
Buyer's Depository Account
$
Payments of all Income from Loan
Loan Borrower

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Alternative Risk Retention Solutions: Thinking Outside the Box

REGULATORY LANDSCAPE FOR SECURITIZATION TRANSACTIONS

I. Introduction

The financial crisis lead to the adoption of numerous rules and regulations that target (in whole or in part) securitization transactions. Many of these rules and regulations were adopted in order to implement various sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The rules and regulations include (i) regulations that implement Section 13 of the Bank Holding Company Act (also known as the "Volcker Rule"), which was added by Section 619 of the Dodd-Frank Act, (ii) the U.S. risk retention rule (the "Risk Retention Rule") that implements section 15G of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which was added pursuant to Section 941 of the Dodd-Frank Act, (iii) Rule 15Ga-2 of the Exchange Act that implements Section 15E of the Exchange Act, which was amended pursuant to Section 932(a)(8) of the Dodd Frank Act, and (iv) Regulation AB II.

These rules and regulations can be found at the respective web addresses set forth below:

Volcker Rule: https://www.sec.gov/rules/final/2013/bhca-1.pdf

Risk Retention Rule: https://www.fdic.gov/news/board/2014/2014-10-21_notice_dis_a_fr.pdf

Third Party Due Diligence Report: http://www.sec.gov/rules/final/2014/34-72936.pdf

Regulation AB II: https://www.sec.gov/rules/final/2014/33-9638.pdf

Additionally, attached hereto are the consensus memorandum related to "ownership interests" in CLOs under the Volcker Rule referred to in Part II.F.2 and various Clients & Friends Memoranda that more fully address these rules and regulations.

Due to time constraints, these materials and the presentation primarily will focus on the Volcker Rule and the Risk Retention Rule, each of which must be addressed in the structuring phase of a transaction.

II. Volcker Rule

A. The Volcker Rule Applies to "banking entities"

The Volcker Rule applies to the activities and investments of "banking entities". Under the Volcker Rule, a "banking entity" is defined broadly and includes (i) FDIC-insured depository institutions, (ii) companies that control an FDIC-insured depository institution, (iii) bank holding companies (including a foreign banking organization) and (iv) affiliates or subsidiaries of any of the foregoing.

B. Prohibitions and Restrictions

The Volcker Rule's statutory language (Section 619 of the Dodd-Frank Act) has three basic elements:

(i) A prohibition on acquiring or retaining an ownership interest in, or sponsoring, a private equity or hedge fund (referred to in the final regulations as a "covered fund"), subject only to a handful of exceptions, including sponsoring or owning de minimis interests in funds "organized and offered" by the banking entity for certain asset management purposes and, with respect to foreign banking organizations, covered fund activities conducted "solely outside of the United States";

(ii) Restrictions on certain transactions with a private equity or hedge fund if the banking entity or any of its affiliates serves as the fund's sponsor, investment adviser, or investment manager, or if the banking entity "organized and offered" the fund (these restrictions are referred to commonly as "Super 23A & B"); and

(iii) A general prohibition on "proprietary trading," subject to a few exceptions, including market-making, dealing, an, only with respect to foreign banking organizations, trading activities conducted "solely outside of the United States."

C. Definition of "Covered Fund"

Subject to certain exclusions, an issuer will be a "covered fund" if it (i) would be an investment company but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "ICA"), (ii)(a) is a commodity pool for which the commodity pool operator has claimed exempt pool status under Rule 4.7 of the regulations of the Commodity Futures Trading Commission (the "CFTC") or (b) could qualify as an exempt pool and the participation units of such entity have not been publicly offered to persons who are not qualified eligible persons under Rule 4.7 of the CFTC's regulations or (iii) is a foreign issuer that (a) is sponsored, or has an ownership interest held, by a U.S. banking entity (or a foreign affiliate of a U.S. banking entity), (b) is organized primarily for the purpose of trading securities, and (c) would be an investment company but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the ICA if such foreign issuer were subject to U.S. securities laws.

D. Other Exemption or Exclusion from ICA Registration; Common ABS Transactions are Excluded

If an issuer relies on Section 3(c)(5) of the ICA or Rule 3a-7 under the ICA, it will not be a "covered fund" for purposes of the Volcker Rule and thus the Volcker Rule's restrictions on activities of banking entities and required compliance related to covered funds will not apply with respect to such issuer.

If an issuer would ordinarily rely on Section 3(c)(1) or 3(c)(7) of the ICA, but relies on Section 3(c)(5) of the ICA or Rule 3a-7 under the ICA in addition to Section 3(c)(1) or

Section 3(c)(7), such reliance would take the issuer outside the definition of "covered fund" for purposes of the Volcker Rule. Note: The "either or" approach advocated by this paragraph has disclosure and opinion ramifications that will be discussed during the presentation.

The most common types of loan securitizations (such as those backed by residential and commercial mortgages, student loans, credit card receivables, auto loans and leases, and equipment leases, which represent a substantial majority of the current securitization market), as well as securitizations of more esoteric asset classes (such as those backed by time share loans, container leases and servicer advances), will not be subject to the Volcker Rule.

E. Certain Exclusions to the Definition of "Covered Fund"

The exclusions that are most relevant in the securitization context are the exclusions for loan securitizations, qualifying asset-backed commercial paper conduits, qualifying covered bonds and wholly-owned subsidiaries. This discussion will focus on the loan securitization exclusion.

The loan securitization exclusion will apply to an issuer if its underlying assets or holdings are comprised solely of:

(i) loans (defined as any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative);

(ii) any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans and that satisfy the other requirements of this exclusion;

(iii) certain interest rate or foreign exchange derivatives that (a) "directly relate" to the loans held by the issuing entity or the related asset-backed securities ("ABS"), and (b) reduce the interest rate and/or foreign exchange risks related to such loans or related ABS;

(iv) certain cash equivalent investments (as more fully described in the adopting release to the Volcker Rule published at 79 Fed. Reg. 5536 (Jan. 31, 2014) (Federal Reserve, FDIC, OCC and SEC) ("the Adopting Release"); 79 Fed. Reg. 5508 (Jan. 31, 2014) (CFTC)); and

(v) certain other rights or instruments (as more fully set forth in the Volcker Rule and described in the Adopting Release)

F. Prohibition With Respect to Ownership Interest and Sponsorship

1. *General*

If an issuer is a covered fund that cannot avail itself of one of the exclusions from the covered fund definition, then any banking entity, subject to certain exceptions specified in the

Volcker Rule and below, may not, *as principal*, directly or indirectly, acquire or retain any "ownership interest" in or "sponsor" such covered fund.

2. *Ownership Interest*

An "ownership interest" in a covered fund means any equity, partnership, or other similar interest.

An "other similar interest" in a covered fund means an interest that on a current, future or contingent basis[1]:

(i) has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)[2];

(ii) has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;

(iii) has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(iv) has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

(v) provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

(vi) receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

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1 Although the phrase "current, future or contingent basis" does not appear in the text of the final regulations, it is included in the preamble's discussion of the definition of "ownership interest."

2 The holder of an interest referred to in clause (i) above need only have the right to "participate in" the selection or removal process of the parties specified above. It is not necessary that such holder be able to control such selection/removal process, or actually participate in the selection or removal process.

(vii) any synthetic right to have, receive, or be allocated any of the rights in paragraphs (i) through (vi) above.

The analysis of what constitutes an ownership interest or other similar interest is highly fact specific. The creditor remedy exclusion referred to in clause (i) above is often focused on when seeking to determine whether a loan to a covered fund or a note or other debt instrument issued by a covered fund is an ownership interest or other similar interest. The voting rights with respect to a loan or a note or other debt instrument issued by a covered fund are also focused on when making such determination. One topic that was debated when the Volcker Rule was enacted was whether the rated debt securities of collateralized loan obligations ("CLOs") constitute an ownership interest or other similar interest. The debate focused on two features that are typical with respect to such debt securities – temporary deferrals of required interest payments or the mandatory early amortization in certain circumstances from available excess cash flow. Twenty-eight law firms ultimately signed a consensus memorandum that concluded neither interest deferral features nor early amortization features should cause debt securities of CLOs to be considered an ownership interest or other similar interest. A copy of the consensus memorandum is included with these materials.

3. *Sponsorship*

A "sponsor" means any entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund, (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

A trustee of a securitization transaction generally will not be considered a sponsor if it does not exercise any investment discretion for the securitization.

Generally, a banking entity that structures and offers the securities of a broadly syndicated CLO that is a covered fund in the manner typically done in the market would **not** be a "sponsor". The concept of sponsor involves a level of control (directly or indirectly) of the CLO issuer by the arranging banking entity that does not exist in a typical broadly syndicated CLO.

G. Exemption for Holding an Ownership Interest Organized and Offered by a Banking Entity

Notwithstanding that a securitization issuer may be a covered fund, a banking entity may acquire and retain an ownership interest as principal in such securitization vehicle if the banking entity or affiliate thereof "organizes and offers" the securitization so long as certain conditions specified in the Volcker Rule are satisfied. The conditions include that such "organizing and offering" is for purposes of establishing the securitization and providing the securitization with sufficient initial equity for investment to permit the covered fund to attract unaffiliated investors, subject to certain limitations, including a limit of 3% of the total value of the outstanding ownership interests in the securitization (or such greater amount that may be required to be retained by such banking entity or affiliate under the Risk Retention Rule).

In addition, a banking entity may acquire such an ownership interest if it is in connection with certain underwriting and market making-related activities with respect to a covered fund. Such underwriting and market-making activities must comply with certain conditions on underwriting and market making.

H. Exemption for Certain Permitted Foreign Covered Fund Activities

Notwithstanding that a securitization issuer may be a covered fund, certain qualifying foreign banking organizations may acquire or retain any ownership interest in, or act as sponsor to, a covered fund so long as the activity is: (i) conducted "solely outside of the United States"; and (ii) no ownership interest in the covered fund is offered for sale or sold to a resident of the United States. In particular, the following conditions must generally be satisfied:

(i) the banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(ii) the banking entity (including the relevant personnel) that makes the decision to acquire or retain the ownership interest or act as the sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(iii) the investment or sponsorship, including any related hedging transactions, is not accounted for as principal by any U.S. branch or affiliate of the banking entity;

(iv) ownership interests in the covered fund are not targeted to residents of the United States; and

(v) no financing for the banking entity's ownership or sponsorship is provided by a U.S. branch or affiliate of the foreign banking entity.

This exemption does not require that the covered fund itself have no contact whatsoever with the U.S. Thus, a foreign banking entity would be permitted to have an ownership interest in or sponsor a covered fund that itself is located in the U.S., or that contains securitized U.S. assets, provided only that the prescribed criteria are met.

I. Opinion Issues

There are practical considerations with respect to the delivery of a legal opinion that addresses any or all of the topics described in this section. A separate set of materials addresses some of these considerations.

III. **Risk Retention Rule**

A. Risk Retention Rule Applies to a "sponsor" of a "securitization transaction"

The Risk Retention Rule generally requires a "sponsor" of a "securitization transaction" or a majority-owned affiliate thereof ("MOA") to retain an economic interest in the credit risk of the underlying assets of the securitization transaction.

The Risk Retention Rule applies to a sponsor of a securitization transaction regardless of whether the related offering is registered with the SEC under the Securities Act of 1933 or is exempt from registration.

B. Effective Dates of the Risk Retention Rule

The effective date of the Risk Retention Rule with respect to residential mortgage-backed securities is December 24, 2015.

The effective date of the Risk Retention Rule with respect to all other ABS is December 24, 2016.

Subject to certain conditions, for CLO transactions that priced before the final Risk Retention Rules were published on December 24, 2014, a no action letter permits the refinancing of CLO notes without the collateral manager retaining an eligible risk retention interest under the Risk Retention Rule. The no action letter is available at www.sec.gov/divisions/corpfin/cf-noaction/2015/crescent071715-reg-rr.pdf and a copy of the no action letter is included in these materials.

C. Risk Retention Requirement

1. *General*

The Risk Retention Rules require the sponsor or its MOA to hold a vertical slice of the notes or securities issued by the securitization issuer or a horizontal slice of the subordinated notes (the first loss tranche) of the securitization issuer or a combination thereof.[3]

2. *Vertical Slice Retention*

The vertical slice requirement may be satisfied by holding an interest in each tranche of the securitization transaction that is equal to 5% of the face value of such tranche.

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[3] It should be noted that this discussion only addresses the U.S. risk retention rules. There is a separate regime that governs European risk retention rules and is not included in this discussion.

3. *Horizontal Retention*

The horizontal slice requirement may be satisfied by holding an interest in the subordinated notes of the securitization transaction that is equal to 5% of the fair value of all tranches of the securitization transaction.

The fair value must be determined in accordance with GAAP and evidence of such determination must be provided to investors in the securitization transaction a reasonable period of time prior to the sale of an ABS and a reasonable period of time after the closing date of the securitization transaction.

4. *Majority-owned affiliate (MOA); CMV*

The retention requirements of the Risk Retention Rule may be satisfied by a majority-owned affiliate (an "MOA") of a person holding the required retention piece. A "majority-owned affiliate" of a person means an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, in each case as determined under GAAP.

Most collateral managers do not have sufficient capital to acquire the required risk retention pieces for multiple transactions. As a result, they must seek capital from third party investors. This capital infusion could be made directly in the collateral manager or an MOA related thereto. Alternatively, a collateral manager could opt to form a new collateral manager vehicle (a "CMV") and capitalize it with third party capital. The option chosen by a collateral manager will depend on the facts and circumstances of such collateral manager and certain issues associated with the use of an MOA or a CMV (some of which will be discussed during the presentation).

5. *Hedging, Transfer and Finance Restriction*

The Risk Retention Rule generally prohibits affiliates of the sponsor from hedging the credit risk the sponsor or any of its MOAs is required to retain. The hedging prohibition is designed to capture hedging activities that are linked to the credit risk of the related ABS interests or exposures required to be retained by the sponsor or any of its MOAs. Hedge positions that are not materially related to the credit risk of such ABS interests or exposures required to be retained by the sponsor are not prohibited by the Risk Retention Rule.

The Risk Retention Rule generally prohibits a sponsor from transferring any interest or assets that it is required to retain thereunder to any person other than an MOA. This prohibition also applies to each such MOA.

The Risk Retention Rule prohibits a sponsor and its affiliates from pledging as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) any ABS interest that the sponsor is required to retain with respect to a securitization unless the obligation is with full recourse to the sponsor or its affiliate (including an MOA under certain circumstances), as applicable.[4]

The hedging and transfer restrictions expire as follows:

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

a. the date on which the total unpaid principal balance (if applicable) 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 cut-off date of the securitization transaction;

b. 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

c. two years after the date of the closing of the securitization transaction.

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

a. 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% of the total unpaid principal balance of such residential mortgages at the closing of the securitization transaction; or

b. seven years after the date of the closing of the securitization transaction.

6. *Specific Provisions for Asset Classes or Structures*

The Risk Retention Rule contains provisions that are specific to certain types of asset classes or structures. These include revolving pool securitizations (seller's interest), CMBS (B piece buyer), originator retention, asset-backed commercial paper conduit, government sponsored entities, tender option bonds and CLOs. The remainder of these materials will focus

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[4] Although the Risk Retention Rule does not expressly address the disposition of a pledged retained interest, the adopting 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.

on CLOs because there are certain unique features of CLOs that require analysis and structuring prior to December 24, 2016.

7. *Unique Features of CLOs*

A collateral manager of a CLO that closes prior to December 24, 2016 does not have to satisfy the retention requirements of the Risk Retention Rule with respect to such CLO. There are, however, certain features of CLOs that could trigger the application of the Risk Retention Rule to a collateral manager of a CLO that closed prior to December 24, 2016. Specifically, CLOs contain provisions which permit the debt to be refinanced or re-priced. The occurrence of these events could be viewed as a new securitization transaction that triggers the application of the Risk Retention Rule. There is a fair degree of uncertainty as to how a collateral manager can satisfy the retention requirements for a CLO with respect to which no such requirement initially existed. The SEC provided no action relief for CLOs that closed prior to the date on which the Risk Retention Rule was adopted ("Pre-Adoption CLOs") pursuant to the no action letter described in Section III.B above. Subject to certain requirements specified in the no action letter, a collateral manager of a Pre-Adoption CLO will not be required to comply with the Risk Retention Rule if a refinancing or re-pricing of such Pre-Adoption CLO occurs on or after December 24, 2016. Market participants have also received non-binding verbal advice with respect to CLOs that closed after the date on which the Risk Retention Rule was adopted, but prior to December 24, 2016 ("Post-Adoption CLOs"). If a refinancing or re-pricing of a Post-Adoption CLO occurs on or after December 24, 2016, the collateral manager of such Post-Adoption CLO must comply with the risk retention requirements by either acquiring 5% of each tranche that is being refinanced or re-priced or an interest in the outstanding subordinated notes equal to 5% of the fair value of all tranches being refinanced or re-priced.

8. *Opinion Issues*

There are practical considerations with respect to the delivery of a legal opinion that addresses any or all of the topics described in this section. Some of these considerations will be discussed during the presentation.

Clients&FriendsMemo

The Volcker Rule's Impact on Banking Entities' Ownership and Sponsorship of Structured Finance and Securitization Transactions

December 17, 2013

On December 10, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the **"Agencies"**) released the long-awaited final regulations[1] (the **"Final Regulations"**) that implement Section 13 of the Bank Holding Company Act (also known as the **"Volcker Rule"**), which was added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **"Dodd-Frank Act"**). This memorandum will focus on the Volcker Rule's impact on structured finance and securitization transactions.

The Agencies previously issued a proposed version of the regulations (the **"Proposed Regulations"**) in November 2011, which generated a significant number of comments from participants in the financial markets and the general public. We have previously published memoranda on (i) the general prohibitions of the Volcker Rule as set forth in the statutory provisions of the Act;[2] and (ii) the application of the proposed Volcker Rule to: foreign banking organizations; municipal bonds and municipal tender option bond programs; and financial institutions' ownership and sponsorship of structured finance and securitization transactions.[3]

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1 For the text of the Final Regulations see http://www.federalreserve.gov/aboutthefed/boardmeetings/final-common-rules-20131210.pdf.

2 See *An Analysis of the Dodd-Frank Act's Volcker Rule*, October 15, 2010, at http://www.cadwalader.com/resources/clients-friends-memos/an-analysis-of-the-dodd-frank-acts-volcker-rule.

3 See, *The Volcker Rule's Significant Impact on a Foreign Banking Organization's Proprietary Trading Activities*, October 13, 2011, at http://www.cadwalader.com/resources/clients-friends-memos/the-volcker-rules-significant-impact-on-a-foreign-banking-organizations-proprietary-trading-activities; *A Critical Analysis of the Potential Impact of the Volcker Rule on Municipal Bonds*, December 12, 2011, at http://www.cadwalader.com/resources/clients-friends-memos/a-critical-analysis-of-the-potential-impact-of-the-volcker-rule-on-municipal-bonds; and *The Volcker Rule's Impact on Financial Institutions' Ownership and Sponsorship of Structured Finance and Securitization Transactions*, November 3, 2011 at http://www.cadwalader.com/resources/clients-friends-memos/the-volcker-rules-impact-on-financial-institutions-ownership-and-sponsorship-of-structured-finance-and-securitization-transactions.

Based on the changes that were made by the Agencies in the Final Regulations, the most common types of loan securitizations (such as those backed by residential and commercial mortgages, student loans, credit card receivables, auto loans and leases, and equipment leases, which represent a substantial majority of the current securitization market), as well as securitizations of more esoteric asset classes (such as those backed by time share loans, container leases and servicer advances), will not be subject to the Volcker Rule and, as a result, the activities of banking entities with respect to such securitizations will not become subject to the restrictions and compliance requirements imposed by the Final Regulations.

However, certain other types of structured finance and securitization transactions will be subject to the Volcker Rule, such as: collateralized loan obligations **("CLOs")** that are backed in part by bonds or other non-permitted securities; synthetic asset-backed securities; and certain resecuritizations and repackagings of securities. This memorandum will discuss the restrictions and compliance requirements imposed by the Volcker Rule on banking entities with respect to those other types of securitizations.

Volcker Rule Generally

The Volcker Rule, among other things, prohibits any "banking entity" from engaging in proprietary trading and acquiring or retaining an "ownership interest" in, or having certain relationships with, a "covered fund", subject to certain exemptions.

Conformance Period

Banking entities will have until July 21, 2015 to bring any existing activities and investments into compliance with the Volcker Rule, subject to two 1-year extensions at the discretion of the Agency that oversees the relevant banking entity upon a determination that an extension would not be detrimental to the public interest (the **"Conformance End Date"**).[4]

What is a "Banking Entity"?

The Volcker Rule applies to the activities and investments of "banking entities". Under the Volcker Rule, a "banking entity" is defined broadly and includes (i) FDIC-insured depository institutions, (ii)

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[4] Although conformance is not required until July 21, 2015, a banking entity is "expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of [the Volcker Rule and the Final Regulations] by no later than the end of the conformance period". *See* Board of Governors of the Federal Reserve System, *Order Approving Extension of Conformance Period* (Dec. 10, 2013), at p. 3.

companies that control an FDIC-insured depository institution, (iii) bank holding companies (including a foreign banking organization) and (iv) affiliates or subsidiaries of any of the foregoing.

How Are Structured Finance and Securitization Transactions Affected?

Essential to analyzing the impact of the Volcker Rule with respect to any securitization transaction is determining whether such securitization is a "covered fund" under the Volcker Rule. If the securitization IS NOT a covered fund, then the restrictions in the Volcker Rule on the activities of a banking entity with respect to such securitization will not apply. If the securitization IS a covered fund, and a bank entity sponsored or acts as investment adviser or investment manager to and/or "organized and offered" such covered fund, then such banking entity will be subject to the restrictions and compliance requirements, described below, with respect to such securitization.

What is a "covered fund"?

Under the Volcker Rule, unless an issuer fits within one of the specific exclusions discussed below, such issuer will be a "covered fund" if it (i) would be an investment company but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (**"ICA"**), (ii) is a commodity pool for which the commodity pool operator has claimed exempt pool status under Section 4.7 of the regulations of the Commodity Futures Trading Commission (**"CFTC"**) or that could qualify as an exempt pool and the participation units of which have not been publicly offered to persons who are not qualified eligible persons under Section 4.7 of the CFTC's regulations or (iii) is a foreign issuer that (a) is sponsored, or has an ownership interest held, by a U.S. banking entity (or a foreign affiliate of a U.S. banking entity), (b) is organized primarily for the purpose of trading securities, and (c) would be an investment company but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the ICA if such foreign issuer were subject to U.S. securities laws.

> *Note: Any securitization that is not an investment company pursuant to Section 3(c)(5) of the ICA or Rule 3a-7 under the ICA will not be a "covered fund" for purposes of the Volcker Rule and thus the Volcker Rule's restrictions on activities of banking entities and required compliance related to covered funds will not apply with respect to such securitization.*

> *Note: A securitization issuer that would ordinarily rely on Section 3(c)(7) of the ICA and would therefore be a covered fund under the Volcker Rule could instead opt to maintain its exemption pursuant to Rule 3a-7 to the extent it could be structured to comply with the requirements of Rule 3a-7. This solution would not work, however, for any actively managed securitizations (e.g., CLOs) that need the flexibility to engage in any*

discretionary trading of assets for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.[5]

Express exclusions from covered fund definition

In response to the significant number of comments received regarding the covered fund definition in the Proposed Regulations, the Agencies included in the Final Regulations exclusions from the covered fund definition for a number of entities. As a result, any issuer that fits within any of these exclusions will not be a covered fund, notwithstanding that such issuer would otherwise fall within the definition of covered fund described above. The exclusions that are most relevant in the securitization context are the exclusions for loan securitizations, qualifying asset-backed commercial paper (**"ABCP"**) conduits, qualifying covered bonds and wholly-owned subsidiaries.

- *Loan securitizations*. The loan securitization exclusion will apply to an issuing entity of asset-backed securities[6] (**"ABS"**) if the underlying assets or holdings are comprised solely of:

  (1) loans (defined as any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative[7]);

  (2) any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans and that satisfy the requirements of clauses (5) and (6) below (**"Permitted Rights and Other Assets"**);

  (3) certain interest rate or foreign exchange derivatives that (i) "directly relate" to the loans in the issuing entity, the related ABS or Permitted Rights and Other Assets[8] and (ii) reduce

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[5] The key requirements in order for a securitization issuer to avail itself of Rule 3a-7 are: (1) issued debt must be rated no lower than BBB-/Baa3 by each rating agency rating such issuer's debt, unless all investors are either (a) institutional accredited investors under Section 501(a)(1), (2), (3) or (7) of Regulation D under the Securities Act of 1933, as amended (the **"Securities Act"**), or (b) qualified institutional buyers under Rule 144A under the Securities Act (who are also permitted to buy non-fixed income securities under Rule 3a-7); and (2) the issuer must comply with certain restrictions on the sale and disposition of collateral, namely that it does not dispose of assets "for the primary purpose of recognizing gains or decreasing losses resulting from market value changes."

[6] As defined in Section 3(a)(79) of the Securities Exchange Act of 1934, as amended (the **"Exchange Act"**).

[7] The Agencies indicated in the preamble (the **"Preamble"**) accompanying the Final Regulations that "the determination of whether an instrument falls outside the definition of loan because it is a security or a derivative is based on the federal securities laws and the Commodity Exchange Act. Whether a loan, lease, extension of credit, or secured or unsecured receivable is a note or evidence of indebtedness that is defined as a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the transaction."

[8] The Agencies indicated in the Preamble that they "would expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives would exceed the greater of either the outstanding principal balance of the loans supporting the asset-backed securities or the outstanding

the interest rate and/or foreign exchange risks related to such loans, the related ABS or Permitted Rights and Other Assets;

(4) certain special units of beneficial interest (**"SUBI"**) and collateral certificates (which are issued in certain intermediate securitizations that are created solely for the purpose of facilitating a securitization)[9];

(5) cash equivalents for purposes of the Permitted Rights and Other Assets; and

(6) securities received in lieu of debts previously contracted with respect to the loans supporting the ABS.

In addition, in order to qualify for the loan securitization exclusion, the issuing entity is not permitted to own or hold any of the following:

(1) a security, including an ABS, or an interest in an equity or debt security other than as permitted above;

(2) a derivative, other than as permitted above; and

(3) a commodity forward contract.

Note: Issuers of synthetic ABS and resecuritizations and repackagings of securities that ordinarily rely on Section 3(c)(7) of the ICA would not qualify for the loan securitization exclusion, and therefore would be covered funds.

Note: In addition, CLOs typically rely on Section 3(c)(7) of the ICA for purposes of the exemption from the registration requirements of the ICA. As result, most CLOs will be covered funds unless they qualify for the loan securitization exclusion. CLOs, whether issued before the recent financial crisis (so-called "CLO 1.0"-era deals) or during the past three years (so-called "CLO 2.0"-era deals), are typically permitted to invest in limited "buckets" (generally expressed as a percentage of the portfolio) of senior secured bonds. Except as noted below, the presence of any bonds in the portfolio of a CLO issuer after the Conformance End Date would disqualify such CLO issuer from the loan securitization

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principal balance of the asset-backed securities. . . . (For example, a $100 million securitization cannot be hedged using an interest rate hedge with a notional amount of $200 million.)"

9 The SUBI and collateral certificates are permitted assets where (i) the special purpose vehicle (**"SPV"**) that issued the SUBI or collateral certificates itself satisfies the conditions of the loan securitization exclusion, (ii) the SUBI or collateral certificates must be used for the sole purpose of transferring economic risks and benefits of the loans to the issuing entity for the securitization and may not directly or indirectly transfer any interest in any other economic or financial exposures, (iii) the SUBI or collateral certificates must be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization and (iv) the SPV issuing the SUBI or collateral certificates and the issuing entity for the excluded loan securitization transaction must be established under the direction of the same entity that initiated the loan securitization transaction.

exclusion. Even if the collateral manager that is responsible for the management of a CLO issuer's portfolio sold all of the bonds in the portfolio before the Conformance End Date and agreed not to use, after the Conformance End Date, any bond bucket available under the CLO transaction documents, it remains to be seen whether, in the absence of formal amendments to such transaction documents, banking entities could become comfortable that such arrangements ensure a CLO qualifies for the loan securitization exclusion. This issue may be more acute for CLO 2.0-era deals, since most deals from the CLO 1.0-era have entered their amortization phase during which little or no investment in additional assets is permitted and/or may have been optionally redeemed or reached their scheduled final maturity prior to the Conformance End Date.

Note: A securitization vehicle, including a CLO issuer, will not fail to qualify for the loan securitization exclusion solely due to the fact that it owns an asset that does not meet the definition of "loan" so long as it received such asset in connection with a bona fide restructuring, workout, or foreclosure of a loan held by that entity. Specifically, Section __.10(c)(8)(iii) of the Final Regulations permits the ownership of "securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities."

- Qualifying ABCP conduits. The qualifying ABCP conduit exclusion will apply to an issuing entity of ABCP if the underlying assets or holdings are comprised solely of:

  (1) loans or other assets that would be permissible under the loan securitization exclusion, and

  (2) ABS that are supported solely by assets permissible under the loan securitization exclusion and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.

In addition, in order to qualify for the qualifying ABCP conduit exclusion, the issuing entity must issue only ABS, comprising of a residual and securities with a term of 397 days or less and a "regulated liquidity provider"[10] must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term ABS issued in the event that funds are required to redeem the maturing securities.

[10] A regulated liquidity provider is (i) a depository institution as defined in Section 3 of the Federal Deposit Insurance Act; (ii) a bank holding company or a subsidiary thereof; (iii) a savings and loan holding company, provided all or substantially all of the holding company's activities are permissible for a financial holding company, or a subsidiary thereof; (iv) a foreign bank whose home country supervisor as defined in Section 211.21 of the Federal Reserve Board's Regulation K 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 or (v) a sovereign nation.

Note: This exclusion would not be available to certain ABCP programs, including structured investment vehicles, securities arbitrage programs and other programs that do not satisfy the requirements of this exclusion, most notably the permissible assets limitation, the initial issuance requirement and the 100% liquidity requirement.

Note: Clause (2) of the above exclusion clarifies that the ABS being financed have been issued by and acquired directly from the issuer or acquired directly from the underwriter and not purchased in the secondary market. Under this exclusion, ABCP conduits may no longer purchase ABS interests in the secondary market. This requirement may potentially impact subsequent syndications by underwriters in the ABCP market although regulators most likely did not intend such a result.

Note: Not all ABCP conduits have 100% liquidity coverage and, if they do, it is not clear why a "regulated liquidity provider" is required so long as such provider has a high enough credit standing. Also, it is unclear why the federal banking agencies would require the regulated liquidity provider to provide 100% liquidity coverage when the liquidity provider is typically the bank sponsor of the ABCP conduit. The Volcker Rule's purpose is to protect banks, not investors in ABCP conduits.

- Qualifying covered bonds. The qualifying covered bond exclusion will apply to an entity that owns or holds a dynamic or fixed pool of assets that covers the payment obligations of covered bonds only if such assets or holdings meet the requirements of the loan securitization exclusion. In addition, the covered bonds must be debt obligations that are issued either directly (i) by a foreign banking organization[11] (in which case, the payment obligations of the covered bonds must be fully and unconditionally guaranteed by the entity that owns the permitted cover pool, as described in the prior sentence) or (ii) by the entity that owns the permitted cover pool (in which case, (a) the payment obligations of the covered bonds are fully and unconditionally guaranteed by a foreign banking organization and (b) the issuer of the covered bond is a wholly-owned subsidiary (as described in the wholly-owned subsidiary exclusion below) of such foreign banking organization.

  Due to the requirement that a cover pool can only contain assets that would satisfy the loan securitization exclusion, covered bond programs that include non-loan assets, such as RMBS, would not be able to rely on this exclusion.

[11] Foreign banking organization" has the same meaning as in Section 211.21(o) of the Board's Regulation K (12 CFR 211.21(o)), but does not include a foreign bank organized under the laws of certain U.S. territories or possessions.

- *Wholly-owned subsidiaries.* The wholly-owned subsidiary exclusion will apply to any entity, if all of its outstanding ownership interests are owned directly or indirectly by the banking entity (or an affiliate thereof), except that: (i) up to five percent of the entity's ownership interests may be owned by directors, employees, and certain former directors and employees of the banking entity (or an affiliate thereof); and (ii) within the five percent ownership interests described in clause (i) above, up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

  Note: The wholly-owned subsidiary exclusion was included simply to prevent a wholly-owned entity from becoming a covered fund merely because it relies on Section 3(c)(1) or 3(c)(7) of the ICA as the exemption from being regulated as an investment company. A wholly-owned subsidiary of a banking entity, although excluded from the definition of covered fund, still would itself be a banking entity, and therefore remain subject to the prohibitions and other provisions of the Volcker Rule. For example, a wholly-owned subsidiary could not itself acquire an ownership interest in a covered fund, unless an exemption was available.

Impact of Securitization or Structured Finance Transactions Being Covered Funds

If a securitization or structured finance transaction is a covered fund that may not avail itself of one of the exclusions from the covered fund definition, then any banking entity, subject to certain exceptions that will be discussed below, may not, as principal, directly or indirectly, acquire or retain any "ownership interest" in or "sponsor" such covered fund.

In order to make clear that the scope of the above-referenced prohibitions relate to a banking entity acting as principal, the Final Regulations expressly provide that the prohibited activities do not include acquiring or retaining an ownership interest in a covered fund by a banking entity:

(1) acting solely as agent, broker, or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;

(2) through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are or were employees of the banking entity (or an affiliate thereof);

(3) in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no

event may the banking entity retain such instrument for longer than such period permitted by the appropriate agency; or

(4) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

What is an "ownership interest"?

The Final Regulations define "ownership interest" to mean any equity, partnership, or other similar interest. An "other similar interest" is defined to mean an interest that on a current, future or contingent basis[12]:

(1) has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(2) has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;

(3) has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(4) has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

(5) provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

(6) receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

[12] Although the phrase "current, future or contingent basis" does not appear in the text of the Final Regulations, it is included in the Preamble's discussion of the definition of "ownership interest." See p. 608 of the Preamble.

(7) any synthetic right to have, receive, or be allocated any of the rights in paragraphs (1) through (6) above.

Note: The holder of an interest referred to in clause (1) above need only have the right to "participate in" the selection or removal process of the parties specified above. It is not necessary that such holder be able to control such selection/removal process, or actually participate in the selection or removal process.

In the Preamble, the Agencies made clear that the "definition of ownership interest will apply regardless of the type of legal entity or the name or legal form of the particular interest. The determination of whether an interest is an ownership interest under the final rule will depend on the features and characteristics of the particular interest, including the rights the particular interest provides its holder, including not only voting rights but also the right to receive a share of the income, gains, or profits of a covered fund, the right to receive a residual, the right to receive excess spread, and any synthetic or derivative that would provide similar rights."

Note: CLOs typically issue multiple tranches of rated, secured debt and a single tranche of unrated, unsecured equity (typically in the form of subordinated notes or preferred shares) with the most senior tranche of debt (which bears the least risk of loss) at the top of the capital structure and the most subordinated equity tranche (which bears the most risk of loss) at the bottom of the capital structure. So long as a CLO is a covered fund, the equity tranche of a CLO is unambiguously captured by the definition of "ownership interest." Whether any other tranche within a CLO's capital structure would constitute an "ownership interest" is a function of whether such tranche has on a current, future or contingent basis any of the contractual rights or features specified in the definition of "other similar interest", above.

In most CLOs, the collateral management agreement provides that the senior-most tranche of debt outstanding (typically referred to in the transaction documents as the "controlling class") has the right, either by itself or shared with the equity tranche, to remove the collateral manager for "cause" and/or nominate or approve the appointment of a successor collateral manager in connection with the resignation of the collateral manager or its removal for "cause." As such, the controlling class and any class that could become the controlling class of a CLO (i.e., any debt tranche) would appear to be captured by the language of clause (1) of the "other similar interest" definition above, unless the CLO transaction documents limited such contractual rights of a CLO debt tranche to the exercise of "remedies upon the occurrence of an event of default or an acceleration event." If a legacy CLO does not qualify for the loan securitization exclusion from the definition of "covered fund", then treatment of a CLO debt tranche as an "ownership interest" in a covered fund would necessarily result in a banking entity being prohibited on and after the Conformance End Date from holding a position in either a debt *tranche or the equity tranche of such CLO, unless (as discussed below) the banking entity "organized and offered" the covered fund that issued any such tranche. The exemption for "organized and offered" covered funds should not apply to legacy CLO transactions and going forward would only permit a limited amount of such ownership interests to be held by a banking entity.*

It is unclear whether the Agencies intend that debt tranches in CLOs be considered ownership interests in CLOs solely as result of the voting rights granted to such debt tranches on a current or contingent basis to participate in the removal of the collateral manager and the selection of the successor collateral manager. Collateral managers typically can only be removed for "cause." As a result, the right to remove and approve a successor collateral manager is more akin to a creditor's remedy being exercised as a result of a "default" by the collateral manager under the related collateral management agreement.

If a CLO debt tranche in fact represents an ownership interest in a covered fund as a result of the voting rights described above, then taking away such rights from the holder via an amendment, irrevocable waiver or assignment to a third party prior to the end of Conformance End Date should result in such debt tranche no longer being deemed an ownership interest in a covered fund for purposes of the Volcker Rule. The question exists as to whether an irrevocable waiver or assignment by the debt tranche holder would change the characterization of debt tranche as an ownership interest.

Lastly, as discussed above, if a legacy CLO were able to only hold loans then such legacy CLO would no longer be a covered fund.

Note: Until greater clarity is obtained from the Agencies regarding whether debt tranches constitute ownership interests in a CLO that is a covered fund, it seems advisable to include an amendment provision in CLOs going forward that would permit a holder of a debt tranche that is a banking entity to amend the related indenture in a manner that would alter any voting rights granted to such holder so that such debt tranche would no longer constitute an ownership interest, or to make such other changes as may be necessary to ensure the ability of banking entities to own CLO debt.

What is a "sponsor"?

The Final Regulations define "sponsor" to mean any entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund, (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or

(iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

In the context of a securitization, the Agencies indicated in the Preamble that the term "sponsor" would include a trustee that has the right to exercise any investment discretion for the securitization. The Agencies also stated that for issuers of ABS, this would generally not include a trustee that executes decision making, including investment of funds prior to the occurrence of an event of default, solely according to the provisions of a written contract or at the written direction of an unaffiliated party. In addition, the Agencies indicated that a trustee with investment discretion may avoid characterization as a sponsor if it irrevocably delegates all of its investment discretion to another unaffiliated party with respect to the covered fund – although such unaffiliated party that is so delegated would then be considered the "sponsor."

> *Note: Based on the definition of "sponsor" in the Final Regulations, a banking entity that structures and offers the securities of a broadly syndicated CLO that is a covered fund in the manner typically done in the market would not be a "sponsor". The concept of sponsor under the Final Regulations involves a level of control (directly or indirectly) of the CLO issuer by the arranging banking entity that does not exist in a typical broadly syndicated CLO.*[13] *The investment manager of a CLO selects the trustee and collateral administrator. In addition, the investment manager selects the corporate service company that will provide the directors of the CLO issuer. Furthermore, other than the name of the banking entity broker-dealer on the CLO's offering document and related marketing materials (as would be expected as part of a securities offering), the CLO issuer does not typically use the banking entity's name or variation of such name for any purpose, including in the legal name of the CLO issuer. Lastly, the assets to be included in a broadly syndicated CLO are selected by the investment manager consistent with eligibility and other criteria developed for the transaction documents and acquired from sellers in the market, which may include affiliates of the arranging bank..*[14]

[13] See pp. 633-636 of the Preamble.

[14] Based on comments received from the industry, the Agencies acknowledged that banking entities can have different types of relationships with and provide services to a covered fund without being deemed a sponsor of such covered fund. In relation to the final definition of "sponsor," the Preamble notes that "[i]f the parties that commenters described do not serve in those capacities for a covered fund, do not have those rights with respect to a covered fund or do not share a name with a covered fund, such parties would not be a sponsor for purposes of the final rule, and, therefore, they would not be subject to the restrictions applicable to the sponsor of a covered fund, including the restrictions contained in section 13(f)." See pp. 633-636 of the Preamble.

Exemption for holding an ownership interest in a covered fund that is "organized and offered" by a banking entity

Notwithstanding that a securitization vehicle may be a covered fund, the Final Regulations permit a banking entity to acquire and retain an ownership interest as principal in such securitization vehicle if the banking entity or affiliate thereof "organizes and offers" the securitization so long as certain conditions[15] are satisfied. The conditions include that such "organizing and offering" is for purposes of establishing the securitization and providing the securitization with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, subject to a limit of generally 3% of the total value of the outstanding ownership interests in the securitization (or such greater amount that may be required to be retained by such banking entity or affiliate under the risk retention rule (the **"Risk Retention Rule"**) that will be implemented under Section 15G of the Exchange Act). In addition, the Final Regulations impose an aggregate limit on all such ownership interests in "organized and offered" funds, equal to 3% of the banking entity's Tier 1 capital. Ownership interests held pursuant to the "organized and offered" exemption must also be deducted from the banking entity's Tier 1 capital[16] and the banking entity and its affiliates must comply with the restrictions on relationships and transactions described below.

> Note: *A banking entity must take affirmative steps to "organize and offer" a covered fund under Section __.11(a) of the Final Regulations. Given that very particular conditions must be satisfied, it is extremely unlikely that a banking entity could inadvertently organize and offer a covered fund solely as a result of its activities in relation to such covered fund. Presumably, a banking entity would only seek to satisfy the requirements of "organizing and offering" a covered fund if it intended to hold an ownership interest in, or sponsor, such covered fund.*

Exemption for underwriting and market making with respect to a covered fund

In addition, notwithstanding the general prohibition of a banking entity acquiring an "ownership interest" in a covered fund, a banking entity may acquire such an ownership interest if it is in connection with certain underwriting and market making-related activities with respect to a covered fund. Such underwriting and market-making activities must comply with the Volcker Rule's conditions on underwriting and market-making, found in Section __.4 of the Final Regulations.

> Note: *If a banking entity has an "ownership interest" in a covered fund that was "organized and offered" by such banking entity or an affiliate thereof, other securities constituting an ownership interest issued by such covered fund that are held by a broker-dealer affiliate of such banking entity as part of its market-making or underwriting activities need to be included for purposes of calculating compliance with the 3% "de minimis"*

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[15] These conditions are set forth in Section __.11(a) of the Final Regulations.

[16] See Section __.12 of the Final Regulations.

limitation imposed in relation to its permitted ownership of the covered fund and with respect to its ownership in covered funds collectively, as well as the deduction from Tier 1 capital for such ownership.

Exemption for certain permitted foreign covered fund activities

Notwithstanding that a securitization vehicle may be a covered fund, the Final Regulations permit certain qualifying foreign banking organizations to acquire or retain any ownership interest in, or act as sponsor to, a covered fund so long as the activity is[17]: (i) conducted "solely outside of the United States"; and (ii) no ownership interest in the covered fund is offered for sale or sold to a resident of the United States[18]. In particular, the following conditions must generally be satisfied:

(1) the banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(2) the banking entity (including the relevant personnel) that makes the decision to acquire or retain the ownership interest or act as the sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(3) the investment or sponsorship, including any related hedging transactions, is not accounted for as principal by any U.S. branch or affiliate of the banking entity;

(4) ownership interests in the covered fund are not targeted to residents of the United States; and

(5) no financing for the banking entity's ownership or sponsorship is provided by a U.S. branch or affiliate of the foreign banking entity.

Note: The Final Regulations do not require that the covered fund itself have no contact whatsoever with the U.S. Thus, a foreign banking entity would be permitted to have an ownership interest in or sponsor a covered fund that itself is located in the U.S., or that contains securitized U.S. assets, provided only that the prescribed criteria are met. This may allow offshore banking entities located outside of the U.S. to invest in securitization issuers that hold U.S. assets, provided the fund's shares are not targeted to investors who are residents of the U.S.

[17] See Section __.13(b) of the Final Regulations.

[18] "Resident of the United States" is defined as a person that is a "U.S. Person" as defined in Rule 902 of Regulation S under the Securities Act.

Restrictions on relationships and transactions with covered funds

If a securitization or structured finance transaction is a covered fund (i.e., it may not avail itself of one of the exclusions from the covered fund definition), then no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund (including a banking entity that organizes and offers an asset-backed securitization and retains an ownership interest solely due to the Risk Retention Rule), and no affiliate of such entity, may enter into a transaction with the covered fund (or with any other covered fund that is controlled by such covered fund) that would be a covered transaction as defined in Section 23A of the Federal Reserve Act (the **"FRA"**) and will be subject to Section 23B of the FRA, in each case, as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereto. These two aspects of the Volcker Rule are referred to as "Super 23A" and "Super 23B."

Generally speaking, under Super 23A, if a banking entity serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund, or that continues to hold an ownership interest due to the Risk Retention Rule, then that banking entity, and any affiliate of that banking entity, is barred from engaging in certain transactions with the covered fund, including:

> (1) a loan or extension of credit to the fund (including a derivative transaction, securities lending / borrowing transaction, or repo or reverse repo transaction that results in credit exposure to the covered fund);
>
> (2) a purchase of, or an investment in, securities issued by the covered fund (excluding any securities held under the "organized and offered" exemption);
>
> (3) a purchase of assets from the covered fund; and
>
> (4) the issuance of a guarantee, acceptance, or letter of credit on behalf of the covered fund.[19]

Generally speaking, under Super 23B all transactions between the covered fund and the banking entity (or any affiliate) must be on terms and conditions that are substantially the same as or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving nonaffiliated entities.

> Note: *Because of these restrictions on relationships and transactions with covered funds described above, banking entities may be prohibited from entering into derivatives transactions with covered funds that they sponsor or have an ownership interest in.*

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[19] In the Preamble, the Agencies make it clear that banking entities may accept covered fund shares as collateral for loans to third parties (notwithstanding the fact that such transactions are regulated by Section 23A of the FRA).

Note: Even if a banking entity or affiliate thereof is required to retain an ownership interest in a covered fund under the Risk Retention Rule, the restrictions on relationships and transactions with covered funds discussed above under Super 23A and Super 23B would apply.

Note: As noted above, a broker-dealer banking entity that structures and underwrites the securities issued by a typical broadly syndicated CLO that is a covered fund should not be considered a "sponsor" of such CLO for purposes of the Volcker Rule. Assuming that such banking entity and its affiliates do not "organize and offer" such CLO, act as investment manager or investment adviser to such CLO or otherwise own an ownership interest in such CLO (e.g., by virtue of the Risk Retention Rule once finalized), then the restrictions on relationships and transactions with covered funds discussed above under Super 23A and Super 23B would not apply. Accordingly, such banking entity and its affiliate could write an interest rate or hedging swap to such CLO. In addition, such banking entity and its affiliates could provide pre-closing warehouse financing to the CLO issuer. CLO warehousing facilities typically do not permit the lender to remove a collateral manager for "cause" and/or select its replacement (during the period of warehousing financing for a CLO, the occurrence of events that are analogous to, or would be defined in CLO transaction documents as, for "cause" events typically constitute an event of default under the relevant warehouse financing agreement). That said, if the lender in a CLO warehouse financing had any such right to remove and/or select the replacement of the CLO's collateral manager, then unless such right was drafted as a remedy by the lender following an event of default, the lender might have an impermissible ownership interest in the CLO. Of course, the warehouse facility could be structured to only include loan assets and, as a result, benefit from the loan securitization exclusion from the "covered fund" definition.

Adoption of a Compliance Program With Respect to Covered Funds

Banking entities with assets of $50 billion or more (and foreign banking organizations with U.S. consolidated assets of $50 billion or more), as well as any banking entity required to report trading metrics, are subject to certain "enhanced" compliance requirements in Appendix B to the Final Regulations. These enhanced compliance procedures contain a number of obligations relevant to securitization activities, including (i) maintaining documentation regarding all covered funds sponsored, organized and offered, or owned by the banking entity, (ii) adopting a written compliance program describing each business unit's authority to engage in covered funds activities and (iii) establishing of internal controls with respect to the 3% *(or permitted greater percentage pursuant to the Risk Retention Rule)* investment limits, Super 23A, and Super 23B.

Note: Banking entities that have investments that may constitute "ownership interests" in existing securitization transactions that are covered funds will need to determine if the banking entity needs to divest all or part of its holdings to either come into compliance with the prohibitions or, if the applicable issuers are covered by the Volcker Rule but exempt from the prohibitions, how it plans to comply with the reporting and organizational requirements. To the extent banking entities divest, this could result in selling pressure, bank losses and a negative impact on market prices that could impact all investors in similar investments and reduce liquidity for such investments.

New Documentation Requirement for Sponsorship of "Funds" (Including Securitization Vehicles)

The Final Regulations added a new documentation requirement with respect to the sponsorship of "funds" (including securitization vehicles) to the extent the sponsoring banking entity (and its affiliates) has consolidated assets in excess of $10 billion. This provision requires that banking entities that sponsored securitizations that were determined to not be covered funds maintain records for each such securitization that include:

(1) documentation of the exclusions or exemptions other than Sections 3(c)(1) and 3(c)(7) of the ICA relied on by each fund (securitization) sponsored by the banking entity (including all subsidiaries and affiliates) in determining that such fund (securitization) is not a covered fund; and

(2) for each fund (securitization) sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund provided for in the Final Regulations and described above, documentation supporting the banking entity's determination that the fund (securitization) is not a covered fund pursuant to one or more of those exclusions.

* * * *

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

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Clients&FriendsMemo

The Volcker Rule's Impact on Foreign Banking Organizations

December 20, 2013

On Tuesday, December 10, 2013, the three federal banking agencies – the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation – as well as the Securities & Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission, approved a final regulation implementing Section 619 of the Dodd-Frank Act, a statutory provision more generally known as the "Volcker Rule." The 72-page final regulations[1] with the accompanying 892-page explanatory "Preamble"[2] were issued nearly three and a half years after the enactment of the Dodd-Frank Act, and more than two years following the proposed regulations issued in October 2011. In conjunction with the adoption of the final regulations, the Federal Reserve issued an order delaying the conformance date for Volcker for an additional year, until July 21, 2015.[3]

The Volcker Rule and last week's implementing regulations are significant in a number of respects. The Volcker Rule and its regulations reflect a shift in U.S. regulatory policy towards foreign banks. While historically U.S. banking regulation sought to regulate only those activities of foreign banks that are conducted within offices or affiliates located in the U.S., the Volcker Rule regulates a foreign bank's activities conducted outside the U.S. that have certain contacts with the U.S. Second, the Volcker Rule represents the first major rollback in bank and bank holding company powers in recent times, following a three-decade period of expansionary authority. The rollback in powers is particularly noteworthy because few other countries have sought to impose similar limitations on their home country banks, and as recognized by Federal Reserve Staff when the final regulations were approved, few countries are expected to adopt Volcker-like limitations in the near future. Thus, foreign banks that become subject to the Volcker Rule will find that U.S. law is more restrictive than home country law. Finally, while the regulations are highly complex, they are also highly dependent on interpretations and positions fleshed out in the supervisory process, and thus the true impact of the Volcker Rule and its regulations will not be understood for some time.

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1 For the text of the Final Regulations see http://www.federalreserve.gov/aboutthefed/boardmeetings/final-common-rules-20131210.pdf.

2 For the text of the Preamble, see http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf

3 For the text of the Conformance Period Order, see http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf

Overview of the Volcker Rule

The Volcker Rule applies to "banking entities" – defined by statute to include FDIC-insured depository institutions, bank holding companies, savings and loan holding companies, other entities that control an FDIC-insured depository institution, and foreign banks conducting banking activities in the U.S. (referred to generally as a "**foreign banking organization**"), as well as any entity affiliated with any of the foregoing.

The Volcker Rule's statutory language – Section 619 of the Dodd-Frank Act – has three basic elements:

- A general prohibition on "proprietary trading," subject to a few exceptions, including market-making, dealing, and – only with respect to foreign banking organizations, trading activities conducted "solely outside of the United States";
- A prohibition on acquiring or retaining an ownership interest in, or sponsoring, a private equity or hedge fund (referred to in the final regulations as a "**covered fund**"), subject only to a handful of exceptions, including sponsoring, or owning de minimis interests in funds, "organized and offered" by the banking entity for certain asset management purposes and – with respect to foreign banking organizations, covered fund activities conducted "solely outside of the United States"; and
- Restrictions on certain transactions with a private equity or hedge fund if the banking entity or any of its affiliates serves as the fund's sponsor, investment adviser, or investment manager, or if the banking entity "organized and offered" the fund (these restrictions are referred to commonly as "**Super 23A & B**").

The final regulations issued this week provide further clarity on the application of the Volcker Rule to foreign banking organizations in each of these three areas, and address some (but certainly not all) of the concerns voiced in the comment letter process. Adherence to the Volcker Rule and its final regulations will impose a significant burden on foreign banking organizations and will require substantial effort to ensure full conformance by the July 21, 2015 conformance date.

We have attached a summary of the final Volcker Rule regulations, with a particular emphasis on those provisions applicable to foreign banking organizations. However, for most foreign banking organizations, the most important aspects of the final regulations are as follows:

Broad Scope: Despite requests from commenters to limit the broad geographic scope of the Volcker Rule, the final regulations reiterate the extra-territorial scope of the Volcker Rule that appeared in both the statutory language and in the proposed regulations. Under the final regulations, the Volcker Rule applies banking organizations including "any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act," as well as any affiliate or subsidiary of the foregoing (entities subject to the Volcker Rule are collectively referred to as "**banking entities**"). With respect to non-U.S. organizations, a foreign bank that maintains a branch or agency office in the U.S., as well as any foreign bank or foreign company that controls a foreign bank that has a branch or agency in the U.S., is deemed such a "bank holding company." Also covered by the Volcker Rule is any foreign company that controls an FDIC-insured bank or thrift. Finally, any affiliates of these entities are covered as well. *In sum, a non-U.S. bank that has a branch or agency in the U.S., any company or bank that controls such a non-U.S. bank, any non-U.S. company that controls an FDIC-insured bank or thrift, and any of their respective affiliates,*[4] *wherever located in the world, are all considered "banking entities" and each and every such entity is subject to the Volcker Rule.*

As a result of this sweeping scope, the Volcker Rule covers nearly 150 top-tier foreign banking organizations headquartered in more than 50 countries outside the U.S., and every one of their affiliates, wherever located.

Proprietary Trading - Exemption for Trading in Foreign Government Obligations: The Volcker Rule prohibits a banking entity from engaging in "proprietary trading" in "financial instruments" (generally, swaps and securities) subject to various exemptions (including exemptions for market-making, underwriting, risk-mitigating hedging, and trading outside the United States). The proposed regulation contained an exemption for trading in U.S. government obligations (including certain state and municipal obligations), but was silent with respect to whether an exemption was available for foreign banks or U.S. banks with respect to non-U.S. government obligations. This issue attracted criticisms during the public comment process, including comment letters from non-U.S. banking regulators.

The final regulations permit a foreign banking organization (including the U.S. branches of the foreign bank or any U.S. subsidiary) to trade in securities that are the obligations of, issued by, or guaranteed by its home country (including any agency or political subdivision, and any multinational central bank of which that country is a member) under which the foreign bank is organized. With respect to a foreign bank that operates in multiple jurisdictions through branches, it is important to note that this exemption allows only trading in the obligations of the home country of the bank – not the host country where the branch is located. The foreign banking organization may, however, trade in sovereign obligations of the host country (or, for that matter, any other instrument), provided the trading activity is structured to comply with the exemption for trading outside of the United States (discussed immediately below).

Proprietary Trading - Exemption for Trading Outside of the United States: The Volcker Rule's statutory language exempts from the proprietary trading ban those trading activities conducted by

[4] Affiliate" status is determined using the Bank Holding Company Act control test (i.e., holding 25% or more of a voting class, being a GP, controlling the selection of a majority of the directors, trustees, or managing members, or otherwise having a "controlling influence").

foreign banking organizations that occur "solely outside of the United States," but the statute did not define the phrase. The proposed regulations define that phrase, and in doing so, would have imposed a number of conditions for such activities to be deemed "solely outside of the United States," including the requirements that no counterparty to the trade may be a resident of the United States, and that the trade may not be "executed" using U.S. execution or clearing facilities (which would have effectively prohibited trading in most U.S. issuer securities. These conditions attracted criticisms regarding their impracticality in the comment process.

The final regulations soften these conditions somewhat; the prohibition on use of U.S. execution facilities was dropped entirely, and certain U.S. persons are permitted to be counterparties.

Under the final regulations, a transaction is considered to satisfy the exemption for transactions "solely outside of the United States" if the following conditions are met:

- The specific banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arranges, negotiates or executes such purchase or sale) is not located in the U.S. or organized under the laws of the U.S. or of any State, and such banking entity is not be owned or controlled, directly or indirectly, by any U.S. entity;
- The banking entity (including its relevant personnel) that makes the decision to purchase or sell as principal is not located in the U.S. or organized under the laws of the U.S. or of any State;
- The purchase or sale (including any transaction arising from risk-mitigating hedging related to the financial instruments purchased or sold) is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's purchase or sale is provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- The purchase or sale is not conducted "with or through" any U.S. entity.

Notwithstanding this last condition, a purchase or sale may be "with or through" a U.S. entity if conducted "with or through" (i) the foreign operations of a U.S. entity, (ii) a U.S. entity that is an unaffiliated *market intermediary* (i.e., a U.S. registered broker-dealer, swap dealer, securities-based swap dealer, or futures commission merchant) acting as principal and the transaction is promptly cleared, or (iii) a U.S. entity that is an unaffiliated market intermediary acting as agent and the transaction is conducted anonymously on an exchange and promptly cleared and settled.

As set forth in the final regulations, this exemption enables a foreign banking organization to engage in proprietary trading notwithstanding the Volcker Rule, provided that the transaction is arranged, negotiated, executed, booked, and financed by a banking entity located outside the U.S. (i.e., not its

U.S. branch) and not directly or indirectly by a U.S. entity, no U.S. personnel of the foreign banking organization (including its U.S. branch personnel) is involved in the arranging, negotiation, execution or decision-making of the transaction, and the counterparty is not a U.S. entity other than certain qualifying *market intermediaries* or the foreign operations of a U.S. banking organization.

Covered Funds - Foreign Regulated Funds: The Volcker Rule's statutory language and the proposed regulations define a "covered fund" solely with respect to its status under the U.S. Investment Company Act of 1940, i.e., whether the fund would be an "investment company" under the Investment Company Act of 1940 but for the exceptions set forth in Sections 3(c)(1) or (3(c)(7) (related to funds with fewer than 100 investors or funds with only qualified purchasers). If a fund is a covered fund, then no banking entity is permitted to acquire or retain an ownership interest in, or sponsor, the covered fund unless an exception applies.

Because the covered fund definition is based solely on a fund's status under the Investment Company Act, it was unclear how to treat a fund organized outside of the United States that would not be available to U.S. investors, because such funds are not subject to the Investment Company Act at all. Thus, there was a possibility that funds that were fully regulated abroad and authorized for sale to retail investors – such as a UCITS – could be considered a "covered fund."

The final regulations create an exemption for foreign public funds, i.e., issuers organized or established outside the U.S. and authorized to offer and sell ownership interests on a retail basis in the issuer's home jurisdiction (e.g., a UCITS), and which sells such ownership interests predominantly (85% or more) through one or more public offerings outside the U.S. Funds satisfying this exception are not considered "covered funds" and foreign banking organizations are not barred from acquiring or retaining an ownership interest in, or sponsoring, a foreign public fund.

It should be noted, however, that the final regulations' compliance provisions require foreign banking organizations to maintain records documenting the basis for being able to rely on this exemption (and certain of the other exemptions from the covered fund definition).

Covered Funds - Foreign Equivalent Funds: To prevent evasion of the Volcker Rule, the proposed regulations contained a provision that required banking organizations (including apparently foreign banking organizations) to determine whether any fund that is organized outside of the United States *would be* a covered fund if it were organized and offered under the laws of the United States or its shares were offered to U.S. residents; if such a fund *would be* a covered fund, the fund is then deemed a covered fund for purposes of the Volcker Rule. This provision would have required foreign banking organizations to speculate how a fund purposefully established outside the U.S. and not offering its shares to U.S. residents would be treated if the fund were established in the U.S. or its shares were offered to U.S. residents—a very challenging, hypothetical mental exercise.

The final regulations abandoned this requirement with respect to foreign banking organizations. Foreign banking organizations are free to sponsor, or acquire a retain an ownership interest in, a covered fund that is organized outside the U.S. (provided certain requirements, discussed below, are satisfied), without having to speculate how the fund would be regulated if it were organized in, or issuing into, the U.S. It is important to note that this foreign equivalent funds concept was retained (in somewhat modified form), however, for U.S. banking organizations.

Covered Funds - Activities Outside of the United States: With respect to foreign banking organizations, the Volcker Rule's statutory language permits acquiring or retaining an ownership interest in, or sponsoring, a covered fund if such activities are conducted "solely outside of the United States." In the proposed rule, the regulators imposed a number of conditions for such activities to be deemed "solely outside of the United States."

The final regulations' requirements are very similar to those requirements that were proposed, and not much relief was granted notwithstanding criticisms and concerns voiced in the comment process. In the final regulations, for covered fund activities by a foreign banking organization to be considered "solely outside of the United States," the following conditions must be satisfied:

- The banking entity acting as the sponsor, or engaging as principal in the acquisition or retention of an ownership interest, must be neither located in the U.S. nor organized under the laws of the U.S. or of any State, and such banking entity may not be owned or controlled, directly or indirectly, by any U.S. entity;
- The banking entity (including its relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor must be neither located in the U.S. nor organized under the laws of the U.S. or of any State;
- The ownership or sponsorship (including any transaction arising from risk-mitigating hedging related to the ownership interest) must not be accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's ownership or sponsorship may be provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- No ownership interest in the covered fund may be "offered for sale or sold to" a "resident of the United States."[5]

The final regulations define the phrase "offered for sale or sold to," a phrase that first appeared in the proposed regulations but was not defined. The final regulations state that an ownership interest in the covered fund is "offered for sale or sold" to a resident of the U.S. only if it is sold or has been sold pursuant to an offering that "targets" residents of the U.S. While "targets" is not defined in the

[5] Based on urgings by commenters, the final regulation adopts the same definition of "resident of the United States" as found in the SEC's Regulation S. Thus, foreign issuers will be able to use a single definition of "resident of the United States" when structuring an offering to comply with U.S. securities laws and the Volcker Rule.

final regulations, the accompanying Preamble sets forth guidelines of what may be necessary to ensure that an offering does not "target" U.S. residents, including prominent disclosures in the offering materials and controls that prevent distribution of offering materials to U.S. residents.

The accompanying Preamble makes it clear that reliance on the outside of the United States exemption does not preclude a foreign banking organization from engaging in other activities with respect to the covered fund using U.S. subsidiaries or U.S. personnel, provided that the requirements listed above are met. For example, a foreign banking organization may use its U.S. subsidiary or personnel to serve as the covered fund's investment adviser or to provide administrative services for offshore affiliates that serve as the covered fund's sponsor. The Preamble also states that tiered arrangements, e.g., arrangements in which a foreign banking organization sponsors an offshore fund, which in turn sponsors or invests in a U.S. fund, may be problematic if the offshore fund was organized for the purpose of investing in a U.S. fund.

The final regulations also make it clear that existing covered fund arrangements must be brought into compliance by the end of the conformance period (or, if either or both of the two one-year extensions are granted, by the end of the extension period), and that there is no grandfathering for pre-existing covered fund arrangements. Thus, if a foreign banking organization has existing covered fund arrangements that are inconsistent with this outside of the United States exemption – for example, because a U.S. subsidiary acts as a general partner or because the fund either has U.S. investors or is not closed to U.S. investors – the foreign banking organization may need to take steps to address these issues by the end of the conformance period (or any extended conformance period).

Covered Funds – Super 23A & Super 23B Restrictions on Transactions with Certain Covered Funds: The Volcker Rule establishes special restrictions on transactions between a covered fund and any banking entity that serves as an *investment manager, investment adviser, organizer and offeror,* or *sponsor* with respect to that covered fund (or transactions between the fund and any affiliate of such banking entity) – *regardless* whether the banking entity has an ownership interest in the fund. These provisions are nicknamed "Super 23A" and "Super 23B" because they incorporate by reference provisions found in Sections 23A and 23B of the Federal Reserve Act.

- The Volcker Rule's 'Super 23A" provision flatly bars any transaction between such covered fund and the banking entity (or its affiliate) if such a transaction would be considered a "covered transaction" within the meaning of Section 23A of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate" (subject to certain exceptions). Generally speaking, this provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in, a covered fund that is advised, managed, sponsored or organized and offered by the banking entity and its affiliates.

- The Volcker Rule "Super 23B" requires that all transactions between such fund and the banking entity (or its affiliate) comply with Section 23B of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate." Generally speaking, this provision requires all transactions between the fund and the banking entity that advised, managed, sponsored, or organized and offered the fund (or the banking entity's affiliate) to be on arms' length terms.

These aspects of the Volcker Rule, which were incorporated into the proposed regulations with little change from the statutory language, posed significant concern for foreign banking organizations because they were not subject to any geographic restriction. A foreign banking organization (and/or its affiliates), wherever located, that serve as an *investment manager, investment adviser, organizer and offeror,* or *sponsor* to a covered fund appear to be subject to the Super 23A and Super 23B restrictions, even if that covered fund is outside the U.S. and has no U.S. investors.

The final regulations do not expressly limit the seemingly global scope of Super 23A and Super 23B. At most, the final regulations contain an express exemption for acquiring an "ownership interest in a covered fund in accordance with ... the requirements of ... §__.13 of this subpart." Section __.13(b) authorizes covered fund activities that are "outside of the United States" (as explained earlier). Although not explained further in the final regulations or the accompanying Preamble, this exemption appears to enable a foreign banking organization to acquire and retain an ownership interest in a fund that satisfies the outside of the United States exemption, notwithstanding the restrictions of Super 23A. For example, a foreign banking organization could acquire an ownership interest in a covered fund for which an affiliate is the "organizer and offeror," the investment advisor, the investment manager, or sponsor, provided the outside of the United States conditions are met. However, it is not clear that this exemption would permit Super 23A transactions *other than* the acquisition of an ownership interest – such as a loan to the covered fund, a purchase of assets from the fund, or a guarantee issued on behalf of the fund.

However, other language in the Preamble suggests that the Agencies may have intended to treat a fund meeting the conditions of the Outside of the United States exemption as not being a "covered funds" for purposes of the Volcker Rule, including with respect to Super 23A and Super 23B. In connection with the Agencies' explanation of the exemption for "organized and offered" funds, the Preamble states:

> As described in more detail below, a number of commenters expressed concern about applying the requirements of [the organized and offered exemption] and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of [the Volcker Rule] and implementing regulations. The Agencies believe that many of the concerns raised with respect to applying [the organized and offered exemption] and

> the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. *In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State....* Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of [the organized and offered exemption], such as the name-sharing restriction or limitations on director and employee investments.[6]

A similar discussion appears later with respect to the scope of the compliance provisions:

> As discussed in greater detail above in Part IV.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in §__.10(b)(1), a foreign fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, *but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.*[7]

These discussions suggest that any offshore fund that complies with the outside of the United States exemption *isn't a "covered fund" at all;* if so, a foreign banking organization and its affiliates are free to engage in transactions with that fund notwithstanding the limitations of Super 23A, even if the foreign banking organization is the "organizer and offeror," the investment advisor, the investment manager, or sponsor of that fund. Yet, despite the favorable language found in the Preamble, there is no language in the final regulations that expressly confirms this.

Trade Metrics Reporting: Although not required by the Volcker Rule itself, the proposed regulations required banking organizations that engage in proprietary trading activity (including proprietary trading activity that meets certain of the exemptions, such as market-making, underwriting, or transactions solely outside the U.S.) to provide the banking agencies with seventeen trading metrics each month, compiled at the trading desk and business unit levels and calculated generally on a daily basis. The proposal contained two tiers of metrics based on the volume of trading activity, with entities having greater trading activity subject to greater reporting. However, because the thresholds were based on global trading activity, the trade metrics reporting

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[6] See Board of Governors of the Federal Reserve System, Prohibition and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) at pp. 641-42 (emphasis added).

[7] Id. at p. 765 (emphasis added).

obligation would in theory apply to foreign banking organizations that have large trading operations but little or no trading in or with the U.S.

The final regulations modify this concept in several important regards. First, the final regulations specify that, with respect to a foreign banking organization, the metrics are calculated based solely on the trading assets and liabilities of its "subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States." Thus, trading activities by a foreign banking organization's non-U.S. affiliates are not taken into account when calculating the thresholds.

Second, the final regulations provide that these trade metrics reporting thresholds will be reduced over time, and will require *monthly* reporting of trading metrics for the highest thresholds and *quarterly* reporting of metrics for the lower thresholds. Under this sliding scale concept, foreign banking organizations with trading assets and liabilities of U.S. operations of $50 billion or more must begin trade metrics reporting beginning on June 30, 2014 on a monthly basis, 30 days in arrears (but becoming 10 days in arrears in January 2015); foreign banking organizations with trading assets and liabilities of U.S. operations of $25 billion or more must begin trade metric reporting on April 30, 2016, on a quarterly basis, 30 days in arrears; foreign banking organizations with trading assets and liabilities of U.S. operations of $10 billion or more must begin trade metric reporting on December 31, 2016, on a quarterly basis, 30 days in arrears.

Third, the final regulations reduce the number of metrics from seventeen to seven. If a foreign banking entity is subject to trade metric reporting, it is required to provide these seven trading metrics data on its proprietary trading activities subject to the Volcker Rule under the various exemptions (such as market-making, underwriting, and trading in U.S. or foreign government obligations), and it is permitted – not required – to include information on its trading activities conducted pursuant to the "outside of the United States" exemption.

Compliance: Compliance provisions were not specifically mandated in the statutory language of the Volcker Rule. However, the proposed regulations contained very burdensome compliance requirements. The proposed regulations established a two-tiered approach towards compliance, with organizations having a larger volume of Volcker-related activities (i.e., trading and covered funds) being subject to much more detailed compliance obligations. The thresholds for this two-tiered approach once again were based on global activities.

For foreign banking organizations, the final regulations abandon the concept of global thresholds and instead look only to U.S. operations. Moreover, the thresholds are no longer based on the volume of Volcker-related activities but rather simply on U.S. assets.

Under the final regulations, foreign banking organizations with consolidated assets of U.S. operations of less than $50 billion are permitted to adopt standard compliance procedures addressing six core elements. Foreign banking organizations with consolidated assets of U.S. operations of $50 billion or more are required to adopt detailed, "enhanced" compliance procedures consistent with Appendix B of the final regulations. In addition, any banking organization that is required to report trading metrics (including, in theory, a foreign banking organization) is also required to adopt the "enhanced" compliance procedures. It is important to remember that the trade metrics thresholds reduce over time, such that foreign banking organizations that have U.S. trading assets and liabilities of $10 billion or more will *eventually* be obligated to adopted enhanced compliance procedures, regardless of amount of their consolidated U.S. assets.[8] Banking entities engaged in no activities covered by the Volcker Rule (other than trading in U.S. government obligations) are required to adopt compliance procedures only before engaging in activities covered by the Volcker Rule, but otherwise are not required to adopt Volcker compliance procedures.

The compliance provisions apply to any entity in the foreign banking organization that engages in at least *some* Volcker-related activities. The final regulations state that the "terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity." As discussed earlier, there is language in the Preamble suggesting that funds operating under the outside of the United States exemption are not, insofar as a foreign banking organization is concerned, a "covered fund" and therefore no compliance program would be required with respect to these fund activities.

For any banking entity with consolidated assets of more than $10 billion (including foreign banking organizations), the final regulations' compliance provisions contain a new documentation requirement with respect to funds activities. The $10 billion threshold appears to be based on *global* consolidated assets, not U.S. assets, and thus will apply to many foreign banking organizations. These banking entities are required to retain records documenting the legal basis that any fund it sponsors or acquires or retains an ownership interest is not a covered fund based on either the Investment Company Act exclusions or certain of the exemptions found in the final regulations.

Finally, with respect to banking entities that are subject to the "enhanced" compliance procedures, the final regulations adopt a "CEO attestation" requirement. Under this provision, the CEO of the banking entity must annually attest to the appropriate federal banking agency "that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program ... in a manner reasonably designed to achieve compliance with" the Volcker Rule and the final regulations. The regulations provide that "in the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management of the [U.S.] operations of the foreign banking entity who is located in the [U.S.]" The final regulations are unclear as to whether this provision allows the senior management of the U.S. operations to also provide the attestation for any non-U.S. operations of

[8] Banking entities with *global* (not *U.S.*) consolidated assets of $10 billion or less may adopt Volcker compliance procedures by including appropriate requirements in existing policies and procedures

the foreign banking organization engaged in Volcker Rule activities or even whether such CEO attestation will be required.

Effective Date: Although materials accompanying the final regulations stated that the final regulations' effective date is April 1, 2014, this is somewhat misleading. Due to the Federal Reserve's extension of the conformance period for an additional year, full conformance with the Volcker Rule's provisions is not required until July 21, 2015. Foreign banking organizations are permitted to request up to two one-year extensions; applications for the first extension period must be filed by mid-January 2015.

Although conformance is not required until July 21, 2015, a foreign banking organization is "expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of [the Volcker Rule and the Final Regulations] by no later than the end of the conformance period."[9] In that regard, the banking agencies expect all banking entities – including foreign banking organizations – to develop conformance plans for bringing their activities and investments into conformance with the Volcker Rule and will likely begin reviewing those conformance plans in 2014. During the conformance period, banking entities "should not expand [existing] activities and make investments … with an expectation that additional time to conform those activities or investments will be granted." It seems likely that, beginning no later than April 1, 2014 (i.e., the effective date of the final regulations), the agencies will expect banking entities to begin these good faith efforts and to avoid expanding activities or making investments that cannot be brought into compliance by July 21, 2015.

While the conformance period delays compliance with the Volcker Rule's restrictions until July 2015, it does not suspend the obligation to provide trading metrics. Foreign banking organizations whose U.S. trading assets and liabilities exceed the relevant thresholds must begin reporting on the relevant threshold date, regardless of the existence of the conformance period or any extensions granted.

* * * * *

A number of unresolved questions remain regarding the Volcker Rule and its final regulations. Moreover, many aspects of the Volcker Rule are left to later supervisory interpretation by the banking agencies – such as the precise scope of activities permitted under the market-making and risk-mitigating exemptions, and the scope of the compliance program needed to satisfy the regulations' compliance provisions. Many of the unresolved questions will hopefully be resolved in the coming months as banking entities begin to construct their conformance plans and these plans are reviewed by the agencies. The full impact of the Volcker Rule, however, will not likely be understood for several years, or examination cycles, afterwards.

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9 *See* Board of Governors of the Federal Reserve System, *Order Approving Extension of Conformance Period* (Dec. 10, 2013), at p. 3.

Attached is a more detailed explanation of the Volcker Rule. Inasmuch as the Volcker Rule is highly complex, the explanation is by necessity only a high-level summary.

* * * * *

For further information regarding the Volcker Rule and its final regulations, or if you have any questions about this memorandum, please contact any of the Cadwalader attorneys listed below.

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Attachment

Implications of The Volcker Rule On Non-U.S. Banks and Affiliates

I. Overview

Scope: Applies to any FDIC-insured bank or thrift, any bank holding company (including a "foreign banking organization") as well as any affiliate or subsidiary of the foregoing (collectively referred to as "banking entities")

- "FBO" is a foreign bank that maintains a branch or agency office in the U.S.; thus the Volcker Rule applies to a non-U.S. bank that has a branch or agency in the U.S., any foreign organization registered as a "bank holding company," and any of their affiliates, wherever located
- "Affiliate" status is determined using the BHCA control test (i.e., holding 25% or more of a voting class, being a GP, controlling the selection of a majority of the directors, trustees, or managing members, or otherwise having a "controlling influence")

Effective: July 21, 2015

- Prior to July 21, 2015, banking entities are expected to use "good faith efforts ... appropriate for its activities and investments, that will result in the conformance of all of its activities and investments ... by no later than the end of the conformance period"
- Banking entities are permitted to request up to two one-year extensions that may be granted in the Agencies' discretion; the first extension request must be submitted by mid-January 2015
- There is a separate five-year extension period available for holding certain "illiquid funds"
- *There is no "grandfather " concept in the Volcker Rule; all pre-existing investments and activities must be brought into compliance (or terminated) prior to the end of the conformance period (unless an extension is granted)*
- *Notwithstanding the July 21, 2015 conformance date, certain banking organizations will need to begin reporting trading metrics beginning as of June 30, 2014*

Impact: Proprietary trading & funds activities

II. Proprietary Trading

Scope: Prohibits *proprietary trading*, defined as engaging *as principal* in a *trading account* of the banking entity to buy or sell a *financial instrument*

- *As principal* includes trading on the banking entity's own behalf
    - Does not include brokerage, agent or custodian trades
- *Trading account* includes:
    - any account of a banking entity that is licensed or registered as a securities dealer, swap dealer, or securities based swap dealer (regardless whether licensed or registered under U.S. law),
    - any account treated as a "trading account" under the Market Risk Capital Rules *(although this concept appears limited to U.S. banking entities)*; and
    - any account used to purchase or sell a financial instrument for the purposes short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position from any of the foregoing purchases or sales described above
- Purchases or sales in which the banking entity holds the financial instrument for fewer than 60 days are rebuttably *presumed* to be for a *trading account* (and thus *proprietary trading*, if conducted *as principal*)
- *Financial instrument* includes securities, derivatives and swaps (including forwards and futures, and options on securities, derivatives or swaps)
    - Does not include loans, spot FX or spot currency, or physical commodities
- Repos, reverse repos, securities lending / borrowing transactions by banking entities are not considered *proprietary trading*
- Purchases or sales of a security by a banking entity for *liquidity management* purposes are not considered *proprietary trading*
    - *Liquidity management* is subject to a number of conditions, including (i) existence of a written liquidity management plan, (ii) transactions must be limited to those for short-term funding needs, (iii) securities must be highly liquid, (iv) adoption of written policies, internal controls, analysis, and independent testing

- Other exceptions for transactions required by law, in satisfaction of an existing debt, by clearing members / DCOs, or in connection with a pension plan

III. Exemptions from Proprietary Trading

With the exception of a limited exemption for trading foreign government (non-U.S.) obligations and an exemption for transactions outside the U.S., the proprietary trading provisions do not distinguish between U.S. banking entities and non-U.S. banking entities. The exemptions are as follows:

Underwriting:

- Allows trading by an underwriter in connection with the *distribution* (i.e., an offering) of *securities*
- Limited to taking positions that are "designed not to exceed the reasonably expected near term demand of clients, customers or counterparties," and reasonable efforts must be made to reduce the underwriting position within a reasonable period
- If engaged in underwriting, a banking entity's internal compliance procedures (see below) must include written policies and procedures, internal controls, analysis and independent testing
- A banking entity involved in underwriting must adopt trading desk -level product limits; desk limits; internal controls, monitoring and analysis; authorization procedures for exceptions; and "compensation limits on employees designed not to reward or incentivize excessive prohibited proprietary trading"
- *The underwriting exemption is available only to those individual banking entities that are licensed or registered to engage in underwriting activities*

Market Making:

- Allows trading by a *market maker* in *financial instruments*
    - A trading desk is deemed to be engaged in market making if the trading desk that "establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments"
- The *market making* exemption is limited to taking positions that are "designed not to exceed the reasonably expected near term demand of clients, customers or counterparties," evidenced by a

"demonstrable analysis of historical customer demand, current inventory ..., and market and other factors"

- A banking entity involved in *market making* must adopt trading desk -level product limits; desk limits; internal controls, monitoring, analysis; authorization procedures for exceptions; and "compensation limits on employees designed not to reward or incentivize excessive prohibited proprietary trading"
- If engaged in *market making*, a banking entity's internal compliance procedures (see below) must include written policies and procedures, internal controls, analysis and independent testing
- *The market making exemption is available only to those individual banking entities that are licensed or registered to engage in market making activities*

Risk-Mitigating Hedging

- This exemption allows trading in financial instruments for hedging purposes that "[a]t the inception of the hedging activity... [are] designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity"
- *Risk-mitigating hedging* may *not* "give rise, at the inception of the hedge, to any significant or new or additional risk that is not itself hedged contemporaneously"
- Hedging must be subject to ongoing recalibration
- The exemption allows both *individual or aggregate* (e.g., portfolio) *hedging,* but requires that any hedge "demonstrably reduce or otherwise mitigate the specific, *identifiable risk(s)* being hedged"
- If engaged in *risk-mitigating hedging,* a banking entity's internal compliance procedures (see below) must include written policies and procedures (including documentation regarding what positions, contracts or other holdings a trading desk may use in its hedging activities), internal controls, and independent testing, as well as "the conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to *demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged,* and such correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged"

- A banking entity must have internal controls and ongoing monitoring activity, management and authorization procedures
- Compensation arrangements for employees involved in *risk-mitigating hedging* activities must be "designed not to reward or incentivize prohibited proprietary trading"

Trading in U.S. Government Obligations

- This exemption allows trading in obligations issued or guaranteed by the U.S. Government or the government-sponsored enterprises, any the obligation of any U.S. State or any political subdivisions (including municipalities), or the obligations of the FDIC
- The exemption does not apply to *derivatives*

Trading in Foreign Government Obligations

- Under this exemption, a foreign banking organization (including the U.S. branches of the foreign bank or any U.S. subsidiary) may trade in securities that are the obligations of, issued by, or guaranteed by the home country (including any agency or political subdivision, and any multinational central bank of which that country is a member) under which the foreign bank is organized
    - *With respect to a foreign bank that operates in multiple jurisdictions through branches, it is important to note that this exemption allows only trading in the obligations of <u>the home country of the bank</u> – not the host country where the branch is located*
- A foreign bank subsidiary of a U.S. bank holding company, or a foreign affiliate of a U.S. bank holding company that is regulated in that country as a securities dealer, may trade in securities that are the obligations of, issued by, or guaranteed by the home country (including any agency or political subdivision, and any multinational central bank of which that country is a member) under which the foreign bank or securities dealer is organized
- The exemption does not apply to *derivatives*

Trading on Behalf of Customers

This exemption allows trading as trustee or fiduciary on behalf of a customer if conducted for the account of the customer, as well as riskless principal trading

Trading by Regulated Insurance Companies

- This exemption allows trading in the general account of a regulated insurance company in compliance with the laws of the country in which the insurance company is domiciled

Trading by Foreign Banking Entities

- This exemption is applicable *only* to a banking entity that is not directly or indirectly controlled by an entity that is, and is not itself, organized under U.S. or any State law
    - *The exemption is therefore unavailable to all affiliates of a top-tier U.S. bank holding company, or to the U.S. subsidiaries of a foreign banking organization (or any banking entity directly or indirectly controlled by a U.S. subsidiary of a foreign banking organization)*
- Allows trading without restriction (i.e., notwithstanding the provisions of the Volcker Rule) by such banking entities, subject to certain conditions:
- The banking entity is a "qualified banking organization" or meets certain predominance tests regarding the nature and source of its global assets and revenues;
- The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale)" is not located in the U.S. or organized under the laws of the U.S. or of any State;
- The banking entity (including its relevant personnel) that makes the decision to purchase or sell as principal is not located in the U.S. or organized under the laws of the U.S. or of any State;
- The purchase or sale (including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold), is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- The purchase or sale is not conducted "with or through" any *U.S. entity*.
    - Notwithstanding this condition, a purchase or sale may be "with or through" a U.S. entity if conducted with or through (i) the foreign operations of a U.S. entity, (ii) a U.S. entity that is an unaffiliated *market intermediary* (i.e., a U.S. registered broker-dealer, swap dealer, securities-based swap dealer, or futures commission merchant) acting as *principal* and the transaction is promptly cleared, or (iii) a U.S.

entity that is an unaffiliated *market intermediary* acting as *agent* and the transaction is conducted anonymously on an exchange and promptly cleared and settled

- For purposes of the foregoing, a *U.S. entity* is any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State.
- For purposes of the foregoing, a U.S. branch of agency of a foreign bank is deemed to be located in the U.S.
- *This exemption enables a foreign banking organization to engage in proprietary trading notwithstanding the Volcker Rule, provided that the transaction is arranged, negotiated, executed, booked, and financed by a banking entity located outside the U.S. (i.e., not its U.S. branch), no U.S. personnel of the foreign banking organization (including its U.S. branch personnel) is involved in the arranging, negotiation, execution or decision-making of the transaction, and the counterparty is not a U.S. entity other than certain qualifying* market intermediaries *or the foreign operations of a U.S. banking organization*

No Material Conflicts of Interests, Material Exposures, or Threats to Safety and Soundness

- None of the above exceptions are available if the transaction involves or will result in a *material conflict of interest* with a client, customer or counterparty, will result in a *material exposure to a high-risk asset or high-risk trading activity,* or will pose a threat to the safety and soundness of the banking entity or to U.S. financial stability
- The prohibition on conflicts of interest may be avoided if the banking entity makes an appropriate disclosure to the client, customer or counterpart, or if the banking entity establishes information barriers to prevent the conflict of interest from resulting in or involving a material adverse effect on the client, customer or counterparty

IV. Covered Fund Activities

Scope: Prohibits a banking entity, *as principal*, from directly or indirectly acquiring or retaining an *ownership interest* in, or *sponsoring,* a *covered fund*

- *As principal* excludes acquiring or retaining an ownership interest (i) as agent, broker, or custodian conducted for the account of or on behalf of a customer, (ii) through certain deferred compensation or similar plans, or (ii) as trustee or a similar fiduciary capacity on behalf of customers

- *Ownership interest* means any equity, partnership, or *other similar interest*
    - *Other similar interest* is broadly defined to include certain contractual rights or clauses, such as the mere right to participate in the selection or removal of the general partner, managing member, member of the board of directors or trustees, investment manager or investment adviser (whether or not such right is exercised or is outcome-determinative); certain profit-sharing rights or equity-kickers (other than certain profit sharing rights held by investment managers, investment advisers, commodity trading advisers or servicers, or their employees), the rights to any residual; the right to excess spreads; a clause resulting in a modification in the amount of interest paid based on losses or the performance of the covered fund; pass-through income; or synthetic right to have, receive or allocated any of the above rights described above
    - *The broad* other similar *interest definition could cause instruments typically considered to be debt rather than equity to be nonetheless an ownership interest for purposes of the Volcker Rule*
- *Sponsoring* means (i) to serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund; (ii) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) to share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name
- *Covered fund* means an issuer that would be an "investment company" under the Investment Company Act of 1940 but for the exceptions set forth in Sections 3(c)(1) or (3(c)(7) (related to funds with few than 100 investors or funds with only qualified purchasers), and issuers that are certain *commodity pools* as defined under the Commodity Exchange Act
- *Covered fund* also includes funds controlled directly or indirectly by a U.S. banking entity but organized outside the United States (and thus not subject to the Investment Company Act) that holds is, itself out as being, an entity or arrangement that raises money from investors primarily for the purposes of investing in securities for resale or other disposition or otherwise trading in securities, for which the banking entity serves as the sponsor or in which the banking entity has an ownership interest (commonly referred to as *foreign equivalent funds*)
    - *The foreign equivalent fund provisions generally apply only to U.S. banking organizations, not to foreign banking organizations; this is a significant improvement from the proposed regulations, which would have required foreign banking organizations to determine how an offshore fund would be treated if its shares were offered in the U.S.*

- *Covered fund* also does not include an issuer that can rely on Investment Company Act exemption other than Sections 3(c)(1) or 3(c)(7)

V. Exemptions from the *Covered Fund* Definition

Unlike the proposed regulations, the final regulations contain a number of exemptions from the definition of *covered fund*; these exemptions not only enable a banking entity to sponsor or retain an ownership interest in the exempted entity, but also effectively remove the exempted entity from certain transaction restrictions of the Volcker Rule (known as *Super 23A* and *Super 23B,* discussed later). Other than with respect to the *Foreign Public Funds* and *Covered Bond* exemptions, the exemptions generally apply equally to U.S. banking organizations and foreign banking organizations. These exemptions include:

- *Foreign Public Funds:* Issuers organized or established outside the U.S. and authorized to offer and sell ownership interests on a retail basis in the issuer's home jurisdiction (e.g., a UCITS), and which sells such ownership interests predominantly (85% or more) through one or more public offerings outside the U.S. (with certain additional limitations applicable to investors in foreign public funds sponsored by a U.S. bank entity)
    - The compliance provisions of the final regulation require U.S. banking organizations with assets of more than $10 billion to maintain information regarding foreign public funds sponsored by such banking entity
- *Wholly Owned Subsidiaries:* Issuers wholly owned by a banking entity or its affiliates other than (i) up to 5% held by employees, or (ii) certain de minimis holdings by third parties if necessary to establish corporate separateness or addressing bankruptcy, insolvency, or similar concerns
- *Joint Ventures:* Joint ventures with no more than 10 co-venturers, provided that the joint venture is engaged in activities permissible for the banking entity other than investing in securities for resale or other disposition
- *Acquisition Vehicles:* Limited lifetime entities created solely for the purpose of engaging in a bona fide merger or acquisition transaction
- *Foreign Pension or Retirement Accounts:* Pension funds organized outside the U.S. for the benefit of citizens or residents outside the U.S.
- *Insurance Company Separate Accounts:* Separate accounts created by an insurance company, provided that no banking entity other than the insurance company participates in the account's profits and losses

- *Bank Owned Life Insurance:* An separate account created solely for the purpose of enabling the banking entity to acquire BOLI
- *Loan Securitizations:* Issuers of asset-backed securities the assets of which issuer consist entirely of loans, rate or currency swaps related to those loans, and certain other assets related to or incidental such securitization (but generally excluding assets that are securities)
- The compliance provisions of the final regulation require banking entities with assets of more than $10 billion to maintain information regarding loan securitizations sponsored by such banking entity
- *Qualifying ABCP Conduits:* Asset-backed commercial paper conduits owning only loans (or certain related assets) and issuing securities with a legal maturity of 397 days or less, and subject to a liquidity coverage provided by a FDIC-insured bank or thrift, bank holding, savings and loan holding company, or foreign bank, or by the U.S. or foreign sovereign
- The compliance provisions of the final regulation require banking entities with assets of more than $10 billion to maintain information regarding ABCP conduits sponsored by such banking entity
- *Qualifying Covered Bond Entities:* Issuers created pursuant to covered bonds offerings by foreign banking organizations (provided the assets of which issuers are limited to those permitted for securitizations, see above)
    - The compliance provisions of the final regulation require banking entities with assets of more than $10 billion to maintain information regarding covered bond entities sponsored by such banking entity
- *SBICs and Public Welfare Investment Funds:* Issuers that are registered small business investment companies, or issuers the business of which is to make investments designed to promote public welfare (as authorized under Section 24 of the National Bank Act)
- *Registered Investment Companies or Excluded Entities:* Issuers registered under the Investment Company Act of 1940, issuers that may rely on an exemption or exclusion other than Section 3(c)(1) or 3(c)(7), or a regulated business development company
- *FDIC Receivership Entities:* Entities created by or on behalf of the FDIC in connection with an FDIC receivership or conservatorship (or an Orderly Liquidation Proceeding under Title II of Dodd-Frank)

Exemption from the Prohibition on Sponsorship or Ownership of Covered Funds

The final regulations contain several exemptions from the prohibition on *retaining or acquiring an ownership interest* in, or *sponsoring*, a *covered fund*. While these exemptions enable a banking entity to sponsor, or retain an ownership interest in, the *covered fund*, the entity nonetheless remains a *covered fund* and thus the transaction restrictions of the Volcker Rule (known as *Super 23A* and *Super 23B,* discussed later) may apply. With the exception of the exemption for *Corporate Funds Activities Outside the U.S.*, these exemptions below apply equally to U.S. banking organizations and foreign banking organization. These exemptions include:

- *Organized and Offered Funds:* This exemption permits a banking entity to sponsor a covered fund, and permits the banking entity to retain (or its affiliates to acquire) an ownership interest in the covered fund, provided that such ownership interests are reduced to de minimis levels within one year. This exemption is subject to a number of conditions:
- The banking entity (or an affiliate thereof) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services;
- The covered fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity (or an affiliate thereof), pursuant to a written plan or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund;
- The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under certain thresholds set forth in the Volcker Rule;
- The banking entity and its affiliates comply with the requirements of Super 23A and Super 23B;
- The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;
- The covered fund, for corporate, marketing, promotional, or other purposes:
    - Does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof); and
    - Does not use the word "bank" in its name;
- No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity

or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest; and

- The banking entity:
  - Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):
    - That "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate";
    - That such investor should read the fund offering documents before investing in the covered fund;
    - That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and
    - The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and
  - Complies with any additional rules of the appropriate Federal banking agencies, the SEC, or the CFTC, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.
- Banking entities (and their affiliates) are required to reduce their ownership interests in organized-and-offered funds to certain de minimis limits within one year:
  - *Per-fund limit:* 3% of the total number or value of the outstanding ownership interests in the fund (provided, that a banking entity is permitted to retain a larger amount solely if required under the separately proposed risk retention rules)
  - *Aggregate limit:* the aggregate value of all ownership interest of the banking entity and its affiliates in all organized-and-offered covered funds may not exceed 3% of the banking entity's tier 1 capital

- In addition, for purposes of compliance with regulatory capital requirements, a banking entity's ownership interest in all organized-and-offered covered funds must deduct from its Tier 1 capital
- Detailed provisions for the calculation of the de minimis limits (including treatment of ownership interests held by employees or directors) are included in Section __.12 of the regulations
- *Organized and Offered Asset-Backed Securities Funds:* The final regulation specifically authorizes a banking entity to rely on the organized-and-offered fund exception with respect to asset-based securitizations. This exemption therefore permits a banking entity to organize and offer an asset-backed securities fund that does not meet the *Loan Securitizations* exemption discussed previously and thus is a covered fund (for example, if the fund contains assets other than loans)
    - *Organized-and-Offered Asset-Backed Securities Funds* must meet all of the requirements of the *Organized-and-Offered Fund* exemption, other than the requirements that (i) the banking entity provide bona fide trust, fiduciary, investment advisory, or commodity trading services, and (ii) the covered fund is organized and offered only in connection with the provision of such services and only to persons that are customers of such services
    - Covered funds organized and offered under this exemption remain subject to the restrictions of *Super 23A* and *Super 23B* and thus certain transactions between the banking entity (or any affiliate) and the covered fund are prohibited
    - *An* ownership interest *acquired or retained under this exemption must be included in the "de minimis" and capital set-off calculations described above.*
- *Market Making and Underwriting.* This exemption allows a banking entity to retain or acquire an ownership interest in a covered fund if in connection with market making or underwriting activities (as described in the Proprietary Trading provisions of the Volcker Rule)
- *An* ownership interest *acquired or retained under this exemption must be included in the "de minimis" and capital set-off calculations described above.*
- This exemption does not permit a banking entity to *sponsor* a covered fund.
- *Risk Mitigating Hedging.* This narrow exemption permits a banking entity to acquire or retain an ownership interest if "designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund"
    - This exemption allows acquiring or retaining an ownership interest if [a]t the inception of the hedging activity... [it is] designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates

one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee that directly provide advisory , commodity trading advisory, or other services to the covered fund"

- Risk-mitigating hedging may not "give rise, at the inception of the hedge, to any significant or new or additional risk that is not itself hedged contemporaneously," and "must be subject to continuing review, monitoring, and management by the banking entity"
- A banking entity must have internal controls and ongoing monitoring activity, management and authorization procedures
- Compensation arrangement being hedged must relate "solely to the covered fund in which the banking entity (or any affiliate) has acquired an ownership interest and such compensation arrangement must provide that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement"
- Ownership interests held under this exemption are not required to be included in the de minimis and capital set-off calculations
- This exemption allows only acquisition or retention of an ownership interest, but not *sponsoring*
- *This exemption is considerably narrower than the exemption appearing in the proposed regulation, which allowed acquisition or retention of ownership interests if designed to mitigate a risk to an obligation to a customer*

- Covered Funds Activities Outside the U.S.
  - This exemption is applicable only to a banking entity that is not directly or indirectly controlled by an entity that is, and is not itself, organized under U.S. or any State law
    - *The exemption is therefore unavailable to all affiliates of a top-tier U.S. bank holding company, or to the U.S. subsidiaries of a foreign banking organization (or any banking entity directly or indirectly controlled by a U.S. subsidiary of a foreign banking organization)*
  - This exemption allows acquiring or retaining an ownership interest of, or sponsoring, a covered fund without restriction (i.e., notwithstanding the provisions of the Volcker Rule) by such banking entities, subject to certain conditions:

- The banking entity is a "qualified banking organization" or meets certain predominance tests regarding the nature and source of its global assets and revenues;
- The banking entity acting as the sponsor, or engaging as principal in the acquisition or retention of an ownership interest, is neither located in the U.S. nor organized under the laws of the U.S. or of any State;
- The banking entity (including its relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor is neither located in the U.S. nor organized under the laws of the U.S. or of any State;
- The ownership or sponsorship (including any transaction arising from risk-mitigating hedging related to the ownership interest) is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- No ownership interest in the covered fund is *offered for sale or sold to* a *resident of the U.S.*
  - A *resident of the U.S.* is defined as under the SEC's Regulation S
  - An ownership interest in the covered fund is *offered for sale or sale to* a resident of the U.S. only if it is sold or has been sold pursuant to an offering that "*targets*" residents of the U.S.
    - The accompanying Preamble states that a sponsor of a foreign fund will not be viewed as *targeting* U.S. residents "if it conducts an offering directed to residents of one or more countries other than the [U.S.]; includes in the offering materials a prominent disclaimer that the securities are not offered in the U.S. or to residents of the [U.S.]; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the [U.S.]"
- Ownership interests held under this exemption are not required to be included in the de minimis and capital set-off calculations
- *This exemption enables a foreign banking organization to sponsor, or retain or acquire an ownership interest in, a covered fund notwithstanding the Volcker Rule, provided that the sponsorship is conducted, and the ownership interest held*

and financed, by a banking entity located outside the U.S. (i.e., not its U.S. branch), no U.S. personnel of the foreign banking organization (including its U.S. branch personnel) is involved in the decision-making, and the ownership interests in the covered fund are sold in an offering not targeting U.S. residents

- This exemption does not preclude a foreign banking organization from engaging onshore in other activities with respect to the covered fund; for example, the foreign banking organization could serve as an investment adviser to the covered fund through a U.S. affiliate, or could use U.S. personnel with respect to administrative or back-office functions with respect to sponsorship or ownership activities.

- Acquisitions by an Insurance Company. This exemption allows the acquisition or retention of an ownership interest in a covered fund if held in the general account or in one or more separate accounts of an insurance company, conducted compliance with the laws of the country in which the insurance company is domiciled

No Material Conflicts of Interests, Material Exposures, or Threats to Safety and Soundness

- None of the above exceptions are available if the transaction involves or will result in a *material conflict of interest* with a client, customer or counterparty, will result in a *material exposure to a high-risk asset or high-risk trading activity,* or will pose a threat to the safety and soundness of the banking entity or to U.S. financial stability
    - The prohibition on conflicts of interest may be avoided if the banking entity makes an appropriate disclosure to the client, customer or counterpart, or if the banking entity establishes information barriers to prevent the conflict of interest from resulting in or involving a material adverse effect on the client, customer or counterparty

VI. Super 23A / Super 23B

The Volcker Rule establishes special restrictions on transactions between a *covered fund* and any banking entity that serves as an *investment manager, investment adviser, organizer and offeror,* or *sponsor* with respect to that fund (or transactions between the fund and any affiliate of such banking entity) – *regardless* whether the banking entity has invested in the fund. These restrictions are fairly onerous:

- No Covered Transactions (Super 23A)
    - The Volcker Rule flatly bars any transaction between such covered fund and the banking entity (or its affiliate) if such a transaction would be considered a "covered transaction" within the meaning of Section 23A of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate."
    - Generally speaking, this provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in, the covered fund.
        - Notwithstanding Super 23A, investments in the fund are permitted to the extent otherwise authorized by the Volcker Rule (e.g., ownership interests held pursuant to the Organized and Offered exception, market making and underwriting activities, and pursuant to the risk retention rule)
- Arms' Length (Super 23B)
    - The Volcker Rule requires that all transactions between such fund and the banking entity (or its affiliate) comply with Section 23B of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate."
    - Generally speaking, this provision requires all transactions between the fund and the banking entity (or its affiliate) to be on arms' length terms.
- *Neither the Volcker Rule nor the final regulations contain a blanket exemption from Super 23A or Super 23B with respect to foreign banking organizations or their activities conducted abroad. Thus, the Super 23A and Super 23B restriction on transactions with covered funds appears to apply to non- U.S. entities operating solely outside the United States, if the non- U.S. entity is merely affiliated with a foreign banking organization. The effect of this is, Super 23A appears to bar certain transactions between a foreign banking organization and a covered fund that is sponsored, organized, advised, or managed by that foreign banking organization (or an affiliate), even if no party to the transaction is located in or otherwise connected to the U.S., and even if the covered fund is not "offered for sale or sold to" U.S. residents.*
- *The final regulations, however, contain an exemption for acquiring an "ownership interest in a covered fund in accordance with … the requirements of … §__.13 of this subpart." Section __.13(b) authorizes covered fund activities that are outside of the U.S., as explained earlier. Although not explained in the final regulations or the accompanying Preamble, this exemption appears to enable a foreign banking organization to acquire and retain an ownership interest that satisfies the Outside the U.S. exemption, notwithstanding*

the restrictions of Super 23A. For example, a foreign banking organization could acquire an ownership interest in a covered fund for which an affiliate is the "organizer and offeror," the investment advisor, the investment manager, or sponsor, provided the Outside the U.S. conditions are met. However, it is not clear that this exemption would permit Super 23A transactions other than acquisition of shares – such as a loan to the covered fund, a purchase of assets from the fund, or a guarantee issued on behalf of the fund.

- *The language in the Preamble suggests that the Agencies may have intended to treat a fund meeting the conditions of the Outside of the United States exemption as not being a "covered funds" for purposes of the Volcker Rule, including with respect to Super 23A and Super 23B. In connection with the Agencies' explanation of the exemption for "organized and offered" funds, the Preamble states:*

> *As described in more detail below, a number of commenters expressed concern about applying the requirements of [the organized and offered exemption] and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of [the Volcker Rule] and implementing regulations. The Agencies believe that many of the concerns raised with respect to applying [the organized and offered exemption] and the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State.... Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of [the organized and offered exemption], such as the name-sharing restriction or limitations on director and employee investments.*

A similar discussion appears later with respect to the scope of the compliance provisions:

> *As discussed in greater detail above in Part IV.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in §__.10(b)(1), a foreign fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.*

This language suggests that any offshore fund that complies with the Outside of the United States exemption isn't a "covered fund" at all; if so, a foreign banking organization (and its affiliates) are free to engage in transactions with that fund notwithstanding the limitations of Super 23A, even if the foreign banking organization is the "organizer and offeror," the investment advisor, the investment manager, or sponsor of that fund. Yet, despite the favorable language found in the Preamble, there is no language in the final regulations that expressly confirms this.

VII. Trade Metrics Reporting

Scope:

- The trade metrics reporting obligations only to those banking organizations that have *trading assets and liabilities* equaling or exceeding certain thresholds, determined based on the four previous calendar quarters
- *Trading assets and liabilities* is not defined in the final regulation, but it appears that the regulators intend to incorporate the term as used in Call Report Instructions and capital regulations
- For purposes of the calculations, trading assets and liabilities involving obligations of or guaranteed by the U.S. or any agency of the U.S. are excluded
- For U.S. banking organizations, the threshold is calculated based on *global* considered trading assets (including all affiliates); *for foreign banking organizations, the threshold is calculated solely based on trading assets and liabilities of its "subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the [U.S.]"*
- The initial threshold of $50 billion and commences as of June 30, 2014, but the threshold will be reduced to $25 billion on April 30, 2016, and to $10 billion on December 31, 2016
- Reporting is required monthly, 30 days in arrears (reduced to 10 days in arrears in January 2015) for banking entities with trading assets and liabilities of $50 billion or more; for other banking organizations, reporting is quarterly, 30 days in arrears
    - *Thus, foreign banking organizations with historical trading assets and liabilities of U.S. operations of $50 billion or more must begin trade metrics reporting beginning on June 30, 2014 on a monthly basis, 30 days in arrears (but becoming 10 days in arrears in January 2015); foreign banking organizations with trading assets and liabilities of U.S. operations of $25 billion or more must begin trade metric reporting on April 30, 2016, on a quarterly basis, 30 days in arrears; foreign banking organizations with trading assets and liabilities of U.S. operations of $10 billion or more must begin*

trade metric reporting on December 31, 2016, on a quarterly basis, 30 days in arrears

- Trade metrics reporting entail seven metrics:
  - Risk and position limits and usage
  - Risk Factor Sensitivity
  - Value-at-Risk and Stress Value-at-Risk
  - Comprehensive Profit and Loss Attribution
  - Inventory Turnover
  - Inventory Aging; and Customer-Facing Trade Ratio
  - Trading metrics must be gathered and reported at the trading desk level, generally reflecting calculations conducted on a daily basis
  - Details on the calculations are set forth in Appendix A to the final regulation
  - Banking entities are required to reporting trading metrics with respect to market-making, underwriting, risk-mitigating hedging, and U.S. and foreign government obligations. Banking entities may, but are not required to, include trading metrics with respect to other exempted trading activity (such as trading outside of the United States)

VIII. Compliance

Scope: The compliance requirements vary depending on nature of the activities engaged in and the size of the entity (on a consolidated basis)

- Banking entities engaged in no activities covered by the Volcker Rule (other than trading in U.S. government obligations) are required to adopt compliance procedures only before engaging in activities covered by the Volcker Rule, but otherwise are not required to adopt Volcker compliance procedures

- Banking entities with consolidated assets of $10 billion or less may adopt Volcker compliance procedures by including appropriate requirements in existing policies and procedures

- Banking entities with consolidated assets of less than $50 billion (or foreign banking organizations with consolidated assets of U.S. operations of less than $50 billion) are permitted to adopt standard compliance procedures addressing six elements

- Banking entities with consolidated assets of $50 billion or more (or foreign banking organizations with consolidated assets of U.S. operations of $50 billion or more), or any banking entity, regardless of size, that is required to provide trade metrics reporting under Appendix A, are required to adopt "enhanced" compliance procedures consistent with Appendix B
  - *It is important to recognize that the threshold for reporting trading metrics will decrease from $50 billion to $10 billion by December 31, 2016; this will*

have the effect of increasing the number of banking organizations subject to the enhanced compliance procedures.

- *The final regulations require foreign banking organizations to adopt compliance procedures (either standard or enhanced, depending on their assets); these compliance procedures must be adopted by the foreign banking organization and its affiliates, wherever located, and are not limited to the U.S. subsidiaries and operations of the foreign banking organization*

IX. Six Elements:

- Written policies and procedures "to ensure that all activities and investments conducted by the banking entity that are subject to [the Volcker Rule and the final regulations] comply with the [Volcker Rule and the final regulations]"
- A system of internal controls reasonably designed to monitor compliance with [the Volcker Rule and the final regulations] and to prevent occurrence of prohibited activities and investments
- A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and the final regulations, including management review of trading limits, strategies, hedging activities, investments, incentive compensation, among others
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel (either inside or outside of the banking entity)
- Training for trading personal and managers, and other appropriate personnel
- Retention of records sufficient to demonstrate compliance, to be retained for a period of at least five years.

X. Enhanced Compliance (Appendix B)

- The *enhanced* program requirements impose highly detailed compliance obligations, including desk-level requirements, with respect to each of the six elements. The overall compliance program must be approved by the board of directors or an appropriate committee of the board (or an equivalent body) and senior management, and include governance procedures establishing management accountability.
- In particular, the enhanced compliance procedures requires the CEO of the banking entity to annually attest to the appropriate federal banking agency "that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program ... in a manner reasonably designed to achieve compliance with" the Volcker Rule and the final regulations.

- The regulations provide that "in the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management of the [U.S.] operations of the foreign banking entity who is located in the [U.S.]"
    - *The final regulations are unclear as to whether this provision allows the senior management of the U.S. operations to also provide the attestation for any <u>non-U.S. affiliate</u> engaged in Volcker Rule activities.*

XI. Fund Documentation

- For any banking entity with consolidated assets of more than $10 billion (including foreign banking organizations), the compliance procedures require retention of records documenting:
    - the exclusions or exemptions other than Section 3(c)(1) or 3(c)(7) under the Investment Company Act for any fund sponsored by the banking entity (i.e., establishing that the fund is able to rely on an exemption other than Sections 3(c)(1) or 3(c)(7));
    - supporting any the determination by the banking entity that any fund is not a *covered fund* based on the *Organized and Offered, Foreign Public Fund, Loan Securitization, Qualifying ABCP Conduit,* or *Qualifying Covered Bond* exemptions in the final regulations
    - Certain information regarding seeding vehicles that will become registered investment companies or business development companies; and
    - With respect to U.S. banking organizations only, information regarding the aggregate amount of investment in foreign public funds (to the extent exceeding $50 million)
- *Note that, with exception of the last requirement, these documentation requirements apply equally to U.S. banking organizations and foreign banking organizations*

Clients&FriendsMemo

Final Credit Risk Retention Requirements for Asset-Backed Securities Transactions

October 30, 2014

I. Introduction

On October 21-22, 2014, the federal regulatory agencies responsible for implementing regulations under The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") finalized rules for risk retention requirements in asset-backed securities (as further defined below, "**ABS**") transactions.[1] The final rules (the "**Final Rules**")[2] contain clarifications and revisions to the reproposed rules (the "**Reproposed Rules**")[3] highlighted in Part II–*Executive Summary of Significant Changes from the Reproposed Rules* below, but in most respects the Final Rules are substantially the same as the Reproposed Rules. Parts III through VII below are a restatement of our prior Clients & Friends Memo[4] updated to reflect the Final Rules.

As required by the Dodd-Frank Act, the Final Rules become effective with respect to residential mortgage-backed securities ("**RMBS**") one year after publication in the Federal Register, and with respect to all other ABS two years after such publication.

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1 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 (collectively, the "**Agencies**") published a joint notice of proposed rulemaking containing proposed rules (the "**Original Proposal**", available at http://www.sec.gov/rules/proposed/2011/34-64148.pdf) 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**").

2 The Final Rules are available at https://www.fdic.gov/news/board/2014/2014-10-21_notice_dis_a_fr.pdf.

3 The Reproposed Rules were released by the Agencies on August 28, 2013 pursuant to a notice of proposed rulemaking after receipt of comments from over 10,500 persons, institutions and groups on the Original Proposal. The Reproposed Rules are available at https://www.sec.gov/rules/proposed/2013/34-70277.pdf).

4 Our prior Clients & Friends Memo, "Reproposed Credit Risk Retention Requirements for Asset-Backed Securities Transactions", dated September 13, 2013, is available at http://www.cadwalader.com/resources/clients-friends-memos/reproposed-credit-risk-retention-requirements-for-asset-backed-securities-transactions.

II. Executive Summary of Significant Changes from the Reproposed Rules

The highlights of the Final Rules, including the most significant changes between the Reproposed Rules and the Final Rules are:

- *Repeal of Cash Flow Restrictions:* The proposed restrictions on payments to a horizontal interest retained by the sponsor (such that the rate of payment on that retained interest would not exceed the rate of principal amortization on the transaction as a whole) have been eliminated in the Final Rules. The elimination of the proposed cash flow restrictions is particularly significant for CLOs and CMBS, since compliance with such restrictions was seen by the market as commercially unfeasible, given that investors in the "equity tranche" of a CLO or the "B-piece" in a CMBS transaction require that interest be paid to them on a current basis.

- *Elimination of Certain Fair Value Calculations:* The Final Rules do not require vertical retentions to be measured using fair value. Horizontal retentions must be valued using a fair value methodology acceptable under U.S. GAAP.

- *Exclusion of non-economic REMIC residual interests.* The definition of ABS interest has been modified to exclude non-economic residual interest issued by a REMIC and uncertificated regular interest in a REMIC held only by another REMIC where both REMICs are part of the same structure and a single REMIC issues ABS interests to investors.

- *Credit Risk May be Held Through Majority-Owned Affiliates.* In addition to the sponsor being permitted to hold credit risk through a majority-owned affiliate,[5] originators, originator-sellers and third party purchasers may also do so.

- *Determination of Retained Value.* The required percentage of eligible vertical, horizontal or combined retained interest must be determined as of the closing date of the securitization transaction. Disclosure requirements relating to fair value measurement of horizontal and combined residual interests will be required a reasonable time prior to the sale of the ABS as described in the Reproposed Rules but the Final Rules permits ranges of fair values to be disclosed if the tranche sizes or rates have not been determined. Actual fair value measurements must be disclosed post-closing.

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5 "Majority-owned affiliate" of a person means an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under U.S. GAAP.

- *Revolving Pool Securitizations*. The term "Revolving Pool has been substituted for "Master Trust" to accommodate revolving deals in other than trust form. The Reproposed Rules required a sponsor to retain a seller's interest of not less than 5%. The Final Rules require the sponsor to maintain a seller's interest of not less than 5%. The Final Rules amend the definition of "revolving pool securitization" to exclude the monetization of excess spread. The Final Rules permit Sponsors to satisfy the risk retention requirement by holding a seller's interest that is either *pari passu* or partially or fully subordinate to one or more series of investor interests issued, or by holding a subordinate horizontal interest, and permit Sponsors to use cut-off dates in establishing the outstanding value of the revolving pool.

- *ABCP Conduits.* Under the Final Rules an ABCP conduit sponsor may rely on any of the risk retention options in the Final Rules if it meets the criteria for such option and need not be limited to the ABCP option. The Final Rules clarify the types of assets that can be acquired by an ABCP conduit and extends the maximum maturity of the asset-backed CP to 397 days from the nine-months in the Reproposed Rules. Disclosure requirements have been simplified and can be updated monthly rather than at each ABCP issuance.

- *CLOs*. For the most part, the Final Rules relating to CLOs are largely identical to the Reproposed Rules. The Final Rules continue to apply risk retention requirements to CLOs, irrespective of whether the underlying loans are purchased or transferred from various secondary market sources or otherwise; and the Agencies confirm that they view the manager of an open market CLO[6] (the "CLO Manager") as its sponsor. The Final Rules preserve the "lead arranger" option as a means of satisfying the sponsor's risk retention requirements with respect to "Open Market CLOs" (as defined below). The disclosures required to be made by sponsors when this option is used have been slightly expanded and the certifications required to be made by the lead arranger and the CLO Manager[7] have been revised to be more in line with those required of depositors with respect to QRMs and other qualifying asset classes.

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6 Throughout this memo, the lowercase use of "open market CLO" denotes an "arbitrage" or "broadly syndicated CLO" (in which the securitized loan assets are purchased on the secondary market), as distinct from a "balance sheet CLO" (in which the securitized loan assets are purchased as a portfolio from a single institution or its affiliates, including the entities that originated such loan assets), while the title case use of "Open Market CLO" denotes a CLO that purchases and holds "CLO-eligible loan tranches" in conformity with §__9 of the Final Rules (*i.e.*, the "lead arranger" option).

7 Note that §__9 of the Final Rules, which sets forth the risk retention requirements for "Open Market CLOs," defines "CLO manager" as "an entity that manages a CLO, which entity is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 et. seq.), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser." References throughout this memo to "CLO Manager," solely in the context of "Open Market CLOs," should be read to include the foregoing definition from §__9 of the Final Rules. See the discussion of "Open Market CLOs and the 'Lead Arranger' Option," below.

- *Tender Option Bonds*. The Final Rules permit tender option bonds ("TOBs") with a notice period of up to 397 days (as opposed to 30 days, as in the Reproposed Rules) to qualify for the specialized risk retention options contained in the Final Rules applicable to TOBs. The Final Rules add flexibility for sponsors to meet the risk retention requirements: the sponsor of a qualified tender option bond entity may combine tender option bond risk retention options with each other, as long as the sum of the retained interests equal at least 5% (*e.g.*, the sponsor may hold 3% of the face value of the bonds deposited into the entity and at least 2% of the fair value of all ABS interests issued by the entity).

- *Residential Loans*. The Final Rules exempt certain types of community-focused residential mortgages that are not eligible for QRM status, and also exempts certain closed-end loans secured by a residential dwelling (*e.g.*, home purchase, refinance, home equity loans, second or vacation homes, and mobile homes and trailers used as residences). In addition, the definition of QRM and the exemptions for community-focused residential mortgages and 3-4 unit residential mortgages will be subject to period review by the Agencies.

III. The Final 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 ABS, 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 Final Rules generally require sponsors to satisfy the 5% risk retention requirements for assets they securitize and provide some alternatives for retention by majority-owned affiliates, originators, originator-sellers, and third parties purchasers 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 Final Rules permit transfers, under limited circumstances, among the sponsor and qualified third-party purchasers in CMBS transactions after a five year holding period. The Final Rules also restrict hedging or transferring the retained risk, subject to sunset provisions, the terms of which differ for RMBS and all other ABS. The Final Rules also contain some exemptions that eliminate or reduce the required risk retention for certain ABS.

The Final Rules 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.

Under the Final Rules, sponsors (and originators, B-piece buyers and their respective majority-owned affiliates) are prohibited from pledging any retained interest as collateral for any non-recourse financing.[8]

IV. Party to Retain Risk

A. Sponsor

Under the Final Rules, the "sponsor"[9] of a "securitization transaction"[10] in which "asset-backed securities" ("**ABS**")[11] are issued is required to retain an economic interest in the

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[8] Although this restriction does not appear to expressly sunset, as is the case for transfer and hedging restrictions discussed in Part V.H, the restriction on non-recourse financing applies to ABS interests "required" to be retained. This suggests that if the ABS interest can be transferred, it should be able to be financed with nonrecourse financing.

[9] "**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. Note that the definition of "sponsor" under the Final Rules is different than as used in the Volcker Rule. The Volcker Rule's definition of "sponsor" focuses on the degree of control over the issuing entity. As a result, a banking entity might be considered to "sponsor" a vehicle for the purposes of the Final Rules, but not for Volcker Rule purposes, and *vice versa*. Care will be required when drafting documents because the term "sponsor" may be used in different regulatory contexts in the same document.

The Final Rules state 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 V.F of this memo, or (y) each loan held by the CLO qualifies for the exemption for "qualifying commercial loans" described in Part VI.B.1 of this memo. As a practical matter, CLO Managers may find it very difficult to structure a CLO transaction that satisfies the commercial loan exemption requirements.

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

[11] "**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 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

credit risk of the "securitized assets",[12] unless otherwise exempted under the Final 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 (or at least one of their majority-owned or wholly-owned affiliates) retains an economic interest in the credit risk of the securitized assets which satisfies the Final Rules.[13]

> *Note: Status as the "sponsor" has significant Volcker Rule implications. The Volcker Rule per se deems the "securitizer" under the Final Rules (which includes any "Sponsor") to be the equivalent of the "organizer and offeror" of the issuer. This means that, if the issuer is a "covered fund" (for example, a fund under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 that fails to qualify for the Volcker Rule's securitization-of-loans exemption), then the amount of ownership interest in the issuer that may be held by the sponsor (and its affiliates) will be capped by the Volcker Rule at 3% or such greater amount as required by the Final Rules. In addition, status as the "sponsor" of the issuer that is a covered fund would restrict the ability of the sponsor or its affiliates to enter into certain transactions with the issuer (such as a loan to, swap with, guarantee on behalf of, or purchase of assets from, the issuer).*

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made clear that "synthetic" securitizations are not within the scope of Section 15G set forth in the Reproposed Rules because the term asset-backed security includes only those securities that are collateralized by self-liquidating financial assets.

12 "**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 Reproposed 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 (other than (i) a non-economic residual interest issued by a REMIC or (ii) an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors), 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.

13 Although the Final Rules and the Preamble (as defined below) make it clear that there can be only one party that is acting as the "retaining sponsor" for purposes of the risk retention rules, nothing in the Final Rules or the Preamble seems to prevent a second sponsor that is also an "originator" from taking a portion of the required risk retention in its capacity as an originator.

B. Originator

The Final Rules permit a sponsor to allocate its risk retention obligations to originator(s)[14] of the securitized assets (or a majority-owned affiliate of the originator) in certain circumstances and subject to certain conditions.

For purposes of the Final 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 an originator may assume must be at least 20% but cannot exceed the percentage, by unpaid principal balance, of securitized assets it originated. The risk retention that an originator may assume must also be held in the same manner and proportion (as between horizontal and vertical interests) as the sponsor.

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 V.H of this memo. 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 Final 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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[14] "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.

C. Other Parties

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

V. Form and Amount of Risk Retention

Unless one of the exemptions described in Parts VI or VII of this memo applies to reduce or eliminate the risk retention requirement, generally, the sponsor of a securitization transaction (or a majority-owned affiliate of the sponsor) is required to retain an economic interest in the credit risk of the securitized assets equal to at least 5% of all ABS interests in the issuing entity issued as part of the transaction, including those retained by the sponsor (other than certain non-economic residual interests)[15].

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 that satisfies the risk retention requirements described below, determined as of the closing date of the securitization transaction.

- *Vertical Risk Retention*. An eligible vertical interest is an interest in each class of ABS interests issued in the securitization that constitutes the same proportion of the face value of such class. Therefore, to satisfy its risk retention obligation solely through the use of an eligible vertical interest, a sponsor is required to retain not less than 5% of the face 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 Final 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 will also meet the definition of eligible vertical interest.
- *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 or allocation date on which the issuing entity has insufficient funds to satisfy its obligation

[15] The Final Rules modified the definition of ABS interest to exclude non-economic residual interest issued by a REMIC and uncertificated regular interest in a REMIC held only by another REMIC where both REMICs are part of the same structure and a single REMIC issues ABS interests to investors.

to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable 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 Final Rules permit multiple classes to constitute an eligible horizontal residual interest, as long as they are the most subordinate classes in the capital stack (excluding any non-economic residual interests). To satisfy its risk retention obligation solely through the use of an eligible horizontal interest, a sponsor is required to retain an eligible horizontal residual interest having a fair value not less than 5% of the fair value of all ABS interests issued by the issuing entity, determined in accordance with U.S. GAAP.

- *Combined Eligible Vertical and Horizontal Retained Interest.* If a sponsor retains both an eligible vertical interest and an eligible horizontal residual interest, the percentage of the fair value of the eligible horizontal interest and the percentage of the eligible vertical interest must equal at least 5%.
- *Horizontal Cash Reserve Account.* In lieu of holding all or any part of an eligible horizontal residual interest, the Final Rules 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.[16] 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 Final Rules) may not be released to the sponsor.

[16] The Final Rules also permit such funds to be applied to pay critical expenses of the issuing entity unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses, which expenses will be paid prior to any payments to holders of ABS interests (and are made only to parties not affiliated with the sponsor).

- *Required Disclosures*: The Final Rules 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, a reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests:
    - The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction (or foreign currency amount, if the ABS interests are not denominated in U.S. dollars)) of the eligible horizontal residual interest that the sponsor expects to retain at the closing of the securitization transaction;[17]
    - A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
    - A description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;
    - All key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the eligible horizontal residual interest to be retained by the sponsor;
    - To the extent applicable to the valuation methodology used, this would include, but not be limited to, quantitative information about each of the following: discount rates, loss given default (recovery), prepayment rates, default rates, lag time between default and recovery and the basis of forward interest rates used;

[17] The Final Rules state that if the specific prices, sizes, or rates of interest of each tranche of the securitization are not available, the sponsor must disclose a range of fair values (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor expects to retain at the close of the securitization transaction based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitization. A sponsor disclosing a range of fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest of each tranche of the securitization must also disclose the method by which it determined any range of prices, tranche sizes, or rates of interest. These changes in the Final Rules resolve a potential circularity problem presented in the Reproposed Rules, which arose because the Reproposed Rules presumed that the value of the ABS interests had been determined, when in fact the calculations were required to be performed prior to pricing.

- The required disclosures must include, at a minimum, descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations; and[18]

- A summary description of 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 default rates.

  A reasonable time after the closing of the securitization transaction, the sponsor is required to disclose:

- The fair value (expressed as a percentage of the fair value of all of the 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 the eligible horizontal residual interest the sponsor retained at the closing of the securitization transaction, based on actual sale prices and finalized tranche sizes;

- The fair value (expressed as a percentage of the fair value of all of the 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 the eligible horizontal residual interest that the sponsor is required to retain under this section; and

- To the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale and required under the Final Rules materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.

  Note: The Final Rules do not specify what constitute a "reasonable time".

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[18] To the extent the disclosure required includes a description of a curve or curves, the description is required to include a description of the methodology that was used to derive each curve and a description of any aspects or features of each curve that could materially impact the fair value calculation or the ability of a prospective investor to evaluate the sponsor's fair value calculation. To the extent a sponsor uses information about the securitized assets in its calculation of fair value, such information shall not be as of a date more than 60 days prior to the date of first use with investors; provided that for a subsequent issuance of ABS interests by the same issuing entity with the same sponsor for which the securitization transaction distributes amounts to investors on a quarterly or less frequent basis, such information shall not be as of a date more than 135 days prior to the date of first use with investors; provided further, that the balance or value (in accordance with the transaction documents) of the securitized assets may be increased or decreased to reflect anticipated additions or removals of assets the sponsor makes or expects to make between the cut-off date and the closing date of the securitization

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

- The amount to be placed (or that is placed) by the sponsor in the eligible 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 interests are not denominated in U.S. dollars)) of the eligible horizontal residual interest that the sponsor is required to fund through the eligible horizontal cash reserve account in order for such account, together with other retained interests, to satisfy the sponsor's risk retention requirement;
- A description of the material terms of the eligible 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.

- *Vertical interest*. With respect to any eligible vertical interest, the sponsor must disclose a reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests:
  - the form of the eligible vertical interest;
  - the percentage that the sponsor is required to retain as a vertical interest; and
  - a description of the material terms of the vertical interest and the amount that the sponsor expects to retain at the closing of the securitization transaction.

  A reasonable time after the closing of the securitization transaction, the sponsor is required to disclose the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount previously disclosed.

B. CMBS B-Piece Buyer Retention

For CMBS transactions,[19] the Final Rules allow a sponsor to satisfy all or a portion of its risk retention obligation if a third-party purchaser ("B-piece buyer"), or a majority owned

[19] For a discussion of the Final Rules as they relate to CMBS transactions, see our prior Clients & Friends Memo "Risk Retention for Commercial Mortgage-Backed Securities: Fact Sheet," dated October 29, 2014, available at http://www.cadwalader.com/resources/clients-friends-memos/risk-retention-for-commercial-mortgage-backed-securitiesfact-sheet.

affiliate thereof, 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 Final 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.[20] Each B-piece buyer would be required to satisfy, and would be subject to, all of the requirements set forth in the Final 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.[21] The Final Rules define "commercial real estate loans" as loans that are secured by (1) 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, refinancing or financing of the property or rental income[22] from the property or (2) loans secured by a fee interest in improved land that is leased to a third party if the improvements on such land are nonresidential or residential with five or more single family units.. 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.

[20] In a situation where the risk retention is being held by both a B-piece buyer (in a horizontal interest) and the sponsor (as a vertical interest), even thought the sponsor is required to hold a vertical interest in all the CMBS classes issued, including the most subordinate CMBS interests, the sponsor's vertical interest should not be counted as a B-piece interest and should not prevent two independent third-party B-piece buyers from participating in the retention of the horizontal risk retention interest.

[21] "Servicing assets" are rights or other assets designed to assure the servicing or the timely distribution of proceeds to ABS interest holders and rights or other 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 securitized assets, including proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

[22] "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."

Note: As opposed to the Reproposed Rules, the Final Rules provide that a "commercial real estate" loan includes 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.

- 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;
    - transaction documents must provide standards with respect to the operating advisor's experience, expertise and financial strength (although the Final 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 (whether by principal prepayments, realized losses or appraisal reduction amounts), 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 that 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. The required quorum for such vote (i) may not exceed 20% of the outstanding principal balance of the CMBS and (ii) must require at least three investors that are not affiliated with each other.

  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 Final 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 Final Rules require the disclosure of the purchase price of each B-piece. 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.[23] 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).
  - Restrictions on the transfer of a B piece will not apply if all of the mortgage loans in a pool, have been defeased with cash or cash equivalents (which can include obligations backed by the full faith and credit of the United States).[24]
- *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 Final 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.

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[23] For more detail on these restrictions and the narrow exceptions thereto, see Part V.H.

[24] This provision appears in the context of the B-piece buyer's transfer restrictions (Section __.7(b)(8)(i)) and arguably does not apply to other risk retention parties. We are unaware of any reason to justify this distinction.

C. Revolving Pool Securitizations (Seller's Interest)

Revolving master trusts and similar revolving pools of assets 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 pools 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 Final Rules would allow a sponsor of a revolving asset pool securitization to satisfy the risk retention requirement by maintaining a "seller's interest" in an amount not less than 5% of the aggregate unpaid principal balance of all outstanding investor ABS interests issued by the issuing entity.[25] 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 pool securitization.

The Final Rules define a "revolving pool securitization" as an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass, or tranche of ABS that are collateralized by a common pool of securitized assets that will change in composition over time, and that does not monetize excess interest and fees from its securitized assets. 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.

> *Note: The definition of "revolving pool securitization" has been expanded from "revolving master trust" in the proposed rule in order to include revolving securitization structures that are*

[25] A sponsor of a revolving pool may also use either of two forms of subordinated horizontal interest in order to reduce the amount it is required to maintain as seller's interest in satisfaction of the risk retention rule. A sponsor may hold an eligible horizontal residual interest(as described in Part V.A of this memo) in the securitization's outstanding series of ABS interests, or alternatively, may also retain a horizontal interest 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 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 pool securitization (whether incurred in that period or carried over from prior periods) to the extent that such payments would have been included in amounts payable to more senior interests in the series.

commonly referred to as "master trusts" but do not use issuing entities organized in the form of a trust.

Note: The securitization structure need not specifically state its intention to issue multiple series in its organizational documents, as long as the entity has the ability, under its constituent legal powers, to issue more than one series.

The Final Rules define a "seller's interest" as an ABS interest or ABS interests (i) collateralized by the securitized assets and servicing assets owned or held by the issuing entity, other than certain assets not considered a part of seller's interest; (ii) that is either pari passu with each series of investor ABS interests issued, or partially or fully subordinated to one or more series in identical or varying amounts, with respect to the allocation of all distributions and losses with respect to the securitized assets prior to early amortization of the revolving securitization (as specified 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 pool securitization" 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.

Note: Assets not considered part of the seller's interest are (i) servicing assets that have been allocated as collateral only for a specific series in connection with administering the revolving pool securitization, such as a principal accumulation or interest reserve account; and (ii) assets that are not eligible under the terms of the securitization transaction to be included when determining whether the revolving pool securitization holds aggregate securitized assets in specified proportions to aggregate outstanding investor ABS interests issued.

The seller's interest must satisfy the 5% test at the closing of each issuance of ABS interests to investors by the issuing entity, and at least monthly at a seller's interest measurement date specified under the securitization transaction documents, until no ABS interest in the issuing entity is held by any person not a wholly-owned affiliate of the sponsor.

> *Note: In determining the percentage of seller's interest at the closing of each issuance, sponsors can use a specified "as of" date or cut-off date for data about the pool's assets. This cut-off date must be no more than 60 days prior to the date of first use of the related disclosures with investors, or for securitizations with quarterly or less frequent distribution, no more than 135 days prior to the date of first use of the disclosures. A sponsor must describe its use of specified dates in its disclosures to investors.*

In the case of a revolving pool securitization that holds collateral certificates issued by another revolving pool securitization having the same sponsor, the Final 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 pool securitization. The proportion of the seller's interest retained at the level of the pool securitization that issued the collateral certificates must equal the proportion that the collateral certificates represent of the principal balance of the securitized assets of the pool securitization 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 invested only in the types of assets in which funds held in a horizontal cash reserve account are permitted to be invested; and (iii) in the event of an early amortization, makes payments of amounts held in the account to holders of investor ABS interests in the same manner as payments to holders of investor ABS interests of amounts received on securitized assets.

> *Note: The Final Rules have removed the requirement that the excess funding account be pari passu to each series of investor ABS interests with respect to allocation of losses.*

The Final Rules clarify that for a sponsor of a pool securitization, a reduction in the seller's interest below the percentage required by the Final Rules after the revolving pool securitization commences early amortization, pursuant to the terms of the securitization transaction documents, of all series of outstanding investor ABS interests, 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 commencement of early amortization; (ii) the terms of the seller's interest continue to make it pari passu with or subordinate in identical or varying amounts to each series of investor ABS interests issued with respect to the allocation of all distributions and 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 Final Rules for the combination of a seller's interest with a horizontal interest; and (iv) the revolving pool securitization issues no additional ABS interests after early amortization is initiated to any person not a wholly-owned affiliate of the sponsor, either at the time of issuance or during the amortization period.

- *Required Disclosure*. If a sponsor of a revolving asset pool securitization elects to use the seller's interest option to satisfy the risk retention requirement, the Final Rules require that the sponsor disclose or cause to be disclosed in writing to potential investors, under the caption "Credit Risk Retention," (i) a reasonable period of time prior to the sale of the ABS interests, a description of the material terms of the seller's interest, and the percentage that the sponsor expects to retain at the closing of the securitization transaction, measured in accordance with the Final Rule as a percentage of the aggregate unpaid principal balance of all outstanding investor ABS interests issued, or as a percentage of the aggregate unpaid principal balance of outstanding investor ABS interests for one or more series issued, as required by the terms of the securitization transaction; (ii) a reasonable time after the closing of the securitization transaction, the amount of seller's interest the sponsor retained at closing, if that amount is materially different from the expected amount; (iii) a description of the material terms of any horizontal residual interests offsetting the seller's interest in accordance with the Final Rule; and (iv) disclosure of the fair value of those horizontal residual interest retained by the sponsor for the series being offered to investor and described in the disclosures, as a percentage of the fair value of the investor ABS interests issued, described in the same manner and within the same timeframes as is required for disclosure of eligible horizontal residual interests.

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.

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 397 days, exclusive of days of grace ("ABCP"), may satisfy the risk retention requirements if each originator-seller[26] that transfers assets to collateralize the ABCP retains an economic interest in the credit risk of such assets in the same amount and manner as would be required using the standard risk retention[27] or revolving pool securitizations[28] 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 Final 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.

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26 "Originator-seller" means an entity that originates assets and sells or transfers those assets, directly or through a majority-owned affiliate, to an intermediate SPV, and includes (except for the purposes of identifying the sponsorship and affiliation of an intermediate SPV pursuant to this option) any affiliate of the originator-seller. For purposes of this definition, "majority control" means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under U.S. GAAP.

"Intermediate SPV" means a special purpose vehicle that: (1)(i) is a direct or indirect wholly-owned affiliate of the originator-seller; or (ii) has nominal equity owned by a trust or corporate service provider that specializes in providing independent ownership of special purpose vehicles, and such trust or corporate service provider is not affiliated with any other transaction parties; (2) is bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit and from each originator-seller and each majority-owned affiliate in each case that, directly or indirectly, sells or transfers assets to such intermediate SPV; (3) acquires assets from the originator-seller that are originated by the originator-seller or acquired by the originator-seller in the acquisition of a business that qualifies for business combination accounting under U.S. GAAP or acquires asset-backed securities ("ABS") interests issued by another intermediate SPV of the originator-seller that are collateralized solely by such assets; and (4) issues ABS interests collateralized solely by such assets, as applicable.

27 See Part V.A. above: Standard Risk Retention.

28 See Part V.C. above: Revolving Pool Securitizations (Seller's Interest).

2. The ABS interests acquired by the ABCP conduit are:

   (i) ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets:

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

   (iii) ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller and by servicing assets;

   (iv) ABS interests described in paragraphs (i), (ii) or (iii) above that are collateralized, in whole or in part, by assets acquired by an originator-seller in a business combination that qualifies for business combination accounting under U.S. GAAP, and, if collateralized in part, the remainder of such assets are assets described in paragraphs (i), (ii), or (iii) above, or

   (v) 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 ABS interests issued by the intermediate SPV, or (C) from another person who acquired the ABS interests directly from the intermediate SPV;

Note: Paragraph (2) above clarifies that the assets being financed have been originated by the originator-seller and not purchased and aggregated. In general, eligible ABCP conduits may not purchase ABS interests in the secondary market; provided, however, that at any time, an eligible ABCP conduit that acquired an ABS interest in accordance with this option may transfer to another eligible ABCP conduit if (x) the sponsors of both eligible ABCP conduits are in compliance with this option and (y) the same regulated liquidity provider has entered into one or more commitments to provide 100% liquidity coverage to all the ABCP issued by both eligible ABCP conduits.

Note: ABCP conduits may have different regulated liquidity providers and, if they do, it is unclear why, in order to transfer ABS interests between eligible ABCP conduits, that the same regulated *liquidity provider must provide 100% liquidity to both eligible ABCP conduits, especially when a regulated liquidity provider already covers 100% of the credit risk, well above the requisite risk retention already retained by the originator-seller required by the Final Rules.*

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

   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, except as provided in the second note above.

4. A regulated liquidity provider[29] has entered into a legally-binding commitment to provide 100% liquidity coverage (in certain specified forms) to all the ABCP issued by the ABCP 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 interests 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 loans or receivables or performing ABS interests does not meet the requirements of the eligible ABCP conduits section of the Final 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 Final Rules) liquidity provider is required so long as such provider has a high enough credit standing.

[29] "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.

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 Final 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 Final Rules (unless an exemption for the transaction exists).

- Responsibility for Compliance. The Final 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 each originator-seller which is satisfying a risk retention obligation in respect of ABS interests acquired by an eligible ABCP conduit with the requirements of this option and must (A) promptly notify investors, and upon request, 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 interests 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 that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation of this option and the amount of ABS interests issued by an intermediate SPV of such originator-seller 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 interests; 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 interest 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 securitized assets underlying the ABS interests, acquired by the ABCP conduit, (ii) approve (1) all originator-sellers 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 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 have incentives to monitor the quality of such assets. However, sponsors may have difficulty monitoring compliance by the originator-sellers 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 material terms 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 securitized assets; (ii) the standard industrial category code (SIC Code) for the originator-seller 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 percentage amount of risk retention pursuant to the rule by the originator-seller, and whether it is in the form of an eligible horizontal residual interest, vertical interest, or revolving pool securitization seller's interest, as applicable. Each of the foregoing items of disclosure must be as of a date not more than 60 days prior to the date of first use with investors. 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 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 are not required to be disclosed to investors under the Final Rules. However, under the eligible ABCP conduit option, the sponsor must promptly notify investors, and upon request, the SEC and its appropriate Federal banking agency, if any, of the name of any originator-seller that fails to retain risk in accordance with this option or hedges its risk retention in violation of this option.

E. Treatment of Governmental Sponsored Entities

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 Agencies note 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 begins to operate other than under the conservatorship or receivership of the FHFA, such GSE or entity will 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.*

> *Note: The Agencies noted the ongoing efforts to reform the operations of the GSEs and expressed an intent to revisit and, if appropriate, modify the provisions of the Final Rules applicable to the GSEs once the future of their statutory and regulatory framework become clearer.*

F. CLOs

General

Notwithstanding the extensive commentary received by the Agencies on the Reproposed Rules, the Final Rules, as they relate to CLOs, are largely identical to the Reproposed Rules. As discussed in more detail below, the Final Rules provide two options for risk retention for CLOs[30, 31]: (i) CLO Manager risk retention (by itself or through a majority-owned affiliate) and (ii) CLOs composed exclusively of CLO-eligible loan tranches that otherwise meet the "lead arranger" risk retention criteria. In the Preamble, the Agencies make the following observations:

- *Open Market CLOs*. The Agencies believe the Final Rules place risk retention responsibility on the parties most capable of ensuring and monitoring the credit quality of the assets collateralizing open market CLOs – *i.e.*, the CLO Manager or the lead arranger of the underlying loans. The Agencies believe that these two options will (i) promote discipline in the underwriting standards for loan assets being securitized and (ii) reduce the risk that such loans pose to financial stability.

> *Note: The Agencies' concern with promoting such discipline and reducing such risk appears to be an outgrowth of what they see as recent developments in the leveraged loan market. The Agencies note that "[h]eightened activity in the leveraged loan market has been driven by search for yield and a corresponding risk appetite by investors" and that evidence exists of a "widespread loosening of underwriting standards" that coincides with such activity.*[32]

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30 The Agencies state in the preamble accompanying the Final Rules (the "**Preamble**") that they believe it is appropriate to require risk retention for both open market CLOs and balance sheet CLOs. The Agencies note that many commentators to the Reproposed Rules raised a variety of concerns about the application of the risk retention requirements to open market CLOs. Although open market CLOs of broadly syndicated loans account for most of the new issuance activity in the CLO market today, we note that the Final Rules preserve from the Reproposed Rules a provision that permits risk retention by the "originator" of one or more securitized assets that acquires its eligible interest from the sponsor, which acquisition may offset the amount of the sponsor's risk retention requirements. This provision may have particular value for non-bank middle-market originators and private loan funds that use balance sheet CLOs for long-term financing of their loan portfolios and business platforms. It is not yet clear whether new origination structures can be created such that open market CLOs of broadly syndicated loans also would be able to use this mechanism for satisfying the risk retention requirements.

31 The Final Rules include an exemption from the risk retention requirements (largely unchanged from the Reproposed Rules) for static securitizations of "qualifying commercial loans" (*i.e.*, loans that meet specified underwriting criteria) that meet certain requirements. Although this exemption is theoretically available to CLOs, as a practical matter few (if any) CLOs structured in the market today would be able to satisfy these requirements.

32 See pp. 201-202 and 230 of the Preamble.

- *CLO Manager as Securitizer*. The Agencies confirm their belief that a CLO Manager is clearly included within the definition of "securitizer" under Section 15G of the Exchange Act[33] because the CLO Manager is the person who "organizes and initiates" a CLO by (1) selecting the commercial loans to be purchased by the CLO issuing entity, (2) directing such issuing entity to purchase such loans in accordance with specified investment guidelines and (3) then, managing the securitized loans on behalf of the CLO. As a result, the CLO Manager is subject to the risk retention requirements of the Final Rules.[34]

In addition, as discussed in Part II of this memo, the Final Rules remove the proposed cash flow restrictions on payments to an eligible horizontal residual interest retained by a sponsor. This change from the Reproposed Rules is particularly significant for CLOs, since compliance with such restrictions was seen by the market as commercially unfeasible, given that investors in the "equity tranche" of a CLO require that excess interest spread be paid to them in accordance with the CLO's priority of payments on a current basis.

- *Impact on the CLO Market*.

  Agencies' Perspective – The Agencies acknowledge that requiring open market CLO Managers to satisfy the risk retention requirement under the Final Rules could result in fewer CLO issuances and less competition in the CLO market.[35] In this regard, the Agencies make the following observations:[36]

  - Other entities, such as hedge funds and loan mutual funds, also purchase commercial loans; the market will "adjust" to the Final Rules; and "lending to creditworthy commercial borrowers, on appropriate terms, will continue at a healthy rate."

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33 The Volcker Rule incorporates the definition of "securitizer" under the Final Rules. As a result, a CLO Manager that is a "banking entity" for purposes of the Volcker Rule will need to consider the implications of such rule to the extent that the related CLO it manages is a "covered fund." See the discussion of "Sponsor" in Part IV.A of this memo.

34 The Agencies also disagree with commentators' assertions that Congress intended Section 15G to apply primarily to securitizations within the originate-to-distribute model. The Agencies note that Section 15G specifies that retention applies to all securitizers unless they have a specific exemption under the statute or the Agencies provide a specific exemption in accordance with criteria set forth in the statutory text. See 15 U.S.C. 78o-11(b)(1) ("[T]he Federal banking agencies and the Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party."), which is cited in footnote 167 of the Preamble. See, also, 15 U.S.C. 78o-11(c)(1)(G)(i) and 15 U.S.C. 780-11(e).

35 See pp. 229-230 of the Preamble.

36 See p. 230 of the Preamble.

- The projected impacts on the CLO market identified by commentators are justified by the benefits that will be produced by subjecting open market CLOs to the risk retention rules.
- The CLO Manager and lead arranger options provide sufficient flexibility to avoid significant disruptions to the CLO and credit markets.

Market's Perspective – Market participants are still analyzing the Final Rules and the impact such rules will have on the CLO market going forward. After considering the Final Rules and obtaining preliminary feedback from market participants, we offer the following observations on the potential consequences of risk retention on open market CLOs:

- *"Lead Arranger" Retention Option*. Market feedback has been that the lead arranger option will not be widely adopted (if at all) by arranging banks of commercial loans. As a result, the only viable form of risk retention for open market CLOs will be retention by the CLO Manager or a majority-owned affiliate thereof. Market participants are, however, considering possible originator structures as a means of satisfying all or a portion of the required 5% retention amount.

> *Note: The use of the originator structure for open market CLOs may prove very challenging. Under a plain reading of the Final Rules, it should be quite simple to set up a warehousing entity that "initiates the securitization by transferring" loans to the CLO. However, the Agencies went to great lengths to explain that the sponsor of a CLO needs to be the entity responsible for loan credit selection, which seems to be only the true, original lender of the loans or the CLO Manager that is selecting the loans.*[37]

- *CLO Managers*. If CLO Manager retention remains the only viable form of retention for open market CLOs, general market consensus is that the number of CLO Managers that are able to issue new CLOs will decrease.[38] CLO Managers wishing to continue issuing new transactions (or, as discussed more fully below, to comply with the risk retention requirements that may apply to otherwise grandfathered CLOs) will need to

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[37] The originator structure will be a more viable solution to satisfy all or a portion of the risk retention requirements for middle-market CLOs. See footnote 29 above.

[38] The Agencies note that many who commented on the Reproposed Rules asserted that imposing standard risk retention requirements could cause CLO Managers to exit the market or be acquired by larger CLO Managers. If the commenters prove to be correct, the CLO market could see consolidation among CLO Managers and, consequently, as the Agencies acknowledge, fewer CLO issuances and less competition in the market. See pp. 203, 207-208 and 229-230 of the Preamble.

access additional capital, either directly or through a majority-owned affiliate, to finance their future retention requirements.

> *Note: As needed, CLO Managers are expected to work with their accountants to create structures that permit investors to participate in, and help fund, such CLO Managers' risk retention requirements via a majority-owned affiliate. Whether such structures are considered a majority-owned affiliate of the CLO Manager under the Final Rules will be a function of whether "majority control" exists as determined in accordance with GAAP. In this regard, we note that the control rules under GAAP are in the process of being republished. Hence, structures being considered will need to take this into consideration. We also note that if at any point during the required retention period the affiliate is no longer considered to be "majority-owned" as described above, the CLO Manager will technically no longer be in compliance with the risk retention requirements.*

- CLO Issuance. *Pre-Effective Date* – As discussed below, CLOs whose closing dates occur prior to the effective date of the Final Rules generally will be grandfathered. As a result, CLO Managers and arranging banks could be expected to close as many open market CLOs as market conditions permit before the risk retention rules take effect. However, CLO Managers without an effective strategy to finance their long-term business operations (including financing any future required risk retention obligations) after the effective date of the Final Rules may encounter headwinds prior to such date in marketing their transactions. In addition, as discussed below under "Application to Grandfathered Deals," CLO issuance may be adversely impacted by the potential consequence the risk retention rules may have on the ability of CLOs to effect additional issuances, refinancings and/or re-pricings. Due to such uncertainties, certain changes to CLO transaction documents (including with respect to reinvestment and amendment provisions) should be considered in structuring new transactions that will close before the effective date of the Final Rules.

  Post-Effective Date – It is too early to definitively say how issuance of open market CLOs will be impacted by the Final Rules, given that market participants need a period of time to fully analyze and adjust their businesses and market practices in response to such rules. However, unless material forms of capital can be raised by CLO Managers to finance their retention requirements and/or novel originator structures that are compliant with the Final Rules are created, overall issuance of open market CLOs may be materially lower than it is today.[39]

- _Application to Grandfathered Deals_. The Final Rules will become effective on the date that is two years after publication thereof in the Federal Register. Even though CLOs typically have long lives due to their ability to reinvest principal proceeds in additional or substitute assets, a CLO generally will be "grandfathered" from the risk retention requirements so long as its closing date occurs prior to the effective date for the Final Rules. However, many CLOs include features, typically exercisable at the option of the holders of a majority of the "equity tranche" of the CLO, that permit the issuance of additional notes of one or more CLO tranches and the refinancing and/or re-pricing of one or more rated CLO tranches from time to time, subject to specified conditions. The exercise of these features would involve, except arguably in the case of certain refinancings and re-pricings, "the offer and sale of asset-backed securities by an issuing entity" and thus constitute a "securitization transaction" in respect of which the risk retention requirements of the Final Rules must be satisfied by the CLO Manager (as the "sponsor" of the securitization).

    Note: A strong argument can be made that a CLO Manager should not be deemed to be a sponsor under the Final Rules for purposes of triggering risk retention with respect to a grandfathered CLO, solely by virtue of the issuance (or deemed issuance) of securities over which the CLO Manager has no direct control.

    Note: Although not clear from the language of the Final Rules, it may be possible that a refinancing or re-pricing could be effected in such a way (such as refinancing one or more outstanding CLO tranches with the proceeds of a loan or re-pricing one or more outstanding CLO tranches through a supplemental indenture, in either case without the issuance of new or replacement notes) that such action would not, in and of itself, cause the sponsor of a grandfathered CLO to be subject to the risk retention requirements under the Final Rules.

If the risk retention requirements of the Final Rules are determined to apply to otherwise grandfathered CLOs, as the result of the exercise of additional issuance, refinancing or re-pricing features, market participants will need to consider a number of issues. For example, CLO Managers generally do not have specific approval or veto rights in

[39] See *The CLO Salmagundi: Risk Retention*, Wells Fargo Research (Dave Preston and Jason McNeilis), October 21, 2014.

respect of refinancings or re-pricings (although CLO Managers may have rights to approve supplemental indentures entered into in order to effect such actions; and most CLO indentures generally prohibit the issuer from entering into a supplemental indenture that would have a material adverse effect on the CLO Manager without its consent). Given the potential application of the risk retention rules and the related consequences for a CLO Manager that would result from the exercise of any such feature, CLO indentures for transactions that will close prior to the effective date of the Final Rules will need to be expanded in order to permit compliance with the Final Rules, if such compliance is determined to be necessary and acceptable to the CLO Manager.

- *Financing of Retention Interest*. The Final Rules do not prohibit a sponsor (or a majority-owned affiliate of the sponsor) from financing the acquisition of its retention interest in a securitization transaction. However, the Final Rules do prohibit a sponsor and its affiliates from pledging as collateral for any obligation any interest that the sponsor is required to retain unless such obligation is with full recourse to the sponsor or its affiliate, as applicable.

  Hence, a CLO Manager (or its majority-owned affiliate) generally may be able to borrow (directly or indirectly through its parent) in order to fund the acquisition of a retention interest mandated by the risk retention requirements, but the financing must be on a full recourse basis if the retention interest is pledged as collateral for such financing. This raises an interesting question of what the consequences would be to a sponsor if a lender attempted to foreclose on the retention interest held by a CLO Manager (or its majority-owned affiliate). Although the Final Rules do not expressly address the foreclosure of a pledged retained interest, in its commentary on the Reproposed Rules the Agencies stated 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.[40] The foregoing suggests that any retention interest financing arrangements by a CLO Manager (or its affiliate) should not permit foreclosure on such retention interest until the expiration of the related retention period.

  > *Note: In Europe, for purposes of compliance with Article 405 of the Capital Requirements Regulation, financing of a retention interest in a CLO by an eligible retention holder is not uncommon. Article 12(2) of Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 provides that the retainer may use any retained exposures or securitization positions as collateral for*

[40] See p. 174 of the preamble accompanying the Reproposed Rules.

secured funding purposes, as long as such use does not transfer the credit risk of these retained exposures or securitization positions to a third party. In light of the requirement that the use of any retained exposures or securitization positions does not transfer the credit risk to a third party, these financing arrangements are typically on a full recourse basis. Such arrangements may involve a guaranty by the borrower's parent and typically involve financing a portion of the vertical interest represented by the investment grade tranches and, potentially, below investment grade tranche(s), of the related CLO. If a lender enforces its security interest in the retention notes, the related CLO will no longer be compliant with Article 405 of the Capital Requirements Regulation.[41]

Note: It is anticipated that certain lenders will attempt to develop arrangements to facilitate CLO Managers' financing of their required retention interests in open market CLOs. As we've seen in European CLO transactions, such arrangements will likely involve financing a vertical interest in a CLO. The question remains whether the terms of any such arrangements will be offered on sufficiently attractive terms or whether such arrangements will afford sufficient credit capacity to be a viable source of funding to CLO Managers to finance their future retention requirements.

- *Jurisdictional Scope*. – Non-US ABS transactions, including European CLOs, may trigger risk retention under the Final Rules unless the transaction comes within the safe harbor for foreign-related transactions. See "Foreign Transaction Safe Harbor" in part VII.C of this memo for a summary of the technical requirements of the safe harbor rule. The key prong of the safe harbor that might cause US risk retention rules to apply to a European CLO is the requirement that no more than 10% of the dollar value of classes of ABS securities (based on "fair value") of a transaction are sold to "US persons"[42] in the related offering. Resales of ABS securities to US persons in the secondary market will not count towards this 10% requirement.

  Note: It is unclear at this point what the consequences will be for a non-US ABS transaction that does not meet all of the technical

41 See, generally, *EU Risk Retention Requirement: A workable solution for US CLO collateral managers?*, January 23, 2014, at http://www.cadwalader.com/resources/clients-friends-memos/eu-risk-retention-requirement-a-workable-solution-for-us-clo-collateral-managers.

42 "US person" is defined under the Final Rules and is consistent with the definition of "U.S. Person" set forth in Regulation S promulgated under the U.S. Securities Act of 1933, as amended.

requirements of the foreign transaction safe harbor. The sponsor (i.e., a CLO Manager in the case of an open market CLO) is responsible for retention compliance under the Final Rules. The consequences to a particular sponsor will depend in part on the what authority the Agencies may have over such sponsor.
Note: The foreign transaction safe harbor would not be available with respect to any transaction or series of transactions that, although in technical compliance with the safe harbor, is part of a plan or scheme to evade the requirements of Section 15G and the Final Rules. In such cases, compliance with Section 15G and the Final Rules would be required.

- *Compliance with Non-US Risk Retention Requirements.* The Agencies make clear in the Preamble that compliance with European or other non-US forms of ABS credit risk retention will not satisfy US risk retention under Section 15G of the Exchange Act.[43]

- *Resignation/Removal of the CLO Manager.* CLO management agreements permit the CLO Manager to resign upon prior notice to the issuer and also provide for the removal of the CLO Manager under certain circumstances at the direction or with the consent of one or more specified classes of CLO securities. Although the Final Rules contain certain restrictions on hedging, financing and transferring retention interests, they do not directly address what the resignation or removal of a CLO Manager means for any retention interest previously acquired by such CLO Manager in satisfaction of its risk retention requirements as sponsor of a CLO.

Note: Should a successor CLO Manager be required, as a condition to its appointment, to acquire the retention interest held by a CLO Manager that is resigning or being removed? In the Preamble, the Agencies emphasize the importance of promoting discipline in the underwriting standards of loans being securitized, monitoring the credit quality of CLO collateral and ensuring that the interests of CLO Managers are adequately aligned with CLO investors.[44] Such statements suggest that Section 15G may require a successor CLO Manager to acquire the outgoing CLO Manager's retention interest as a condition to its appointment,

[43] See pp. 274-275 of the Preamble. An open question is whether it is possible to create a structure that qualifies as an "originator" for purposes of satisfying European risk retention requirements, but also can be treated as the "majority-owned affiliate" of a CLO Manager for purposes of satisfying US risk retention requirements.

[44] See, variously, pp. 201, 220, 223-4 and 231 of the Preamble.

particularly if new loan assets may be acquired by the CLO after such appointment.

Note: Additional guidance from the Agencies likely will be required to clarify how risk retention is satisfied in the context of the resignation or removal of a CLO Manager. We note that the European risk retention rules also do not address this point but we anticipate some guidance from the European Banking Authority over the next few months.

- *Open Market CLOs and the "Lead Arranger" Option*. Set out below is a summary of the Final Rules for "**Open Market CLOs**" (as defined below) and the "lead arranger" option for satisfying the risk retention requirements. The primary differences from the Reproposed Rules are: (1) the disclosures required to be made by sponsors in connection with Open Market CLOs have been slightly expanded; and (2) the certifications required to be made by the lead arranger and the CLO Manager have been revised to be more in line with those required of depositors with respect to QRMs and other qualifying asset classes.

Note: As discussed above, the widespread view of market participants is that the lead arranger option is not workable for banks that arrange loans to commercial borrowers.

A sponsor satisfies its risk retention requirements with respect to Open Market CLOs (as defined below) that purchase and hold only "CLO-eligible loan tranches" (as defined below). The Lead Arranger (as defined below) 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 Final 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 terms.

The Final 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 the CLO Manager or originated by originators that are affiliates of the CLO or the CLO Manager.

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).
- 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 arm's-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 Final 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 Final 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 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, on or prior to each date that it acquires a loan constituting part of a new CLO-eligible tranche, that it has policies and procedures to evaluate the likelihood of repayment of loans acquired by the CLO and it has followed such policies and procedures in evaluating each CLO-eligible loan tranche.

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

The Final Rules define a "**CLO-eligible loan tranche**" as a term loan tranche of a syndicated loan that at all times meets 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.
- 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 the calculation or payments of amounts due to the holders of the CLO-eligible tranche, 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 holder(s) of such CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

The Final 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 funded portion 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 that funded 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 credit agreement of the CLO-eligible tranche;
- represents in the credit agreement that such Lead Arranger satisfies the requirements in the first paragraph of this definition and at the time of initial funding will satisfy the requirements in the second paragraph of this definition, and further represents that in its reasonable judgment, the terms of such CLO-eligible loan tranche are consistent with the requirements of the second and third paragraphs of the definition of "CLO-eligible loan tranche"; and
- covenants in the credit agreement to undertake the required 5% retention as set forth in the first paragraph of the definition of CLO-eligible loan tranche.

G. Tender-Option Bonds

Tender option bonds ("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: While tender option bond issuing entities created prior to effective date of the Final Rules are exempt from the risk retention requirements of the Final Rules, the Agencies have clarified that if a*

pre-existing tender option bond issuing entity issues additional securities after the effective date of the Final Rules, then notwithstanding the fact that the issuing entity was formed prior to the effective date of the Final Rules, the sponsors of the issuing entity would be subject to the risk retention requirements with respect to the new issuance of bonds.

The Final 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, including holding an eligible vertical interest, an eligible horizontal interest, or any combination thereof. 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. Finally, the sponsor may satisfy the risk retention requirement by holding any combination of the foregoing interests or securities such that the sum of the percentages held in each form equals at least 5%. The fair value of the tender option bonds are calculated as of the closing date; provided that, if the tender option bond issuing entity issues additional tender option bonds after the closing date, the sponsor must recalculate the fair value of the tender option bonds as of the date of the subsequent issuance.

Note: The Final Rules provide that the Agencies believe that a residual interest in a qualified tender option bond entity would meet the requirements of an eligible horizontal residual interest before, and an eligible vertical interest after, the occurrence of a tender option termination event if: (i) prior to the occurrence of a tender option termination event, the residual holder bears all the market risk associated with the underlying tax-exempt municipal security; and (ii) after the occurrence of a tender option termination event, any credit losses are shared pro rata between the tender option bonds and the residual interest.

The Final 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 terms of all securities issued by the entity must be structured such that all holders of securities who are eligible exclude interest received on such securities will be able to exclude that interest from gross income or, in the case of regulated investment companies, treat such interests as exempt interest dividends.
- A regulated liquidity provider (as defined in Part III.D of this memo) 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 Final Rules define a "tender option bond" as a security that has features which entitle the holders to tender such securities to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase equal to the par amount of such securities plus accrued interest.

- *Disclosure*. The Final Rules would require that the sponsor provide, or 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:

The name and form of organization of the qualified tender option bond entity.

1. A description of the form and subordination features of such retained interest as described in Part V.A.
2. To the extent any portion of the retained interest is an eligible horizontal residual interest the fair value of that interest (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)
3. To the extent any portion of the retained interest is an eligible vertical interest, the percentage of ABS interests issued represented by the eligible vertical interest
4. To the extent any portion of the retained interest is a municipal security held outside of the qualified tender option bond entity (i) the identity of the issuer of the municipal securities, (ii) the face value of the municipal securities deposited into the qualified tender option bond entity, and (iii) the face value of the municipal securities retained by the sponsor or its majority-owned affiliates.

Prohibited Hedging. Sponsors of qualified tender option bond entities are subject to the prohibitions on hedging and transfer described in Part III.H of this memo. The Agencies do not believe that there is any reason to treat sponsors of tender option bonds any differently from sponsors of other asset-backed securities issuances.

H. Hedging, Transfer and Financing Restrictions

General. Except as described above with respect to the defeasance of certain commercial real estate loans, the Final Rules 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 and expressly states that the prohibition also applies to each such majority-owned affiliate. Even absent a transfer from the sponsor, the Final Rules prohibit affiliates of the sponsor from hedging the credit risk the sponsor or any of its majority-owned affiliates is required to retain under the Final Rules.

Under the Final Rules, sponsors and their affiliates are 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 (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) 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 Final Rules. Examples offered by the Agencies in the release accompany the Reproposed Rules, which, in this regard, are substantially identical to the Final Rules, of hedging activities that would not violate the prohibition 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 Final 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 Final 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 Final Rules.

Issuing entities are not prohibited from engaging in interest rate or foreign currency hedging transactions that are for the ultimate benefit of investors in the ABS. However, the Agencies make clear that any credit protection, such as asset-level or pool-level insurance or bond level insurance that covers interests required to be retained by the sponsor, would violate the hedging prohibition unless the sponsor's right to receive payments under any such credit protection is subordinated to all other investors. For example, if the sponsor elects to satisfy its risk retention obligation by holding an eligible vertical interest representing 5% of each class, an issuing entity may purchase credit protection covering 100% of the tranches, but the sponsor would not be entitled to any payments under such credit protection until all other holders are paid amounts then due them.

The Final Rules 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.[45]

Sunset Provisions. The Final 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:

    (i) The date on which the total unpaid principal balance (if applicable) 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 cut-off date 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% 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.

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45 Although the Final Rules do not expressly address the disposition of a pledged retained interest, the Agencies commented, in connection with the Reproposed Rules, 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.

Note: Although the sunset provisions do not address the restriction on non-recourse financing, the restriction on such financing only applies to ABS interests "required" to be retained. This suggests that if the ABS interest can be transferred, it should be able to be financed with nonrecourse financing as well.

VI. Asset Category Exemptions from the Risk Retention Requirements

A. Qualified Residential Mortgages

Under the Final Rules, the risk retention requirements described do not apply to an issuance of RMBS if all of the assets backing the transaction are qualified residential mortgages ("QRMs") currently performing[46] at the closing of the securitization or servicing assets. The Final Rules define a QRM to be the same as a qualified mortgage ("QM"), as defined in Section 129C of The Truth in Lending Act[47] and implemented by the Consumer Financial Protection Bureau ("CFPB") in its ability to repay rule, as amended from time to time. The CFPB issued a final ability to repay rule on January 10, 2013 and issued finalized supplemental rules in May 2013 (together, the "Ability to Repay Rule").[48] The Ability to Repay Rule became effective on January 10, 2014.[49] In general, a QM must have the following features:[50:]

- regular periodic payments that are substantially equal;
- no negative amortization, interest only or balloon features;

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46 Under the Final 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.

47 See 15 U.S.C. 1639c.

48 See 12 C.F.R. 1026.43.

49 The definition of QRM will automatically change as the CFPB clarifies, modifies or adjusts the definition of QM.

50 The Ability to Pay Rule includes several additional definitions of QM, all of which are encompassed by the definition of QM in the Rules:

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**").

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.

- 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 Final Rules, QRMs may consist of both first and junior lien positions and may 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 revolving 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).

In order for a QRM to be exempt from the risk retention requirements described above, the Final 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 will 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 will 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 Final Rules, a sponsor will 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.

- *Periodic Evaluations*. In order to allow the Agencies to assess the impact of the QRM definition on residential mortgage loan underwriting and securitization and to consider the effect of any changes made by the CFPB to the QM definition to which it tied, the Final Rules require the Agencies to commence a review of the QRM definition not later than four years after the effective date of the Final Rules with respect to RMBS and then again every five years after completion of the initial review. The Final Rules also require such review at any time upon request of any of the Agencies.

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 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.

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 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 Final 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 Final Rules as summarized below.

- *Security Interest/Lien*. The Final 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 of such a loan, the originator must have obtained a first lien on such property.
- *Ability to Repay*. The Final 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 (including operating income projections for the property).
    - 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[51] of 50% or less; (2) a leverage ratio[52] of 3.0 or less; and (3) a debt service coverage ratio[53] 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 Final Rules require the following:
  - Loan payments must be based on level monthly payments of principal and interest (at the fully indexed rate) that fully amortize the debt over a term not to exceed five years from the origination date.
  - 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 cut-off date of the related securitization transaction.
  - At the cut-off date of the securitization transaction, all payments due on the loan must be contractually current.

- _Risk Management and Monitoring Requirements_. The Final 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

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[51] "**Total liabilities ratio**" means the borrower's total liabilities, determined in accordance with U.S. 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 U.S. GAAP.

[52] "**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 U.S. GAAP.

[53] 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 (calculated at the fully-indexed rate) on all debt obligations.

- 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 for an amount no less than the replacement cost of the property improvements and naming the originator (or any subsequent holder) as an additional insured or lender 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 Final 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 V.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 Final 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 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 would have had, and based on two years of projections (which include the new debt obligation), the borrower will have, the following debt service coverage ratio:[54]

[54] 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

- a DSCR of 1.5 or greater, if the loan is a qualifying leased CRE loan[55] (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;[56] or
- a DSCR of 1.7 or greater, if the loan is any other type of CRE loan (which would include all hotel loans).

Note: In response to industry comment, the Final Rules provide that if the borrower did not own the property for any part of the last two years (e.g., the borrower is a newly formed SPE), the DSCR calculation should be performed based on the property's operating income during that period.

- *Loan Terms*. The Proposed Rules require the following:
  - A QCRE loan must have (i) a fixed stated interest rate (ii) (an adjustable rate if the borrower obtains a derivative product that results in the borrower paying a fixed interest rate or (iii) an adjustable rate if the borrower entered into an interest rate cap agreement for the term of the loan.

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borrower's annual payments for principal and interest on any debt obligation. "NOI" means the income a CRE property generates for the owner 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.

55 "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% 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.

56 "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.

- 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 level payments of principal and interest that fully amortize the loan 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%; provided, that if the appraisal used a capitalization rate, and that rate was less than or equal to the sum of the 10-year interest rate swap rate plus 300 basis points, the maximum LTV is 60% and the maximum CLTV is 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 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." 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 has an effective date that is not more than six months prior to the origination of the loan by a "competent" and 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 approach.

• *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.[57]

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[57] The notice of proposed rulemaking for the Original Proposal, stated that 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.

- *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 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 Final 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.[58]

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[58] 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.

For ABS comprised solely of automobile loans to qualify for risk retention exemption/reduction, such loans must meet the underwriting standards specified in the Final 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.
    - 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.
- *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 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 Final 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, 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.

VII. Other Exemptions

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

A. General Exemptions

Under the Final Rules, the risk retention requirements do 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,[59] 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 Final Rules; or (B) that was exempted from the credit risk retention requirements pursuant to the Final 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 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.*

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59 "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.

- Any securitization transaction that: (i) is collateralized solely by servicing assets, and by first-pay classes[60] 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 under the Final Rules or that was exempted from the credit risk retention requirements of the Final 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"[61] 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[62] 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.

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[60] 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.

[61] 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.

[62] "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 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.
- 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.
- Any securitization transaction if the ABS issued are collateralized solely by "community-focused residential mortgages," which are defined as certain residential mortgage loans made under designated governmental programs or by non-profit organizations that are designed to ensure access to affordable credit by low and middle income borrowers, minority borrowers and first-time homebuyers. These loans are exempt from the CFPB Ability to Repay Rule and therefore could not be qualified mortgages under that rule or QRMs under the Final Rules. If the securitization contains both community-focused residential mortgages and residential mortgages that are not otherwise exempt from risk retention, the amount of required risk retention is reduced in proportion to the percentage of the pool representing community-focused residential mortgages, but not below 50% of the amount of risk retention otherwise required.
- Any securitization transaction backed solely by owner-occupied three-to-four unit residential mortgage loans, servicing assets and QRMs if the three-to-four-unit residential mortgage loans are deemed to be for business purposes but would otherwise meet the definition of a QM under the CFPB's Ability to Repay Rule and the depositor and the sponsor respectively comply, as to the three-to-four unit residential mortgage loans or QRMs, with the same type of certification and repurchase obligations applicable to QRMs, as described under Part VI.A.

In addition to the exemptions described above, which provide complete relief from the sponsor's risk retention requirements in the applicable securitizations, the Final 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% but less than 100% 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 Final 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 Final Rules. Nevertheless, although Fannie Mae and Freddie Mac do not independently qualify for an exemption, the Final 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 V.E of this memo.

B. Additional Exemptions

The Final 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 Final 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 Final Rules 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 Final Rules. In such cases, compliance with Section 15G and the Final Rules would be required.

VIII. Conclusion

As expected, the Final Rules are substantially similar to the Reproposed Rules. The noteworthy differences between the Reproposed Rules and the Final Rules are recapped in Part II of this memo. The Final Rules did address in a constructive fashion some of the most controversial elements of the Reproposed Rules, and included many constructive amendments or technical clarifications.

Nevertheless, the Final Rules will still have a significant impact on the ABS markets, market participants and transactions.

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C A D W A L A D E R

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Clients&FriendsMemo

New Rules for Third-Party Due Diligence Reports for Asset-Backed Securities

September 9, 2014

On August 27, 2014, the Securities and Exchange Commission (the **"SEC"**) adopted final rules[1] (the "**Final Rules**") implementing, among other things, provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the **"Dodd-Frank Act"**) relating to third-party due diligence reports for asset-backed securities[2] ("**ABS**"). As adopted, the Final Rules will require:

(i) issuers and underwriters of rated ABS, whether or not registered with the SEC, to file with the SEC, at least five business days before the first sale in the ABS offering, a Form ABS-15G containing the findings and conclusions of reports of third-parties who have been employed to provide due diligence services,

(ii) third parties who provided due diligence services in connection with ABS offerings to make available to nationally recognized statistical rating organizations ("**NRSROs**"), pursuant to a prescribed form, information regarding the scope of their due diligence services, a summary of their findings and conclusions, and a certification as to the due diligence review, and

(iii) NRSROs to make publicly available in connection with rating actions for ABS offerings the forms furnished by third-party due diligence services providers and referred to in clause (ii) above.

The Final Rules take effect nine months after they are published in the Federal Register.

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1 For the text of the SEC's Final Rules adopting release (the "**Final Release**"), see http://www.sec.gov/rules/final/2014/34-72936.pdf. The Final Rules adopted in modified form the proposed rules (the "**Proposed Rules**") presented for public comment on May 18, 2011. For the text of the SEC's Proposed Rules release, see http://www.sec.gov/rules/proposed/2011/34-64514.pdf. The Proposed Rules were the subject of a prior Clients & Friends memorandum, dated July 8, 2011, "SEC Proposed Rules Regarding Third-Party Due Diligence Disclosure," available at http://www.cadwalader.com/resources/clients-friends-memos/sec-proposed-rules-regarding-third-party-due-diligence-disclosure.

2 The portions of the Final Rules analyzed in this memorandum apply to "asset-backed securities" within the meaning of Section 3(a)(79) of the Exchange Act, as opposed to the more limited definition of that term in Item 1101(c) of Regulation AB.

New Rule 15Ga-2 and Amendments to Form ABS-15G

Background

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Securities Exchange Act of 1934 (the "**Exchange Act**") to require the issuer[3] or underwriter[4] of any ABS to make publicly available the findings and conclusions of any third-party due diligence report[5] obtained by the issuer or underwriter. In the Final Rules, the SEC adopted new Rule 15Ga-2 and amendments to Form ABS-15G to implement this provision of the Dodd-Frank Act.

What Does Rule 15Ga-2 Require?

Rule 15Ga-2 requires any issuer or underwriter of any ABS that are to be rated by an NRSRO to furnish a Form ABS-15G containing the findings and conclusions of *any* third-party due diligence report obtained by the issuer or underwriter, not just third-party due diligence reports made available to NRSROs. Form ABS-15G must be filed at least five business days prior to the first sale[6] in the related offering.[7] The Final Rules clarify that a single Form ABS-15G may be filed when the issuer and/or one or more underwriters obtained the same third-party due diligence reports.[8]

Rule 15Ga-2 Applies to Registered and Unregistered Offerings of ABS

Rule 15Ga-2 applies to both registered and private offerings of ABS. The SEC stated that issuers and underwriters can disclose the information required by Rule 15Ga-2 without jeopardizing their reliance on private placement exemptions and safe harbors, so long as the only information made publicly available on Form ABS-15G is information required by Rule 15Ga-2, and the issuer does

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3 Because the Final Rules define "issuer" for the purposes Rule 17g-10 (implemented by the Final Rules), in the context of the Final Rules, that term includes the sponsor or depositor that participates in the offering of ABS. See Final Release at page 366.

4 For the purposes of the Final Rules, "underwriter" refers to underwriters of both public and private offerings. See Final Release at pages 368-9.

5 A "third-party due diligence report" means any report containing findings and conclusions of any due diligence services (as defined in Rule 17g-10, discussed below) performed by a third-party.

6 The date of first sale in the offering would be the date on which a purchaser first makes an investment decision and commits to purchase the securities offered. See Final Release at page 371, footnote 1431.

7 Form ABS-15G may be electronically filed with the SEC on the EDGAR system, so that all of the publicly filed information relating to an offering will be available in a single, central repository. The SEC noted that it already requires the filing of certain items on the EDGAR system in connection with private issuances.

8 If Form ABS-15G is being filed by the issuer, it must be signed by the senior officer of the depositor in charge of securitization, or if it is being filed by the underwriter, it must be signed by a duly authorized officer of the underwriter.

not otherwise use Form ABS-15G to offer or sell securities in a manner that conditions the market for offers or sales of its securities.

The Final Rule contains limited exclusions from the requirements of Rule 15Ga-2 for offshore transactions[9] and municipal issuer offerings.[10]

Required Content of Rule 15Ga-2 Disclosure

In the Final Release, the SEC rejected comments to the Proposed Rule that would have limited reporting pursuant to Rule 15Ga-2 to the findings and conclusions contained in final third-party due diligence reports. Therefore, the findings and conclusions of third-party due diligence reports contained in any draft or interim reports provided to the issuer and/or the underwriters must also be reported on Form ABS-15G.

In response to one commenter, the SEC also stated that a summary of findings and conclusions was contrary to Congressional intent, as expressed in the Dodd-Frank Act. In addition, the SEC stated that findings and conclusions themselves were required to be made public rather than having an issuer or underwriter summarize those findings and conclusions because a summary runs the risk of excluding information that could be important to a user of credit ratings. In the SEC's view, "users of credit ratings should be able to compare the totality of third-party due diligence information with what was provided to, and used by, an NRSRO, as disclosed under Rules 17g-7 and 17g-10"[11].

> *Note: In its discussion in the Final Release, the SEC stated that disclosure of the findings and conclusions necessarily requires disclosure of the criteria against which the loans were evaluated, and how the evaluated loans compared to those criteria along with the basis for including any loans not meeting those criteria.*[12]

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[9] For the purposes of Rule 15Ga-2, this means an offering that is not required to be, and is not, registered under the Securities Act of 1933 (the "**Securities Act**"), that is not issued by a U.S. person, as defined in Rule 902(k), and in which the securities are offered and sold in transactions that occur outside the United States.

[10] The SEC noted that municipal ABS are still subject to the requirement of Section 15E of the Exchange Act to make publicly available the findings and conclusions of any third-party due diligence report that they obtain, notwithstanding that they are exempted from filing Form ABS-15G. However, the SEC found municipal ABS are not subject to Rule 15Ga-2 because they are subject to a different regulatory scheme. The municipal ABS exclusion applies to issuers and underwriters of an offering of ABS if the issuer is a municipal issuer (as defined in Rule 17g-10), and the offering is not required to be registered under the Securities Act.

[11] See the Final Release at page 375, footnote 1442.

[12] See the Final Release at page 375.

Commenters on the Proposed Rule noted that Rule 193 requires issuers to review the underlying assets included in any ABS offering. This review may be substantially similar to the third-party due diligence services subject to Rule 15Ga-2. To avoid duplicative filings of substantially similar information, Rule 15Ga-2 provides that if the disclosure required by Rule 15Ga-2 has already been included in the prospectus (including an attribution to the third party that provided the due diligence report)[13], and the prospectus is publicly available at the time Form ABS-15G is furnished by the issuer or underwriter, the issuer or underwriter may refer to that section of the prospectus in Form ABS-15G rather than providing the findings and conclusions directly in Form ABS-15G. However, the SEC stated that the issuer and/or underwriter is still required to file Form ABS-15G referring to that information.

> *Note: If the issuer and an underwriter obtain the same third-party due diligence report, and one of them timely furnishes a Form ABS-15G for that report, the other of them would not be required to furnish a Form ABS-15G for the same report.*[14]

The Final Rules also clarify that Form ABS-15G need only be furnished in connection with the initial credit rating, and not with respect to any subsequent ratings actions, such as a ratings downgrade.[15]

New Rule 17g-10: Certifications Required From "Due Diligence Services" Providers

<u>Background</u>

The Dodd-Frank Act also amended Section 15E of the Exchange Act to require that, in any case in which third-party due diligence services are employed by an NRSRO, issuer or underwriter in connection with a rated ABS offering, the person providing the due diligence services provide a written certification to any NRSRO that produces a credit rating to which such services relate. The certification must state that the person has conducted a thorough review of data, documentation and other relevant information necessary for an NRSRO to provide an accurate rating. To implement this provision of the Dodd-Frank Act, the SEC adopted new Rule 17g-10 and a new Form ABS Due Diligence-15E that must be provided by third-party due diligence service providers to any NRSRO that produces a credit rating to which such services relate.

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[13] Pursuant to Rule 436, any such third-party would be required to consent to being named as an expert in the related registration statement.

[14] See the Final Release at page 373.

[15] See the Final Release at page 373.

"Due Diligence Services"

As defined in Rule 17g-10, an entity is deemed to have provided "due diligence services" if it engaged in a review of the assets underlying an ABS offering for the purpose of making findings with respect to:

1. the accuracy of the information or data about the assets, provided, directly or indirectly, by the securitizer or originator of the assets;

2. whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria or other requirements;

3. the value of collateral securing the assets;

4. whether the originator of the assets complied with federal, state or local laws or regulations; or

5. any other factor or characteristics of the assets that would be material to the likelihood that the issuer of the ABS will pay interest and principal according to applicable terms and conditions.

The SEC stated in the Final Release that the first four prongs of the definition of "due diligence services" are based upon industry practices with respect to residential mortgaged-backed securities "because due diligence services traditionally have been performed with respect to RMBS"[16]. Although the fifth prong of the definition appears to be very broad, the SEC stated that the "catchall" fifth prong is intended to apply to reviews, current and future, that may cover additional asset classes, such as commercial loans, corporate loans, student loans, or credit card receivables.[17]

> *Note: There appears to be a disconnect between Rule 15Ga-2, which requires the filing of a Form 15G-ABS in connection with findings and conclusions in a third-party due diligence report obtained by the issuer or underwriter, and Rule 17g-10, which requires*

[16] See the Final Rules at page 396.

[17] "While the catchall provision is not being eliminated, the definition of due diligence services in Rule 17g-10 (including the catchall prong) is not intended to bring within the definition's scope activities that are performed today in connection with the issuance of [ABS] that are not commonly understood as being third-party due diligence services. ... For example, it is not intended to cover every type of service that involves the performance of diligence in the offering process. The catchall provision is designed to incorporate within the definition reviews that are commonly understood in the securitization market to be third-party due diligence services or analogous services that may develop in the future but are not expressly covered by the first four prongs of the definition." Final Release at page 398.

the delivery to NRSROs of a Form ABS Due Diligence-15E promptly after completion of the due diligence services by the third party. In other words, the obligations under Rule 17g-10 seem to be triggered upon completion of the due diligence services, whether or not a report has been delivered relating to those services.

Implications for AUP Letters

The SEC noted in the Final Release that the first prong of the definition of "due diligence services" includes findings typically covered within the scope of agreed-upon procedures engagement letters that issuers and/or underwriters enter into with accounting firms ("**AUP Letters**"). While the SEC agreed that certain other procedures performed by accounting firms pursuant to typical AUP Letters, such as recalculating projected cashflows and performing procedures that address information included in offering documents, are not intended to be "due diligence services," the SEC stated that one procedure typically reported in AUP Letters, comparing the information on a loan tape with the information contained on the hard-copy documents in a loan file, is an activity that falls under the first prong. The SEC stated that this may necessitate changes to the scope of typical AUP Letters to take into account applicable professional standards. The SEC further stated that the requirements and limitations resulting from relevant professional standards described in those AUP Letters may be included in the written certifications required by third-party diligence services providers on Form ABS Due Diligence-15E.[18]

Note: Although in the discussion of the definition of "due diligence services" in the Final Release, the SEC appears to be focusing on practices that are "commonly understood in the securitization market" to be third-party due diligence services, the broad definition of the term and the explicit application of it to accountants' AUP Letters raises the question as to what other activities by securitization participants or their representatives would constitute "due diligence services."

Non-U.S. Transactions Exempt from the Requirements of Rule 17g-10

Rule 17g-10 does not apply to ABS issuances with obligors or issuers who are non-U.S. persons if the NRSRO has a reasonable basis to conclude that the transactions in the ABS issued by the obligor or the issuer will be effected only outside of the United States. However, the third-party due diligence services provider is still required to deliver an executed Form ABS Due Diligence-15E to any NRSRO that requests it.

[18] The content of Form ABS Due Diligence-15E is discussed below.

Rule 17g-10 "Safe Harbor"

At the time they conclude their services, persons providing due diligence services may not know the identity of NRSROs to which the Form ABS Due Diligence-15E certification must be delivered. To address this concern, the SEC, following the suggestion of many commenters, agreed to include in Rule 17g-10 a "safe harbor" such that if the specified conditions are satisfied, the third-party due diligence services provider will be deemed to have satisfied its obligation to provide the Form ABS Due Diligence-15E under 17g-10. To avail itself of the safe harbor, third-party due diligence services providers must provide an executed Form ABS Due Diligence-15E to:

1. any NRSRO that provided a written request for the form prior to the completion of the due diligence services stating that the services relate to the credit rating the NRSRO is producing;

2. any NRSRO that provides a written request for the form after the completion of the due diligence services stating that the services relate to a credit rating the NRSRO is producing; and

3. the issuer or underwriter of the ABS for which the due diligence services relate that maintains the Rule 17g-5 website with respect to the ABS.

In this way, each NRSRO that is providing a credit rating will have access to the Form ABS Due Diligence-15E, even when an NRSRO is rendering an unsolicited credit rating. It also eliminates the obligation of third-party due diligence services providers to ascertain the identities of every NRSRO producing a credit rating based upon that third-party's due diligence services. To avail themselves of the safe-harbor, third-parties must deliver an executed Form ABS Due Diligence-15E "promptly" after completion of their due diligence services.[19]

New Form ABS Due Diligence-15E

Required Content of New Form ABS Due Diligence-15E

The new Form ABS Due Diligence-15E required to be filed pursuant to Rule 17g-10 requires the following five items:

1. the identity and address of the provider of third-party due diligence services;

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[19] Generally, this will be in connection with the issuance of the ABS. However, if any third party is employed by an NRSRO, issuer or underwriter to perform subsequent due diligence services with respect to an issuance, the third party will incur new obligations under Rule 17g-10.

2. the identity and address of the issuer, underwriter, or NRSRO[20] that employed the provider of third-party due diligence services;

3. if the due diligence performed by the third party is intended to satisfy the criteria for due diligence published by an NRSRO, the third-party must identify the NRSRO and the title and date of the published criteria in a table provided in the form;

4. a description of the scope and manner of the due diligence services provided in connection with the review of assets that is sufficiently detailed to provide an understanding of the steps taken in performing the review, including in that description: (i) the type of assets that were reviewed; (ii) the sample size of the assets reviewed; (iii) how the sample size was determined and, if applicable, computed; (iv) whether the accuracy of information or data about the assets provided, directly or indirectly, by the securitizer or originator of the assets was reviewed and, if so, how the review was conducted; (v) whether the conformity of the origination of the assets to stated underwriting or credit extension guidelines, standards, criteria or other requirements was reviewed, and if so, how the review was conducted; (vi) whether the value of collateral securing the assets was reviewed and, if so, how the review was conducted; (vii) whether the compliance of the originator of the assets with federal, state, and local laws and regulations was reviewed and, if so, how the review was conducted; and (viii) any other type of review that was part of the due diligence services conducted by the person completing the Form ABS Due Diligence-15E; and

5. a summary of the findings and conclusions that resulted from the due diligence services that is sufficiently detailed to provide an understanding of the findings and conclusions that were conveyed to the person(s) identified in item 2 above.

Required Certification

Form ABS Due Diligence-15E is required to be executed by an individual who is duly authorized by the person providing the third party due diligence services to make the required certification. That person must represent and warrant that: (1) he or she has executed the form on behalf of, and on the authority of, the third party; and (2) the third party conducted a thorough review in performing the due diligence described in item 4 above and that the information and statements contained in the form, including the information and statements referred to in items 4 and 5 above, are accurate in all significant respects on and as of the date of the execution of the form.

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[20] This requirement may be satisfied pursuant to the Rule 17g-10 "safe harbor" discussed above.

NRSROs Must Make Forms ABS Due Diligence-15E Publicly Available

In addition to the certifications required to be made available to NRSROs by third party due diligence providers, the Dodd-Frank Act also required the SEC to adopt a rule requiring an NRSRO that receives a certification from a provider of third-party due diligence services to disclose the certification to the public in a manner that allows the public to determine the adequacy and level of the due diligence services provided by the third party. As a result, the SEC amended Rule 17g-7 to require an NRSRO to publish with any rating action[21] it takes with respect to ABS any executed Form ABS Due Diligence-15E subject to the rating action that is received by the NRSRO or obtained by the NRSRO through a Rule 17g-5 website.

> *Note: The requirement for an NRSRO to publish any Form ABS Due Diligence-15E is irrespective of whether and to what extent the NRSRO used the information in the form in taking the rating action.*

Conclusion: Changes Ahead

The Final Rules impose new obligations and liabilities on providers of third-party due diligence services, NRSROs, issuers and underwriters of ABS. To satisfy the requirements of the Final Rules, we anticipate that participants in ABS transactions will need to do a review of their policies and procedures in connection with the employment of third-party providers of due diligence services, as well as a determination as to what services constitute due diligence services.

Parties to ABS transactions will also need to determine responsibility and liability for satisfying the requirements of the Final Rules, and determine the impact of the Final Rules on the timing of ABS transactions.

* * * * *

[21] Under Rule 17g-7(a), the term "rating action" means: (a) the publication of an expected or preliminary credit rating before the publication of an initial credit rating; (b) an initial credit rating; (c) an upgrade or downgrade of an existing credit rating (including a downgrade to, or assignment of, default); and (d) an affirmation or withdrawal of an existing credit rating if the affirmation or withdrawal is the result of a review of the credit rating assigned by the NRSRO using applicable procedures and methodologies for determining credit ratings.

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

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Clients&FriendsMemo

At Long Last – SEC Adopts Final Regulation AB II

September 5, 2014

On August 27, 2014 the Securities and Exchange Commission (the **"SEC"**) approved final rules relating to asset-backed securities ("**ABS**") disclosure and registration (the **"Final Rules"**)[1]. The Final Rules are contained in a final release[2], which was published on September 4, 2014 on the SEC's website (the **"Final Release"**). The Final Rules represent the culmination of a lengthy rulemaking process, which began with the publication by the SEC in early 2010 of proposed rules[3] (the **"2010 Proposal"**)[4] and the subsequent re-proposal in 2011 of a portion of the proposed rules[5] (the **"2011 Re-Proposal"** and, collectively with the 2010 Proposal, the **"Proposed Rules"**)[6]. Although the Final Rules would make changes not only to Regulation AB, but to various other rules, regulations and forms under the Securities Act of 1933 (the **"Securities Act"**) and the Securities Exchange Act of 1934 (the **"Exchange Act"**), they have become popularly known as "Regulation AB II."

1 For a brief summary of the open meeting at which the Final Rules were adopted, see http://www.cadwalader.com/resources/clients-friends-memos/sec-adopts-regulation-ab-ii

2 Release Nos. 33-9638; 34-72982.

3 Securities Act Release No. 33-9117 (Apr. 7, 2010), 75 FR 23328.

4 Cadwalader's memorandum describing the 2010 Proposal is available at http://www.cadwalader.com/resources/clients-friends-memos/sec-proposes-significant-enhancements-to-regulation-of-asset-backed-securities. The Proposed Rules proposed (1) various changes to the eligibility requirements for use of a shelf registration statement by issuers of ABS, including the creation of two new registration statements under the Securities Act for exclusive use with ABS, (2) changes to the disclosure requirements of Regulation AB, most notably to mandate the disclosure of loan level information about securitized asset pools and the filing of a "waterfall program" used to structure the ABS cash flows, (3) changes to the periodic reporting requirements applicable to ABS, including the requirement to file updated loan-level information on the status of the individual assets in the pool and (4) requiring exempt ABS offerings made in reliance on Securities Act Rule 144A or Regulation D to comply with the line item disclosure requirements of Regulation AB, which are currently only mandatory for registered offerings.

5 Securities Act Release No. 33-9244 (July 26, 2011), 76 FR 47948.

6 The 2011 Re-Proposal primarily modified certain proposed shelf registration eligibility criteria for ABS in light of the adoption, subsequent to the 2010 Proposal, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (**"Dodd-Frank"**), whose requirements relating to ABS , including risk retention, repurchase history reporting and elimination of the ability to cease Exchange Act reporting, overlapped many of the elements first proposed by the SEC in the 2010 Proposal.

I. THE BIG PICTURE--WHAT THE FINAL RULES DO AND DON'T DO...AND WHEN

The policy objective underlying the Final Rules is to address some of the weaknesses exposed in the ABS markets during the recent financial crisis by (1) providing more information to investors about the assets underlying ABS, thereby allowing them to perform their own due diligence and reduce reliance on credit ratings, (2) ensuring that investors in registered ABS have adequate time to review the transaction structure and collateral characteristics before making an investment decision and (3) ensuring that ABS issued under a shelf registration statement, which allows rapid access to capital markets but without prior SEC staff review, are designed by issuers with greater oversight and care. The Final Rules adopt, with modifications reflecting some of the comments received by the SEC, most of the elements of the Proposed Rules with respect to the registration and offering of ABS, as well as enhanced disclosure and periodic reporting with respect to registered ABS, most significantly mandating, for the first time, initial and ongoing asset-level reporting with respect to the assets underlying the most common types of ABS.

Although the Final Rules contain many significant changes to the public ABS registration and offering process and to required disclosures for registered ABS, the SEC did not adopt two of the most controversial elements of the Proposed Rules, namely (1) the proposed requirement that issuers make available the same information in private offerings conducted under Rule 144A or Regulation D as is required by Regulation AB in registered offerings and (2) the proposed requirement to file a waterfall program reflecting the contractual cash flow of the ABS that could be used by investors to output cash flows using their selected interest rate, prepayment and default assumptions together with the asset-level data supplied by the issuer. In addition, as described in Part III.A below, the Final Rules impose initial and ongoing asset-level disclosures only on ABS backed by certain asset classes, rather than on all ABS as had been proposed in the Proposed Rules.

> *Note: While these proposals were not adopted, in the Final Release the SEC expressly states that the proposals remain open, leaving open the possibility that they could be implemented in the future. In addition, during their remarks at the open meeting in which the Final Rules were adopted, at least one SEC commissioner made comments supportive of adopting most of these proposals at a future date. It seems likely to us that, given the addition by Section 942 of the Dodd-Frank Act of Section 7(c) to the Securities Act, mandating the SEC to require issuers to disclose asset-level data if necessary for investors to perform due diligence, the SEC may eventually prescribe loan-level disclosure for asset classes other than those addressed in the Final Rules. Whether efforts to extend Regulation AB disclosures to private transactions again pick up momentum may depend on the success of the investor protections added by the Final Rules and the extent, if any, to which transactions shift into the private markets to avoid some of the elements of the Final Rules.*

The Final Rules will become effective 60 days after publication in the Federal Register. Compliance with the Final Rules, including registration on the new ABS-specific registration forms, will be required not later than one year after the effective date, except for the requirement to provide asset-level information, which will be required not later than two years after the effective date.

II. REVISIONS TO SECURITIES ACT REGISTRATION AND OFFERING PROCEDURES

A. New Registration Forms

In order to better tailor registration forms to the requirements for ABS and to differentiate ABS offerings from other offerings, the Final Rules adopt two new forms of Securities Act registration statements, designated Form SF-1 (for non-shelf offerings) and Form SF-3 (for shelf offerings)[7]. Forms S-1 and S-3 will no longer be available to issuers of ABS. In addition, in order to prevent circumvention of the new shelf eligibility requirements described below for ABS, the Final Rules eliminate the long-standing rule that separately permitted shelf registration of "mortgage related securities"[8].

B. Shelf Eligibility Criteria—New Transaction Requirements

New Form SF-3 eliminates the investment grade requirement that had been a condition to use of Form S-3 for ABS and replaces it with four new transaction requirements for shelf eligibility that are intended to reduce investor reliance on ratings, increase the oversight of ABS and provide substantive investor protection by enhancing the enforcement of their rights under the transaction documents and their ability to communicate with each other for the purpose of exercising those rights. The new transaction requirements are:

- a certification at the time of each offering by the chief executive officer of the depositor regarding the disclosure in the prospectus and the structure of the transaction;

[7] The ability to use the registration forms for ABS turns on whether a security meets the definition of "asset-backed security" contained in Item 1101 of Regulation AB. Under that definition as it currently exists, an offering involving prefunding currently must have a prefunding period not exceeding one year and the amount of prefunding may not exceed 50% of the proceeds of the offering (or of the total asset pool supporting the securities, in the case of master trusts). The Final Rules amend the definition of "asset-backed security" to reduce the maximum prefunding percentage to 25%.

[8] Securities Act Rule 415(a)(1)(vii). That rule, which predated the expansion of Form S-3 to allow registration of any ABS rated in the four highest rating categories, has been little used in the past two decades because of the limitation in the definition of mortgage related security to securities rated in the two highest rating categories.

- a provision in the underlying transaction documents requiring a review of pool assets for compliance with representations and warranties upon the occurrence of specified triggers;

- a provision in the underlying transaction documents providing a dispute resolution mechanism for pool asset repurchase requests; and

- a provision in the underlying transaction documents requiring that investor communication requests be included in the issuing entity's periodic reports on Form 10-D.

The following is a more detailed summary of each of the new transaction requirements:

1. **CEO Certification**: The chief executive officer of the depositor[9] is required to sign a certification for each offering, dated as of the date of the final prospectus, that states verbatim:

   I [identify the certifying individual] certify as of [the date of the final prospectus under § 230.424 of this chapter] that:

   1. I have reviewed the prospectus relating to [title of all securities, the offer and sale of which are registered] (the "securities") and am familiar with, in all material respects, the following: the characteristics of the securitized assets underlying the offering (the "securitized assets"), the structure of the securitization, and all material underlying transaction agreements as described in the prospectus;
   2. Based on my knowledge, the prospectus does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading;
   3. Based on my knowledge, the prospectus and other information included in the registration statement of which it is a part fairly present, in all material respects, the characteristics of the securitized assets, the structure of the securitization and the risks of ownership of the securities, including the risks relating to the securitized assets that would affect the cash flows available to service payments or distributions on the securities in accordance with their terms;

[9] In a rare instance of walking back a liberalized proposal from the 2011 Reproposal, which would have permitted the certification to be signed by the executive officer in charge of the securitization, the SEC states in the Final Release that the certification must be made by the CEO of the depositor because the certification should be signed by a signatory to the registration statement and, as an officer of the depositor at the highest level, the CEO should have oversight of, and be accountable for, the structuring of the transaction and the prospectus disclosure, even if the CEO doesn't personally undertake credit analysis and relies on the work of others to structure the transaction.

4. Based on my knowledge, taking into account all material aspects of the characteristics of the securitized assets, the structure of the securitization, and the related risks as described in the prospectus, there is a reasonable basis to conclude that the securitization is structured to produce, but is not guaranteed by this certification to produce, expected cash flows at times and in amounts to service scheduled payments of interest and the ultimate repayment of principal on the securities (or other scheduled or required distributions on the securities, however denominated) in accordance with their terms as described in the prospectus; and

5. The foregoing certifications are given subject to any and all defenses available to me under the federal securities laws, including any and all defenses available to an executive officer that signed the registration statement of which the prospectus referred to in this certification is part.

The text of the certification is not permitted to be altered in any way. In the Final Release, the SEC notes that any issues in the certification should be taken into account in the prospectus disclosure since the certification is qualified by reference to the prospectus disclosures. The certification, which is a required exhibit to Form SF-3, must be filed as an exhibit to a current report on Form 8-K along with the final transaction documents no later than the date on which the final prospectus is required to be filed[10].

Note: The SEC has attempted to ameliorate some of the commenters' concerns about increased CEO liability for matters beyond his or her expertise and the wording in the Proposed Rules that suggested to some that the certification could be taken as a guaranty of performance by adding materiality qualifiers, strengthening the language that states that the certification is not a guaranty, acknowledging that external, as well as internal, credit enhancements may be taken into consideration by the CEO, removing references to the sufficiency of cash flows and noting that, unlike a Sarbanes-Oxley certification, this certification does not carry potential criminal liability. However, the SEC acknowledged that the certification will create increased potential litigation risk for the chief executive officer, even when prudent measures are designed to structure an offering. That is small comfort to securitization executives and it remains to be seen whether the certification requirement will drive some offerings to Form SF-1 or into the private markets.

2. **Asset Review Provision:** The underlying transaction documents for each offering must provide for the selection and appointment, at the outset of the transaction, of an "asset representations reviewer" who is not an affiliate of the sponsor, depositor, servicer or trustee or be (or be an affiliate of) the party who performed pre-offering due diligence for the

[10] See revised Item 1100(f) of Regulation AB.

sponsor or the underwriter[11]. The asset representations reviewer is required to review, at a minimum, all 60+ day delinquent assets for compliance with representations and warranties, upon the occurrence of a trigger event specified in the transaction documents. Although the Final Rules do not mandate the range of possible trigger events, they require that at, a minimum, the triggers must include a two prong test consisting of (i) exceeding a delinquency threshold specified in the transaction documents[12], followed by (ii) an investor vote to direct the review, based on processes specified in the transaction documents, but which may not involve more than a 5% investor interest in the pool[13] to initiate the vote or more than a simple majority of those investors casting a vote to direct the review. The asset representations reviewer must have authority to access copies of any asset documents necessary to perform its review and may not be the party to determine whether noncompliance with a representation and warranty constitutes a breach of the transaction documents[14]. The asset representations reviewer is required to provide a report of its findings and conclusions to the trustee. Although not part of the shelf eligibility requirement *per se*, the Final Rules also make corresponding revisions to Form 10-D to require disclosure of a review triggering event that occurs during the applicable reporting period and a summary of the asset representations reviewer's findings and conclusions.

3. **Dispute Resolution Provision:** The underlying transaction documents for each offering must provide that if a request to repurchase an asset under the transaction documents is not resolved[15] within 180 days from receipt of the request, the requesting party shall have the right to refer the dispute, at its discretion, to either mediation or arbitration and the party obligated to repurchase must accept the selected dispute resolution method. Rather than

[11] Affiliation between the asset representations reviewer and an investor is not precluded by the Final Rules, but may be prohibited by the transaction documents.

[12] While the determination of the appropriate delinquency level is left up to the transaction documents, the Final Rules require that the percentage be calculated on the basis of the total dollar amount of delinquent assets in the pool over the total amount of assets in the pool at the end of the reporting period. The Final Rules also require, if the asset pool consists of multiple sub-pools, that the calculation be made at the sub-pool level.

[13] In the Final Release, the SEC states that the percentages used to determine the thresholds for investor action are to be calculated excluding any interests held by the sponsor or the servicer and that, as with delinquency percentages, the requisite percentages should be calculated at a sub-pool level if there are multiple pools. The Final Rules are unclear as to whether the percentages for requesting a vote and/or directing a review are to be based on the dollar amount of the investors' interests, on the number of investors or otherwise. Also, because a simple majority of those voting may direct a review, it should be noted that a review may actually be directed by far less than a majority of *all* investors, which may result in the incurrence of substantial review costs to investors upon the direction of only a small fraction of all investors.

[14] In the Final Release, the SEC states that the trustee should make the determination of whether a repurchase is required based on the conclusion by the asset representations reviewer of whether noncompliance with a representation has occurred.

[15] In the Final Release, the SEC indicates that the term "resolved" leaves open the possibility that the repurchase request may be resolved through means other than repurchase.

specifying who pays for dispute resolution, the Final Rules specify that the allocation of expenses shall be determined by the arbitrator, if arbitration is chosen, or by the parties, if mediation is chosen.

4. **Investor Communication Provision:** The underlying transaction documents for each offering must require that the party responsible for filing periodic reports on Form 10-D include in the report any requests received during the applicable reporting period by investors to communicate with other investors regarding the exercise of their rights under the transaction agreements[16]. The required disclosure must contain the name of the requesting investor, the date the request was received, a statement that the investor desires to communicate with other investors and a description of the method investors may use to contact the requesting investor. The substance of the matter which the requesting investor wishes to discuss is not required to be disclosed. The transaction documents may not require verification of ownership by a record holder of the ABS as a condition to exercise of the communication right, but may provide that the party obligated to file the Form 10-D may require a person who is not the record holder to provide a written certification of beneficial ownership together with one other form of documentation of ownership, such as a trade confirmation, account statement or broker's letter.

Note: Replacement of the investment grade criterion with the new transaction requirements will allow lower-rated and unrated ABS classes, which were previously unable to be registered on a shelf basis and were typically offered in a contemporaneous private offering, to be registered on Form SF-3, eliminating some complexity from the offering process for ABS and according those classes the added value of increased liquidity presumed to be enjoyed by registered securities. However, some issuers may prefer to continue to offer junior classes on a private basis to preserve certain flexible document review procedures that would be limited by the prospectus delivery requirements applicable to registered offerings. For example, in CMBS transactions it is not uncommon for issuers to establish a "war room" containing documents that are material to first loss investors (who are contractually restricted from investing in the registered classes), such as full appraisals, but that are not easily susceptible of being filed as a free writing prospectus.

C. Shelf Eligibility Criteria—New Registrant Requirements; Annual Compliance Evaluation

Form SF-3 carries over the registrant requirement from Form S-3 that is designed to ensure Exchange Act filing compliance by shelf registrants. Specifically, to the extent the depositor

[16] The investor communication mechanism may not be used for communications unrelated to the exercise of rights under the transaction documents such as, for example, marketing communications.

or any issuing entity previously established by the depositor or an affiliate was subject to the periodic reporting requirements of the Exchange Act with respect to a class of AB involving the same asset class during the twelve months (and any portion of a month) preceding the filing of the registration statement, such depositor and each issuing entity must have filed all materials required with respect to the ABS under the Exchange Act and that, subject to certain specified exceptions, all such materials shall have been timely filed.

In addition, Form SF-3 adds a new registrant requirement to support compliance with the four new transaction requirements described in Part I.B above. Specifically, to the extent the depositor or any issuing entity previously established by the depositor or an affiliate was required to comply with the transaction requirements for shelf eligibility with respect to a previously issued class of ABS involving the same asset class during the twelve months (and any portion of a month) preceding the filing of the registration statement, such depositor and each issuing entity must have timely filed all CEO certifications and transaction documents containing the required independent asset review, dispute resolution and investor communication provisions (the "**New Shelf Eligibility Filings**"). The registrant is also required to disclose in each prospectus that it has met this registrant requirement. Unlike with respect to Exchange Act filings, a cure provision is included in Form SF-3 with respect to failure to timely make the New Shelf Eligibility Filings. Specifically, the depositor or issuing entity that failed to make a New Shelf Eligibility Filing will be deemed to satisfy the new registrant requirement 90 days after it makes the required filing.

Traditionally, ABS issuers who could not satisfy the registrant requirements of Form S-3 because of a missing or untimely Exchange Act filing were precluded from filing a new shelf registration statement for twelve months after the violation, but were not precluded from continuing to offer securities on a shelf basis under a registration statement that was previously declared effective. In one of the most potentially significant new developments for ABS issuers, the Final Rules add a new Securities Act rule[17] that specifies that any registration statement previously declared effective will no longer meet the requirements for use of Form SF-3 for an offering if the registrant requirements described above are not met as of ninety days after the end of the depositor's fiscal year end prior to the offering. Essentially, this will require the depositor to annually assess whether all Exchange Act filings and all New Shelf Eligibility Filings have been timely made during the twelve months preceding the 90th day after the end of its fiscal year (*i.e.*, as of March 30th for depositors whose fiscal years end December 31). Should any required filing not have been timely made during the twelve-month look-back period, the depositor will immediately lose the ability to offer securities on a shelf basis for twelve months, unless the failure was with respect to a New Shelf Eligibility Filing that was subsequently cured at least 90 days prior to the annual evaluation date.

[17] Rule 401(g)(4).

Note: In the SEC's view, the annual compliance evaluation merely aligns ABS practice with corporate practice, which measures compliance at the time a registration statement is amended to update the registrant's financial statements under Section 10(a)(3) of the Securities Act. However, given the large number of issuances by programmatic issuers under ABS registration statements, the requirement for monthly filings and the reliance on third parties, such as certain servicing function participants, to provide information required to be filed, the opportunities for inadvertent "foot faults" in timely Exchange Act reporting is greatly magnified in the ABS space. To avoid loss of shelf eligibility under these circumstances, ABS sponsors will need to ensure that their Exchange Act compliance programs are even robust than they are currently.

D. Preliminary Prospectuses Required

The Final Rules implement new Rule 430D, applicable exclusively to ABS, which specifies that information omitted from the prospectus included in a registration statement, other than information with respect to offering price, offering syndicate, underwriting and dealer discounts or commissions, amount of proceeds and other matters dependent on the offering price, must be disclosed in a preliminary prospectus filed under new Rule 424(h). That rule, in turn, requires the preliminary prospectus to be filed not later than the earlier of three business days prior to the first sale in the offering or the second business day after first use, if used earlier. This rule, which is designed to ensure that investors have sufficient time to review the offering materials, reduces the delivery period from the five business days that would have been required under the Proposed Rules. In the event of a material change to the information in the preliminary prospectus, the Proposed Rules would have required the filing of a new preliminary prospectus plus the re-commencement of a five business day waiting period before the first sale. The Final Rules, however, provide that a material change to the information in a preliminary prospectus may be contained in a prospectus supplement[18] delineating the change and must be filed at least 48 hours before the first sale in the offering.

E. Miscellaneous ABS Registration Provisions

The Final Rules also implement the following additional changes to the registration and offering process:

- Exchange Act Rule 15c2-8(b), which requires brokers and dealers to deliver a copy of a preliminary prospectus to investors at least 48 hours prior to a confirmation of sale, has been amended to eliminate the exception for ABS, making this rule now applicable to ABS offerings;

[18] As noted in Part II.E, this is now one of the few instances in which a prospectus supplement is permitted.

- In order to prevent circumvention of the new asset-level disclosure rules, the Final Rules amend Rule 415 to limit the registration of continuous offerings to "all or none" offerings, thereby excluding "best efforts" or "minimum-maximum" offerings except where the total offering size is known but a portion of the securities of a class may both be sold through an underwriter to investors and retained by the depositor or an affiliate;
- The Final Rules, through the instructions to Form SF-3, require that a separate registration statement and form of prospectus be filed for each asset class and each country of origin from which the pool assets originate, unless such additional asset classes or jurisdictions represent in total less than 10% of the asset pool. In addition, the Final Rules require that a single prospectus be filed in connection with each offering (except, as noted above, for a supplement to reflect material changes to a previously filed preliminary prospectus), thereby ending the longstanding ABS market practice of presenting disclosure through a base prospectus and prospectus supplement;
- To allow ABS issuers to more effectively manage multiple registration statements, the Final Rules permit, but do not require, ABS issuers to avail themselves of the ability, previously available only to "well-known seasoned issuers" to pay registration fees on a "pay as you go" basis at the time of each offering. Fees paid on a pay as you go basis are required to be reflected in the preliminary prospectus, will be payable at the time of the filing of the initial preliminary prospectus and will calculated on the basis of the registration fee rate in effect at the date of payment;
- The Final Rules codify the SEC's position that a post-effective amendment must be filed to add any information about structural features or credit enhancements that were not reflected in the prospectus filed as part of an ABS registration statement, in order to allow the SEC staff to review and comment on the new features;
- The Final Rules codify the SEC staff's interpretive position that final transaction documents and other documents required to be filed as exhibits to an ABS registration statement are required to be filed no later than the date that the final prospectus is required to be filed;[19]
- The Final Rules codify the SEC staff's interpretive position that an ABS issuer may choose to comply with the Form SF-3 requirement to incorporate by reference subsequently filed Exchange Act reports by either incorporating all subsequently filed Exchange Act reports or incorporating only subsequently filed current reports on Form 8-K; and
- The Final Rules amend Securities Act Rule 190 to require the separate registration of pool assets consisting of collateral certificates or special units of beneficial interest, while codifying

[19] The SEC did not adopt the proposal from the Proposed Rules that would have required final transaction documents to be filed no later than the date the preliminary prospectus is required to be filed.

the SEC staff's interpretive position that no additional registration fee is payable with respect thereto.

III. ENHANCED DISCLOSURE AND REPORTING REQUIREMENTS FOR ABS

A. Disclosure of Asset-Level Information

The Final Rules adopt asset-level disclosures only for ABS backed by residential mortgage loans, commercial mortgage loans, auto loans, auto leases, debt securities[20] and resecuritizations of ABS. Accordingly, no asset-level disclosure is currently being required under the Final Rules with respect to ABS backed by equipment loans or leases, student loans, credit cards, floorplan loans or other assets, although the SEC expressly notes in the Final Release that it is obligated under Section 7(c) of the Securities Act, as added by Section 942 of the Dodd-Frank Act, to prescribe asset-level disclosures for ABS if necessary for investors to independently perform due diligence, and indicates that it is continuing to consider whether asset-level disclosures would be useful to investors in other ABS asset classes which may be less standardized or involve a large number of assets.[21]

Although the Final Rules require asset-level disclosures with respect to residential and commercial mortgage loans, auto loans or auto leases that underlie ABS backing a resecuritization, the Final Rules exempt such disclosure with respect to assets underlying ABS issued prior to the asset-level disclosure compliance date.

[20] In the Final Release, the SEC indicates that "debt securities" includes both corporate debt and resecuritizations of ABS, which are required to provide the same security-level information with respect to the underlying ABS as is required with respect to corporate debt securities, as well as asset-level information with respect to the assets underlying those ABS if those assets are of the classes for which asset-level disclosure is required under the Final Rules.

[21] The Proposed Rules had proposed 28 general fields of asset level information that would have been required to be disclosed for all asset types at the commencement of an offering, together with additional asset-specific fields of information tailored to ABS backed by residential mortgage loans, commercial mortgage loans, automobile loans, automobile leases, equipment loans, equipment leases, student loans, floorplan financings or corporate debt and to resecuritizations. In addition, the Proposed Rules provided for the provision of grouped account information with respect to ABS backed by credit card receivables. The required data fields were described in a proposed new Schedule L, which would have been required to be filed as an exhibit to a current report on Form 8-K (1) at the time of effectiveness of an SF-1 registration statement or at the date of the filing of a preliminary prospectus, in the case of takedowns from an SF-3 registration statement, (2) at the time of filing of a final prospectus and (3) at the time of the filing of a report under Item 6.05 of Form 8-K, which is required to report differences of five percent or more in any material characteristic of the asset pool at the closing date from the description in the final prospectus.[21] In addition, the Proposed Rules had proposed that similar information be filed for each asset class on an ongoing basis, as an exhibit to Form 10-D. The specific fields required to be filed on an ongoing basis were enumerated in a proposed new Schedule L-D.

Note: The exemption for asset-level data in resecuritizations of legacy ABS responds favorably to the concerns expressed by commenters that much of such asset-level data would be virtually impossible to produce because of the lack of mechanisms in place to capture it at the time the legacy ABS was issued.

The Final Rules adopt a single new Schedule AL, which will be contained in new Item 1125 of Regulation AB. Schedule AL specifies the content of a required asset data file for each asset class to which asset-level disclosure applies. To minimize issuers' implementation cost, the required data fields (referred to by the SEC in the Final Rules as "asset data points") comprising the asset data file for each asset class now consist both of the relevant general fields applicable to such asset class as well as the specific fields tailored to that asset class. The applicable asset data file specified in Schedule AL is required to be provided in the XML data format[22] and must be included in the preliminary prospectus, the final prospectus and each Form 10-D for each offering of ABS to which asset-level disclosure applies. The information is required to be provided as of the close of business on the last day of the reporting period identified in the asset data file[23] unless required by Schedule AL to be provided as of another date, such as the origination date, and must be provided for each asset that was a part of the asset pool at any time during the reporting period. The Final Rules include a new Form ABS-EE, which is required to be used for filing the required asset data file through the EDGAR system[24] and which may also be used by the issuer to provide additional explanatory disclosure related to an asset data file or other asset-level information (including definitions and formulas for each additional asset data point) in addition to the information required by Schedule AL.

In the 2010 Proposal, the SEC had attempted to preclude the possibility that disclosure of certain asset-level data might compromise borrower privacy by proposing that borrower income, debt and credit scores be disclosed in ranges and that more broadly defined geographic identifiers, such as Metropolitan Statistical Areas, be disclosed rather than zip codes. In response to concerns raised by commenters that the proposed asset-level disclosures, combined with publicly available information, such as records maintained in county recorders' offices, could be used to re-identify a borrower, the Final Rules omit various proposed data points for residential mortgage and auto ABS,

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[22] The SEC has published a draft EDGAR ABS XML technical specification at http://www.sec.gov/info/edgar/edgarabsxml1_d.htm. The draft specification contains, among other things, the values or coded responses required for the various data points required to be included in the asset data file.

[23] Although the reporting period for an asset data file included in a Form 10-D would be the distribution period covered by the report, it is a bit less clear under the Final Rules what an appropriate reporting period would be for an asset data file included in a preliminary or final prospectus.

[24] Based on the comments it received, in particular with regard to the difficulty of identifying whether users are investors or potential investors, the SEC abandoned the approach suggested in its 2014 staff memorandum of having a portion of the asset-level data provided through password-protected issuer websites.

most notably with respect to borrower income and debt[25], property sales price, original property valuation, loan origination date, first payment date, whether the borrower is self-employed and the borrower's bankruptcy and foreclosure history[26]. In addition geographic information is required to be provided through 2-digit zip codes, which are broader than the originally-proposed Metropolitan Statistical Areas. In spite of the various deletions and modifications to the data points, the SEC acknowledges in the Final Release that the final data points, while striking a balance between offering transparency and protection of borrower privacy, do not completely eliminate re-identification risk, and notes that issuers may have costs associated with consulting privacy experts on the impact of providing the required disclosures.[27]

> *Note: While the SEC has attempted in good faith to mitigate privacy concerns, there is still something fundamentally troubling about a regulator mandating public disclosure of information that it acknowledges may give rise to liability solely as a result of the disclosure.*

A description of the precise data points required in the asset data file for each covered asset class and the modifications to those data points from the data points proposed in the Proposed Rules is beyond the scope of this memorandum. However, a few noteworthy points applicable to all asset classes that are required to disclose asset-level data, and, in addition, to RMBS and CMBS include:

<u>All Asset Classes</u>

- Disclosure of a unique asset number for the asset, and the source of the number is required;
- Consistent with Item 1111(a)(8) of Regulation AB, which requires the disclosure of loans not meeting disclosed underwriting criteria, and the SEC's view that where incrementally higher levels of loan approval may be granted based on judgmental underwriting, the criteria for the first level of underwriting should be disclosed, Schedule AL requires an indicator of whether

[25] Data points with respect to the borrower's front and back-end debt-to-income ratio at origination and at the time of any modification are still required.

[26] In the Final Release the SEC notes that the borrower's bankruptcy and foreclosure history will have been taken into account in arriving at the disclosed credit score.

[27] In the Final Release the SEC states that it has consulted with and received guidance from the Consumer Financial Protection Bureau that collecting and disclosing asset-level information determined by the SEC to be required as necessary for investors to perform due diligence would not cause an issuer to become a "credit reporting agency" subject to the provisions of the Fair Credit Reporting Act or to result in a violation of that Act to the extent that the disclosed information is a consumer credit report.

the asset met the criteria for the first level of underwriting criteria used to originate the pool asset; and

- Data points have been added regarding the status of assets subject to a repurchase demand, which are designed to mirror, at the asset level, the information required to be reported under Rule 15Ga-1.[28]

RMBS

- Data points have been added for 12-month pay history, number of payments past due and paid through date

- Data points have been added for the most recent aggregate balance of senior or junior liens, to the extent known or available.

- Disclosure is required of any recent property valuations obtained by or for "any transaction party,"[29] although this data point does not require updated valuations to be obtained;
- Precise obligor credit scores, rather than credit score ranges, as originally proposed, are required to be disclosed;

- Servicer advances, including cumulative outstanding advances and advance reimbursement information are required to be disclosed for each of four categories: interest advances, principal advances, tax and insurance advances and corporate advances; and

- Information about the effective date and the nature of the most recent loan modification is required to be disclosed.

CMBS

- Asset data points are brought into greater alignment with the industry-standard CREFC® Investor Reporting Package;

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[28] We note that, because most ABS have monthly distribution dates, this requirement will require asset-level repurchase information to be reported more frequently than aggregated repurchase information is required to be reported under Rule 15Ga-1.

[29] In the Final Release the SEC notes that this should be construed broadly to include, without limitation, valuations obtained as part of due diligence conducted by credit rating agencies, underwriters or other parties to the transaction. In order to comply with this requirement, a sponsor may need to negotiate revisions to current forms of underwriting agreements, rating agency engagement letters and other transaction documents to ensure the availability to it and the reliability of the information required to be disclosed.

- As described above for RMBS, disclosure is required of any recent property valuations obtained by or for "any transaction party," although this data point does not require updated valuations to be obtained; and

- Data points about the three largest tenants, based on square feet, are adopted but rent roll information is not required in spite of commenter request for the data.

B. Static Pool Disclosure

The Final Rules make various changes to Item 1105 of Regulation AB that are designed to increase the clarity, transparency and comparability of static pool information. The changes require (1) an introductory narrative explanation to introduce characteristics of the static pool, the methodology used in determining and calculating the characteristics and any abbreviations used, (2) a description of how the characteristics of the static pool differ from the pool of assets underlying the offered ABS[30], (3) graphical presentation of the static pool information if it would aid understanding, (4) explanatory information about why alternative static pool information, if any, is presented or static pool information is omitted[31], (5) presentation of historical delinquency and loss information in increments of 30 or 31 days through at least 120 days and (6) for amortizing asset pools, graphical illustration of delinquencies, prepayments and losses for each prior securitized pool or by vintage origination year. The Final Rules also add a new item 6.06 to Form 8-K and require that, if the issuer wishes to incorporate static pool information by reference into the prospectus rather than including it in the prospectus, the static pool information should be filed under Item 6.06 no later than the effective date of a registration statement on Form SF-1 or the date on which the preliminary prospectus is required to be filed in the case of an offering under a shelf registration statement.

C. Other Changes to Disclosure Requirements

In addition to the adoption of asset-level disclosures for specified asset classes and the additional requirements made applicable to static pool information, the Final Rules also implement the following changes to the existing disclosure scheme for registered ABS:

- Item 1110 of Regulation AB is amended to require identification of each originator of pool assets if the total amount of assets originated by parties other than the sponsor or its

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30 The instructions to amended Item 1105 cite as illustrative differences between the static pool and the offered pool differences in underwriting criteria, loan terms and risk tolerances.

31 In the Final Release the SEC states that this requirement would not be satisfied by a conclusory statement that the required static pool information is unavailable or not material.

affiliates exceeds 10% of the pool[32];

- Items 1104 and 1110 of Regulation AB are amended to require information about the sponsor or any other identified originator if the sponsor or such originator is obligated to repurchase or replace assets for breach of a representation and warranty and there is a material risk that the effect of such party's financial condition on its ability to comply with its repurchase or replacement obligations could have a material impact on the performance of the pool or the ABS;

- Items 1104, 1108 and 1110 of Regulation AB are amended to require disclosure of any interest retained in the transaction by the sponsor, any servicer or any originator of 20% or more of the pool assets, or by their respective affiliates, as well as any security-specific or portfolio hedges entered into by such party to offset the risk position held;

- An instruction has been added to Item 1103 of Regulation AB to clarify that the summary section of the prospectus should summarize material characteristics of the particular asset pool backing the ABS. Illustrative possible statistical summary information cited by the instruction includes types of underwriting or origination programs, underwriting exceptions and post-origination modifications;

- Item 1102 of Regulation AB has been amended to require disclosure, on the cover page of the prospectus, of the Central Index Key (CIK) number of the depositor, the issuing entity and if applicable, the sponsor;

- Item 1111 of Regulation AB has been amended to require a description of the provisions in the transaction agreements governing modification of any terms of the pool assets, including how any such modification may affect cash flows from the pool assets on the ABS;

- Item 1109 of Regulation AB has been amended to require disclosures about the asset representations reviewer comparable to those disclosures now required about the experience, duties, compensation, indemnification and removal of the trustee; and

- Items 1112 and 1114 of Regulation AB, which require disclosure of financial information with respect to significant obligors and significant credit enhancement providers, have been modified to eliminate certain exceptions for obligations of highly rated foreign governments.

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32 Under existing Item 1110, only originators of 10% or more of the pool assets need to be identified.

D. Other Changes to Periodic Reporting Requirements

In addition to requiring asset-level data with respect to certain asset classes to be provided in each report on Form 10-D, the Final Rules also implement the following changes to the Exchange Act reporting requirements for ABS:

- Delinquency and loss information required to be presented in distribution reports on Form 10-D are required, by virtue of an amendment to Item 1121 of Regulation AB, to be presented in 30 or 31 day increments through at least 120 days;

- Form 10-D is amended to require reference to the CIK number, the file number and the date of any previously reported information that is not reported in a current report because it is substantially the same as the same as the information previously reported;

- Form 10-D is amended to require inclusion of information prescribed in new item 1124 of Regulation AB about material changes in the sponsor's or an affiliate's interest in the ABS resulting from an acquisition or disposition (but not a pledge) of the ABS during the reporting period covered by the Form 10-D. In addition, the resulting amount and nature of any interest or asset retained in compliance with law (*i.e.*, under risk retention requirements, when finally enacted), including amounts retained by third parties to satisfy such legal requirements[33], is required to be separately stated;

- Information is required to be included in Form 10-D concerning any resignation or removal during the reporting period of an asset representations reviewer and, if a new asset representations reviewer has been appointed, the information about the reviewer required by the amendment to Item 1109 of Regulation S-K is required to be provided;

- Item 1122 of Regulation S-K is amended to require that if an ABS servicing function participant's assessment of compliance with servicing criteria identifies a material instance of noncompliance, then (1) the material instance of noncompliance must be described in the annual report on Form 10-K for the ABS and (2) the report on Form 10-K must disclose whether the identified instance of noncompliance was determined to involve the servicing of the assets backing the ABS covered by the report. In addition, the report on Form 10-K is also required to contain a discussion of any steps taken to remedy a material instance of

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[33] This would include, for example, unaffiliated B-piece holders who hold a horizontal first loss position in CMBS transactions under the proposed risk retention rules.

noncompliance previously identified by the servicing function participant for its activities on a platform level for assets of the same asset type as those backing the ABS[34];

- Several SEC staff interpretive positions relating to assessments of compliance have been codified in Item 1122 of Regulation AB. First, an instruction to Item 1122 expressly requires that a description of the scope of the asserting party's servicing platform be included in the assessment. In addition, a new servicing criterion has been added to Item 1122(d)(1) to require an assessment that aggregated information is mathematically accurate and that information, whether aggregated or unaggregated, conveyed to another asserting party accurately reflects the information; and

- Forms 10-D, 10-K and 8-K have been amended to include the CIK number of the depositor, the issuing entity and, if applicable, the sponsor.

CONCLUSION

The Final Rules, while sweeping in scope and containing many detailed changes from the Proposed Rules, particularly with regard to asset-level disclosures, feature no real surprises for anyone who has been following the evolution of Reg. AB II since the 2010 Proposal. While there will be much work to be done, principally by issuers, in implementing the new rules, the potentially severe disruption to certain ABS markets that may have occurred if those traditionally private markets were subject to the same disclosure requirements as registered ABS, has been avoided for now by the SEC's decision to defer consideration of requiring Regulation AB disclosures in private offerings of ABS. The Final Rules also represent a sensible balancing of added investor protections and added transaction costs to ABS markets, such as RMBS, that are still struggling to recover from the financial crisis.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this Clients & Friends Memo.

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34 In the Final release, the SEC, noting inconsistent market practice, states its view that Item 1108(b)(2) of Regulation AB, which requires prospectus disclosure of a servicer's servicing experience, requires disclosure of material instances of noncompliance and steps taken to remedy them.

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CLEARY GOTTLIEB

ALERT MEMORANDUM

March 2, 2015 clearygottlieb.com

Newly Released Interpretation of the Volcker Rule Clarifies that Foreign Banks Are Permitted to Invest in Third-Party Funds with U.S. Investors

On February 27, 2015, the regulatory agencies responsible for implementing the Volcker Rule released an FAQ regarding the interpretation of the Volcker Rule's exemption permitting foreign banking organizations to invest in and sponsor covered funds "solely outside of the United States" (the "SOTUS Exemption").[1] The FAQ confirms that the restriction in the SOTUS Exemption on offers and sales to residents of the United States (the "U.S. Marketing Restriction") applies only to marketing and sales activities undertaken by the foreign banking entity seeking to rely on the SOTUS Exemption, and not to third-party funds or fund sponsors.[2] As a result, the FAQ confirms that foreign banks should be able to rely on the SOTUS Exemption to invest in third-party funds without regard to whether those funds sell interests to U.S. investors, provided the other requirements of the SOTUS Exemption are met. The text of the FAQ and the SOTUS Exemption are attached below.

- As interpreted in the FAQ, the scope of the U.S. Marketing Restriction depends on whether the banking entity seeking to rely on the SOTUS Exemption sponsors or serves as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to the covered fund (a "Related Covered Fund") or does not sponsor or serve in any of those roles (a "Third-Party Covered Fund").
    - For Third-Party Covered Funds, the U.S. Marketing Restriction applies only to the marketing activities of the foreign banking organization seeking to rely on the SOTUS Exemption. Therefore, a foreign banking entity should be able to invest in a Third-Party Covered Fund that has been marketed to U.S. residents by the fund's sponsor, manager or distributor (or other parties) so long as the foreign banking entity and its affiliates do not participate in any offers or sales of covered fund interests to a resident of the United States.
    - For Related Covered Funds, the U.S. Marketing Restriction generally would prohibit any offering to U.S. investors, because the banking entity seeking to rely on the SOTUS Exemption would be deemed to have participated in any offering of the fund to U.S. residents. Secondary market sales of interests to U.S. residents should continue to be permissible, consistent with the discussion of such sales in the Final Rule's preamble.[3]
- As a result of the FAQ, foreign banking entities will be able to rely on the SOTUS Exemption to invest in covered funds in a number of scenarios where there was previously some uncertainty, including:
    - Preexisting and new Third-Party Covered Funds with U.S. investors;

- Third-Party Covered Funds sponsored by U.S. asset managers where the manager has an ownership interest in the fund; and

- Third-party securitization vehicles and structured products that are covered funds.

- The FAQ therefore has confirmed that Third-Party Covered Fund sponsors generally should not need to create parallel or feeder fund structures or alternative investment vehicles to segregate U.S. investors from foreign banking entities seeking to rely on the SOTUS Exemption. In addition, foreign banks that were considering restructuring preexisting investments in Third-Party Covered Funds that had been sold to U.S. investors should no longer need to pursue restructuring options with fund sponsors in order to permit reliance on the SOTUS Exemption.[4]

- It also appears that foreign banking entities should be able to rely on the SOTUS Exemption to invest in U.S.-domiciled Third Party Covered Funds with U.S. investors. Nothing in the statute or the Final Rule indicates that a fund must be domiciled outside of the United States in order to be eligible for the SOTUS Exemption, and this FAQ provides no indication that the Agencies hold a different view.

- The FAQ does not address the second major open interpretive question in the foreign fund context—the treatment of controlled foreign funds that are not "covered funds", such as foreign public funds, and whether they could be deemed banking entities subject to the Volcker Rule's restrictions on proprietary trading and covered fund investments. We understand that the Agencies are continuing to consider this issue, which, along with the interpretation of the U.S. Marketing Restriction addressed in this FAQ, have been the most significant open interpretive issues creating concerns among banks about the July 2015 compliance date. Many banks requested an extension of the Volcker Rule conformance period in relation to these issues in formal submissions to the Federal Reserve in January. Both issues were expected to be resolved by interpretation, and we are hopeful that the Agencies will release guidance on the banking entity issue in the near future as well.

* * *

If you have any questions, please feel free to contact any of Derek Bush, Katherine Carroll, Hugh Conroy, Robert Cook, Patrick Fuller, Michael Mazzuchi, Robert Tortoriello, Alex Young-Anglim or any of your regular contacts at the firm. You may also contact any of our partners and counsel listed under "Banking and Financial Institutions" located in the "Practices" section of our website at http://www.clearygottlieb.com.

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1 See Volcker Rule Frequently Asked Questions (Feb. 17, 2015), available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#13.

The Volcker Rule was enacted as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and is codified as Section 13 of the Bank Holding Company Act of 1956, as amended. 12 U.S.C. § 1851. On December 10, 2013, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together with the Federal Reserve, the FDIC, the OCC and the SEC, the "Agencies") approved substantively similar versions of final implementing regulations for the Volcker Rule (the "Final Rule"). See 12 C.F.R. pt. 44 (OCC); 12 C.F.R. pt. 248 (Federal Reserve); 12 C.F.R. pt. 351 (FDIC); 17 C.F.R. pt. 75 (CFTC); 17 C.F.R. pt. 255 (SEC); 79 Fed. Reg. 5536 (Jan. 31, 2014) (Federal Reserve, FDIC, OCC and SEC); 79 Fed. Reg. 5508 (Jan. 31, 2014) (CFTC).

The SOTUS Exemption is located at 12 U.S.C. § 1851(d)(1)(I) and Section __.13(b) of the Final Rule.

2 The U.S. Marketing Restriction provides that a foreign banking entity may rely on the SOTUS Exemption to sponsor or invest in a covered fund only if "[n]o ownership interest in the covered fund is offered for sale or sold to a resident of the United States". Final Rule § __.13(b)(1)(iii). Section __.13(b)(3) further provides that "[a]n ownership interest in a covered fund is not offered for sale or sold to a resident of the United States . . . only if it is sold or has been sold pursuant to an offering that does not target residents of the United States."

3 The preamble to the Final Rule indicates that a secondary market transfer of fund interests to a U.S. resident would not violate the U.S. Marketing Restriction so long as the fund "conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States." 79 Fed. Reg. at 5742.

4 A number of these preexisting investments may also have benefited from the Federal Reserve's extension of the Volcker Rule conformance period for legacy funds. See Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act (Dec. 18, 2014), available at http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm.

Text of Volcker Rule Frequently Asked Question #13 Released by the Agencies

SOTUS Covered Fund Exemption: Marketing Restriction

13. Section 13(d)(1)(I) of the Bank Holding Company Act ("BHC Act") and section 248.13(b) of the final rule provide an exemption for certain covered fund activities conducted by foreign banking entities (the "SOTUS covered fund exemption") provided that, among other conditions, "no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States" (the "marketing restriction"). Does the marketing restriction apply only to the activities of a foreign banking entity that is seeking to rely on the SOTUS covered fund exemption or does it apply more generally to the activities of any person offering for sale or selling ownership interests in the covered fund? Sponsors of covered funds and foreign banking entities have asked how this condition would apply to a foreign banking entity that has made, or intends to make, an investment in a covered fund where the foreign banking entity (including its affiliates) does not sponsor, or serve, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to, the covered fund (a "third-party covered fund").

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The staffs of the Agencies believe that the marketing restriction applies to the activities of the foreign banking entity that is seeking to rely on the SOTUS covered fund exemption (including its affiliates). This is also reflected in the preamble discussion of the marketing restriction and the structure of the final rule as discussed below.

Consistent with Section 13(d)(1)(I) of the BHC Act, the marketing restriction in the final rule provides that "no ownership interest in the covered fund is offered for sale or sold to a resident of the United States." Section 248.13(b)(3) of the final rule provides that an ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of the marketing restriction if it is sold or has been sold pursuant to an offering that does not target residents of the United States. In describing the marketing restriction in the preamble, the Agencies stated that the marketing restriction serves to limit the SOTUS covered fund exemption so that it "does not advantage foreign banking entities relative to U.S. banking entities with respect to providing *their* covered fund services in the United States by prohibiting the offer or sale of ownership interests in *related* covered funds to residents of the United States."[17]

The marketing restriction, as implemented in the final rule, constrains the foreign banking entity in connection with its own activities with respect to covered funds rather than the activities of unaffiliated third parties, thereby ensuring that the foreign banking entity seeking to rely on the SOTUS covered fund exemption does not engage in an offering of ownership interests that targets residents of the United States.

This view is consistent with limiting the extraterritorial application of section 13 to foreign banking entities while seeking to ensure that the risks of covered fund investments by foreign banking entities occur and remain solely outside of the United States.[18] If the marketing restriction were applied to the activities of third parties, such as the sponsor of a third-party covered fund (rather than the foreign banking entity investing in a third-party covered fund), the SOTUS covered fund exemption may not be available in certain circumstances where the risks and activities of a foreign banking entity with respect to its investment in the covered fund are solely outside the United States.[19]

A foreign banking entity (including its affiliates) that seeks to rely on the SOTUS covered fund exemption must comply with all of the conditions to that exemption, including the marketing restriction. A foreign banking entity that participates in an offer or sale of covered fund interests to a resident of the United States thus cannot rely on the SOTUS covered fund exemption with respect to that covered fund. Further, where a banking entity sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund, that banking entity will be viewed by the staffs as participating in any offer or sale by the covered fund of ownership interests in the covered fund, and therefore such foreign banking entity would not qualify for the SOTUS covered fund exemption for that covered fund if that covered fund offers or sells covered fund ownership interests to a resident of the United States.

17. See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 FR 5536 at 5742 (Jan. 31, 2014) (emphasis added).

18. See id. at 5740.

19. The staffs also note that foreign funds that sell securities to residents of the United States in an offering that targets residents of the United States will be covered funds under section 248.10(b)(i) of the final rule if such funds are unable to rely on an exclusion or exemption under the Investment Company Act other than section 3(c)(1) or 3(c)(7) of that Act. If the marketing restriction were to apply more generally to the activities of any person (including the covered fund itself), the applicability of the SOTUS covered fund exemption would be significantly limited because a third-party foreign fund's offering that targets residents of the United States would make the SOTUS covered fund exemption unavailable for all foreign banking entity investors in the fund. The Agencies' discussion of the SOTUS covered fund exemption in the preamble does not suggest that the Agencies understood the SOTUS covered fund exemption to have such a limited application.

The SOTUS Exemption: Section __.13(b) of the Final Rule

(b) *Certain permitted covered fund activities and investments outside of the United States.* (1) The prohibition contained in § 248.10(a) of this subpart does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity only if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(ii) The activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;

(iii) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

(iv) The activity or investment occurs solely outside of the United States.

(2) An activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (b)(1)(ii) of this section only if:

(i) The activity or investment is conducted in accordance with the requirements of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of one or more States and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(1) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(2) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(3) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) An ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of paragraph (b)(1)(iii) of this section only if it is sold or has been sold pursuant to an offering that does not target residents of the United States.

(4) An activity or investment occurs solely outside of the United States for purposes of paragraph (b)(1)(iv) of this section only if:

(i) The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(iii) The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(iv) No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of this section, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.

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Consensus Interpretation of Treatment of Certain CLO Debt Securities Under the Volcker Rule

This memorandum sets forth the consensus interpretation of the undersigned law firms with respect to whether certain types of asset-backed securities issued by collateralized loan obligation ("CLO") issuers ("CLO Debt Securities") should be considered "ownership interests" under the regulations implementing the Volcker Rule (the "Implementing Regulations").[1] In particular, this memorandum addresses whether CLO Debt Securities that provide for temporary deferrals of required interest payments as described below (an "Interest Deferral Feature") or require early amortization in certain circumstances from available excess cash flow (an "Early Amortization Feature") should be considered an "other similar interest" within the meaning of Section __.10(d)(6) of the Implementing Regulations. This memorandum first briefly outlines certain characteristics of CLO Debt Securities and then describes Interest Deferral Features and Early Amortization Features. It then sets out our conclusion that neither Interest Deferral Features nor Early Amortization Features should cause CLO Debt Securities to be considered "other similar interests" or other "ownership interests" under the Implementing Regulations.

A. General Characteristics of CLO Debt Securities

CLO Debt Securities are senior or mezzanine asset-backed debt securities issued by special purpose vehicles (the "CLO Issuers"), the assets of which consist predominantly of interests in commercial loans. Many CLO Issuers constitute "loan securitizations" as defined under Section __.10(c)(8) of the Implementing Regulations and, under this exemption, such issuers would not constitute "covered funds" under the Implementing Regulations. However, CLO Issuers – particularly CLO Issuers organized before the exemptive criteria were specified under the Implementing Regulations – may also hold limited amounts of assets that disqualify the CLO Issuer from constituting a "loan securitization." The question of whether a particular CLO Debt Security constitutes an "ownership interest" is relevant only to holders of CLO Debt Securities issued by a CLO Issuer that does not qualify for the "loan securitization" exemption or cannot qualify for an exemption from registration under the Investment Company Act of 1940 other than Section 3(c)(1) or Section 3(c)(7) thereunder.

While terms of individual CLO Debt Securities vary, for purposes of this memorandum, CLO Debt Securities are presumed to have the following features:

1. *Fixed entitlement.* The CLO Debt Securities are debt securities issued under an indenture and feature payment entitlements consisting solely of: (i) the right to receive interest at a stated interest rate (either fixed or based on a customary index or interbank rate) and (ii) the right to receive a fixed principal payment on a stated final maturity date (generally, fifteen years or less). The interest due on CLO Debt Securities is not expressed as an entitlement to a share of income, gains or profits of the CLO Issuer, nor is the interest due determined or adjusted by reference to the performance of the underlying assets of the CLO Issuer (except that interest may be deferred and

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1 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (January 31, 2014). This memorandum is based on the Implementing Regulations and the preamble to the Implementing Regulations and is subject to revision based on subsequent rulemaking, written interpretations or guidance.

payment delayed pursuant to an Interest Deferral Feature described below). Investors in CLO Debt Securities have rights only to the foregoing principal and interest entitlements expressed as customary terms of debt securities and do not have any right to residual or remaining assets of the CLO Issuer after other claimants of any type or class are paid. CLO Debt Securities are subject to customary limited recourse provisions under the indenture, but the indenture provides that the entitlements to principal and interest are absolute and not subject to any contingency.

2. *Rated investment grade at issuance; not in default.* The CLO Debt Securities are either senior or mezzanine level debt securities that were rated at least investment grade when originally issued. This rating reflects overcollateralization resulting from the CLO Issuer having issued substantial subordinated or equity securities that are junior to the CLO Debt Securities. Thus, the principal amount of loan assets held by the CLO Issuer at issuance exceeds the principal amount of the CLO Debt Securities and the scheduled cash flows on this asset pool exceed the cash flows that would be required to make all payments of the principal and interest on the CLO Debt Securities (and any senior claims), enhancing the creditworthiness of the CLO Debt Securities.[2]

3. *Treated as debt for tax purposes.* Interest payments on the CLO Debt Securities are treated as interest income for U.S. federal income tax purposes, in accordance with a conclusion of tax counsel expressed in connection with issuance of such CLO Debt Securities that such securities should be treated as indebtedness for tax purposes.

4. *No allocation of losses, write-downs or charge-offs.* While the CLO Debt Securities are issued under an indenture providing for limited recourse to the assets of the CLO Issuer, the terms of the CLO Debt Securities do not provide for allocations of losses, write-downs or charge-offs arising from the underlying assets of the CLO Issuer. Although write-downs of the outstanding principal balance of, or reductions in the amount of interest due on, securities of an asset-backed securities issuer as losses are incurred are common for certain types of securitizations (with related adjustments for recoveries if they occur), the transaction documents for CLO Debt Securities do not include such write-downs or reductions. The entitlements to principal and interest under the CLO Debt Securities are absolute and are not reduced to reflect write-downs or charge-offs of the underlying assets of the CLO Issuer.

5. *Indenture terms.* The CLO Issuer is a special purpose vehicle, and the CLO Debt Securities are issued under an indenture which sets forth the terms and conditions of the CLO Debt Securities, the criteria for the collateral pool backing the CLO Debt Securities, restrictions on the operations of the CLO Issuer and customary non-discretionary responsibilities for an indenture trustee pursuant to terms similar to those governing trustees under indentures qualified under the Trust Indenture Act of 1939. The terms of CLO Debt Securities, including the applicable interest rate and principal amount and payment dates for principal and interest, are established by the indenture upon issuance of the CLO Debt Securities. If principal or interest is not paid when due and payable on a class of CLO Debt Securities, an investor may exercise whatever remedies are available to it under the indenture, including legal process, to seek payment (which remedies may,

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[2] By addressing only CLO Debt Securities that are rated investment grade and meet the other criteria described herein, this memorandum is intended only to focus on the type of CLO securities that are most relevant to banking entity investors, rather than to suggest that securities not meeting one or more of these criteria should necessarily be considered to be "ownership interests." Further, this memorandum does not address the effect of a decline in the original rating prior to the acquisition of the CLO security by the banking entity investor.

however, be subject to typical subordination or 'standstill' enforcement provisions in the case of classes of CLO Debt Securities other than the most senior class).

B. Interest Deferral Features and Early Amortization Features

CLO Debt Securities having the general characteristics described above are not "equity" or "partnership" interests as contemplated by the Implementing Regulations. However, the Implementing Regulations also include as an "ownership interest" any entitlement that meets the definition of "other similar interest."[3] Some elements of the "other similar interest" definition have given rise to questions as to whether CLO Debt Securities with particular features should be classified as "other similar interests" and thus as "ownership interests."[4] We describe two such features below.

Under an Interest Deferral Feature, the obligation of a CLO Issuer to make payment of a fixed interest entitlement is deferred where there is not available cash flow from the CLO Issuer's assets to make such payments on a scheduled payment date, generally as a result of the available cash flow being applied first to make interest payments on more senior CLO Debt Securities. Deferral of interest in these circumstances is not optional but is mandatory under the terms of the indenture. Deferral of interest does not result in forgiveness of the CLO Issuer's payment obligations, but instead results either in a separate claim for deferred interest that is payable (with interest on the deferred amount) on a subsequent payment date or in the claim of the CLO Debt Securities in respect of principal being increased by the amount of the deferred interest. In either case, the relevant deferred amount has a priority of payment similar to the priority of the original claim and may itself be subject to deferral if cash flow to make the deferred payment is not available on subsequent payment dates. The deferred amount in all cases becomes due for payment, with interest, no later than the date on which the class of CLO Debt Securities is redeemed or matures.

Under an Early Amortization Feature, a CLO Issuer may be required to effect an early amortization of the principal balance of a CLO Debt Security under certain conditions that relate to

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3 *See* §§__.10(d)(6)(i)(A) through (G) of the Implementing Regulations.

4 In addition to questions concerning Interest Deferral Features and Early Amortization Features, a question has arisen as to whether the limited right of holders of CLO Debt Securities to remove or approve a replacement for the investment manager of a CLO Issuer should be considered a "right to participate in the selection or removal of . . . [an] investment manager" under subparagraph (A) of the definition of "other similar interest". We do not address that question in this memorandum.

CLO Debt Securities meeting the above criteria can be readily seen not to fall within the other elements of the "other similar interest" definition that are not otherwise addressed in detail herein. The terms of the CLO Debt Securities entitle their holder to a fixed claim for a stated principal amount and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate and not to any "share" of the "income, gains or profits" of the CLO Issuer as described in §__.10(d)(6)(i)(B). The CLO Debt Securities do not "receive the underlying assets" of the CLO Issuer "after all other interests have been redeemed" as described in §__.10(d)(6)(i)(C); they are instead the interests that must be redeemed before the assets or proceeds thereof are distributed to the equity interests in the CLO Issuer. As debt securities, the CLO Debt Securities are a fixed claim, the nonpayment of which ultimately gives rise to default and enforcement rights, rather than an entitlement to "income on a pass-through basis"; and their "rate of return" is a stated rate not "determined by reference to the performance" of the CLO Issuer's assets as described in §__.10(d)(6)(i)(F). Furthermore, CLO Debt Securities do not document any "synthetic right" of any kind as described in § __.10(d)(6)(i)(G). Section references in this footnote are to the Implementing Regulations.

the performance of assets held by the CLO Issuer. In circumstances in which these conditions are met, cash flows over and above the amounts necessary to service the CLO Issuer's debt that would otherwise be reinvested in additional collateral or released as distributions to the holders of the more junior securities of the CLO Issuer are instead applied to pay down the principal balance of the CLO Debt Securities. The early payment to the CLO Debt Securities is not in addition to the fixed entitlement to principal under the CLO Debt Securities, but simply represents a partially accelerated repayment of principal which is satisfied from available cash flow.

C. Analysis

1. *Interest Deferral Features do not "reduce" payments.* In the case of an Interest Deferral Feature, a question arises as to whether such a feature falls within the terms of subparagraph (E) of the definition of "other similar interest." This element of the definition includes any interest in a covered fund that "[p]rovides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest."[5]

We do not believe Interest Deferral Features should be considered to fall within subparagraph (E).

The terms of subparagraph (E) expressly refer to "reductions" rather than deferrals or delays in payment. "Reductions" is presumably intended in this context to refer to features similar to the "write-downs or charge-offs" that are also specified in the Implementing Regulations. "Reductions," "write-downs," or "charge-offs" in asset-backed securities are substantively different than mere deferrals or delays. Under customary provisions in receivables and mortgage securitizations that provide for "reductions," "write-downs," or "charge-offs," losses in the pool securing the asset-backed securities result in the principal or stated amount of the securitization interests being reduced. Losses are first applied to the most subordinate class and then sequentially to each more senior class. Such payment entitlements, once written down, are then reinstated only to the extent recovery amounts are actually received. A holder of a security that has been the subject of a reduction, write-down or charge-off also experiences a change in its overall payment entitlement. In particular, so long as the reduction, write-down or charge-off has not been reinstated, the holder will not accrue interest on the portion of the principal amount that has been written down. Correspondingly, a reduction, write-down or charge-off means that distributions in future periods may be available to make interest payments on securities junior to the written down claim. While there may be a claim for reinstatement of such written down amounts, such claim typically is made at a different priority of payment than the original interest claim.

The deferral of payment resulting from an Interest Deferral Feature has a materially different premise and effect from such reduction, write-down or charge-off terms. First, the interest deferral does not directly result from "losses arising from the underlying assets of the covered fund," but from changes in the timing and amount of interest receipts on these underlying assets. More importantly, however, under an Interest Deferral Feature the holder of the CLO Debt Security continues to be entitled to full principal repayment. Such holder is also entitled to payment of

[5] Implementing Regulations §__.10(d)(6)(i)(E).

interest (including any interest deferred), at a similar level of priority, once cash flows to make such interest payments become available. Indeed, the substance of the claim of a holder of CLO Debt Securities for payment under an Interest Deferral Feature is similar to the claim for ordinary default interest; the difference is the legal effect of the failure to make payment. In the case of a defaulted interest payment, the holder of the defaulted claim may have a right to accelerate the defaulted claim and/or exercise certain remedies against the CLO Issuer under the indenture. An Interest Deferral Feature implies that the holder of the claim for unpaid interest does not have "event of default" or similar remedies arising from the failure to make the scheduled interest payment. Nevertheless, the relevant CLO Debt Securities remain entitled to receive the deferred payment of interest when cash flow is available to make such payment after satisfying any obligations in respect of more senior securities, and before amounts are distributed to holders of more junior securities. While an Interest Deferral Feature may result in the reclassification of a claim for "interest" as a claim for "principal," the amount of the claim itself is not "reduced." Interest Deferral Features thus should not be considered to result in amounts being "reduced based on losses arising from the underlying assets of the covered fund."

2. *Early Amortization Features are claims for principal, not excess spread.* In the case of an Early Amortization Feature, the question is whether such a feature falls within subparagraph (D) of the definition of "other similar interest." This portion of the definition includes as an "other similar interest" any "right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests)."[6]

We do not believe Early Amortization Features should be considered to fall within subparagraph (D).

An Early Amortization Feature is a mandatory redemption feature that redirects cash flow (first, from the CLO Issuer's receipt of interest proceeds with respect to the underlying assets and, if insufficient, then from the CLO Issuer's receipt of principal proceeds with respect to the underlying assets) to pay down CLO Debt Securities in their respective order of priority when interest coverage or overcollateralization tests in the indenture are not met. Such an early amortization payment is not, in our view, the right to receive an "excess spread" as that term is used in the Implementing Regulations, because such an early amortization payment results in a dollar-for-dollar reduction in principal due on the related CLO Debt Security and does not entitle the holder of the related CLO Debt Security to receive principal or interest above what is due pursuant to the terms of such CLO Debt Security. An early amortization payment is simply a manner of satisfying a fixed claim for repayment of principal on an accelerated basis by diverting cash flows that would otherwise be reinvested in additional collateral or paid out junior to the related CLO Debt Security in the waterfall and applying them to prepay such CLO Debt Security (*i.e.*, the Early Amortization Feature simply determines *when* principal is paid, not the *amount* to be repaid). Indeed, the preamble to the Implementing Regulations appears to contemplate this distinction, noting that "the reference to 'all or a portion of excess spread' is meant to include within the definition of ownership interest the right to receive any excess spread which remains after the excess spread is used to pay expenses, *maintain credit enhancement such as*

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6 Implementing Regulations §__.10(d)(6)(i)(D).

overcollateralization or is otherwise reduced. "[7] The Early Amortization Feature in CLOs maintains credit enhancement for the CLO Debt Securities by reducing the principal balance thereof until it is once again in line with the required overcollateralization and interest coverage tests in the CLO transaction. An early amortization payment partially satisfies a fixed claim for principal and thereby creates overcollateralization or credit enhancement in relation to the remaining principal claim, without giving the holder of the CLO Debt Securities any additional or different claims over the CLO Issuer's assets. An Early Amortization Feature should thus be considered only a special condition relating to the timing of the payment of principal, rather than a distinct "right to receive all or a portion of excess spread."

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7 79 Fed. Reg. at 5707 n. 2094 (emphasis added).

Accordingly, we do not believe that either Interest Deferral Features or Early Amortization Features should cause CLO Debt Securities to be considered "other similar interests" or other "ownership interests" within the meaning of the Implementing Regulations.

Nothing in this memorandum should be interpreted to mean that securities that do not have the characteristics described above would necessarily be considered "other similar interests" or other "ownership interests" within the meaning of the Implementing Regulations.

The interpretations set forth in this memorandum do not constitute legal advice on any particular set of facts. The views expressed in this memorandum are the views of the undersigned law firms and not the clients that they represent from time to time and are not intended to address any specific matter on which any of the firms may be advising or in which any of the firms may be appearing on behalf of their clients. No person should act or rely on any interpretation contained in this memorandum without first seeking the advice of legal counsel.

August 5, 2014

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July 17, 2015

Response of the Office of Structured Finance
Division of Corporation Finance

Re: Crescent Capital Group LP
Incoming letter dated July 17, 2015

Based on the facts and representations presented, the Division's views are as follows. Capitalized terms have the same meanings as defined in your letter.

The Division will not recommend enforcement action to the Commission if Crescent Capital Group LP does not retain an eligible risk retention interest under Section 15G of the Securities and Exchange Act of 1934 in connection with a Refinancing of CLOs that were issued in a CLO Transaction priced prior to the December 24, 2014 publication of the Credit Risk Retention Final Rules in the Federal Register, on the terms and subject to the conditions set forth in your letter.

This position[1] is based on the representations made to the Division in your letter. Any different facts or conditions might require the Division to reach a different conclusion. Further, this response expresses the Division's position on enforcement action only and does not express any legal conclusion on the question presented.

Sincerely,

David Beaning
Special Counsel, Office of Structured Finance
Division of Corporation Finance

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[1] In reaching this position, the staff has consulted with the staffs of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

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July 17, 2015

Ms. Katherine Hsu
Chief, Office of Structured Finance
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Ms. Hsu:

We are writing on behalf of Crescent Capital Group LP ("Crescent Capital") to request confirmation that the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") will not recommend enforcement action if Crescent Capital does not retain an eligible risk retention interest under the final rules implementing Section 15G of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") in connection with a proposed refinancing of one or more classes of preexisting collateralized loan obligation ("CLO") securities as described below. No-action relief from the Staff is warranted to protect investor expectations that would be frustrated by application of risk retention requirements to the refinancing of a CLO transaction that was priced prior to the publication of the joint rules implementing Section 15G of the Exchange Act as further described below.[1]

[1] See Credit Risk Retention, 79 Fed. Reg. 77602 (Dec. 24, 2014) (the "Final Rules").

I. Background

Crescent Capital is registered as an investment adviser under the Investment Advisers Act of 1940, as amended, and serves as collateral manager (the "Collateral Manager") for a CLO entity (the "CLO Entity") that issued securities in a private placement transaction that priced prior to December 24, 2014 (the "CLO Transaction"). The securities issued in the CLO Transaction consist of multiple classes of debt securities (the "Secured Notes") and equity classes of securities (the "Subordinated Interests"). The Secured Notes are primarily secured by senior secured syndicated corporate loans owned by the CLO Entity, which are subject to limited sale and substitution from time to time in accordance with the terms of the CLO Transaction (the "Collateral Obligations"). Neither the CLO Entity nor the pool of assets is registered as an investment company pursuant to the Investment Company Act of 1940, as amended (the "Investment Company Act"), in reliance on an exemption from registration under the Investment Company Act.

The CLO Transaction has a feature that permits the interest rate on the Secured Notes to be reduced to market clearing levels. The reduction in interest rate may be effected through a "refinancing" of the relevant classes of Secured Notes (a "Refinancing"). In a Refinancing, an existing class of Secured Notes is redeemed with the proceeds of replacement notes ("Refinanced Notes") bearing the new interest rate which are issued by the CLO Entity and sold by a registered broker dealer on the CLO Entity's behalf. The sales of Refinanced Notes may be to existing investors or substitute investors.

The indenture for the CLO Transaction requires the CLO Entity to conduct a Refinancing if directed to do so by specified parties. Upon receiving the direction to conduct a Refinancing of one more classes of Secured Notes (each such class subject to a Refinancing, the "Original Notes"), the CLO Entity will provide a required notice to the holders of the Original Notes, as well as to rating agencies and other transaction parties. The Collateral Manager (on behalf of the CLO Entity) would retain a registered broker dealer to identify eligible purchasers for any Replacement Notes, which will be sold in a private placement transaction. A supplemental indenture will be prepared to modify the interest rate, and notice of such supplemental indenture will be sent to the holders of all securities issued in the CLO Transaction (including the Original Notes).

II. The Proposed Refinancing

The proposed Refinancing will be subject to the following conditions:

- Refinancing will be completed (*i.e.*, by the issuance of the relevant Refinanced Notes) within four years after the original closing date of the CLO Transaction;
- The interest rate applicable to the Refinanced Notes will be lower than the interest rate of the Original Notes;

- Other than the reduction of the interest rate of the Original Notes, after giving effect to a Refinancing:
    - the CLO Entity's capital structure will be unchanged;
    - the principal amount of the Refinanced Notes after a Refinancing and the Original Notes after a Refinancing will be the same;
    - the priority of right of payment of the Refinanced Notes and the Original Notes will be the same;
    - the voting and other consent rights of the Refinanced Notes and the Original Notes will be the same; and
    - the stated maturity of the Refinanced Notes and the Original Notes will be the same;
- The CLO Entity's investment criteria will not change as a result of the Refinancing;
- No securitization of additional assets will be effected by a Refinancing (*i.e.*, proceeds from the issuance of the Refinanced Notes will be used only for the redemption of the Original Notes), it being understood that the Collateral Manager will continue to actively manage the Collateral Obligations on the CLO Entity's behalf;
- No additional Subordinated Interests will be issued in connection with a Refinancing;
- Refinancing will not cause the identity of the holders of Subordinated Interests to change;
- Refinancing of different classes of Secured Notes may occur on different dates; however, each class of Secured Notes will be subject to only one Refinancing and the supplemental indenture executed in connection with Refinancing each class will prohibit any further Refinancing of the Refinanced Notes;
- The offering document for the Replacement Notes will, among other things:
    - (i) include a prominent statement (*e.g.,* on the cover of the offering document) that the sponsor is not retaining a risk retention interest contemplated by the Final Rules in connection with a Refinancing or the Refinanced Notes;

(ii) describe the interest rates of the Refinanced Notes and confirm that all other legal and economic terms of the Refinanced Notes will be the same as the Original Notes; and

(iii) include a statement in a section entitled "Credit Risk Retention" to the effect that reliance on the no-action letter contemplated hereby does not preclude the availability of any applicable private rights of actions for any violation of the federal securities laws.

III. Basis for Relief

Because the CLO Transaction was priced prior to publication of the Final Rules, the refinancing feature was not structured to accommodate risk retention, and neither the Collateral Manager nor the investors in the CLO Transaction expected that the risk retention obligation would apply with respect to a Refinancing. Absent the ability to reduce interest rates of one or more classes of Secured Notes, when interest rates for securities similar to the Secured Notes in the market may have dropped significantly since the issuance of the Secured Notes, the CLO Entity would likely redeem the Secured Notes, imposing additional costs related to the liquidation of its assets, among other effects. A Refinancing permits the CLO Transaction to remain in place at a cost to the CLO Entity more consistent with current market levels. The ability to effect a Refinancing helps preserve investor expectations that they will have the opportunity to exit their investment at par, or remain invested in the CLO Transaction, without the cost of redemption and related reinvestment risk. If a Refinancing were to require the Collateral Manager to retain a risk retention interest, the economic impact to the Collateral Manager of satisfying this obligation would make the Refinancing prohibitively expensive and would frustrate the investor expectations described above.

Asset-backed securities transactions such as the CLO Transaction intrinsically involve fixed investment arrangements in the context of a static capital structure with a limited asset pool. These characteristics adversely affect the ability of such transactions to preserve investor expectations in the face of regulatory changes.

IV. Request for No-Action Relief

Based on the foregoing, Crescent Capital respectfully requests that the Staff confirm that it will not recommend enforcement action if the risk retention interest described in the Final Rules is not retained in connection with a Refinancing in accordance with the terms set forth above.

* * * * *

We appreciate your assistance in this matter. Please do not hesitate to call Michael Mazzuchi (202-974-1572), Paul St. Lawrence (202-974-1782), Joyce McCarty (202-974-1574) or Sarah Crandall (202-974-1627) of the Washington office of Cleary Gottlieb Steen & Hamilton LLP, if you have any questions regarding the relief requested herein. If the Staff does not concur with Crescent Capital's position, Crescent Capital requests an opportunity to confer with the Staff concerning the applicable terms of the Refinancing prior to the issuance of a response.

Very truly yours,

/s/ Michael Mazzuchi

Michael A. Mazzuchi

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Hot Topics in Residential Mortgage Origination, Finance and Securitization

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Private-Label Residential Mortgage-backed Securities

Developments and trends for the MBS sector

KEY POINTS

- An improving economy and tighter lending standards have reduced the risk of default and foreclosure in the MBS sector
- Today, mortgage-backed securities offer attractive yields, compared to US treasuries, with lower-than-historical default risk
- New initiatives in the market may help reignite investor interest in private mortgage-backed securities

Private-Label RMBS

Mortgage-backed securities (MBS), both those backed by government agencies and the private-label non-agency sector, could provide investors with added yield in the current low interest rate market. An improving economy and tighter lending standards have reduced the risk of default and foreclosure in these securities, while low interest rates have contributed to a steady, though not spectacular, supply of new issuance.

Still, many investors continue to shy away, especially from non-agency, private-label residential mortgage-backed securities because of their perceived risk and lack of transparency in this asset class. In this article, we'll review the state of the mortgage market, trends in securitization in both agency and non-agency securities, as well as developments that may make private-label residential mortgage-backed securities more attractive to investors going forward.

The mortgage market

After two years of jobs growth, the housing market has improved but has not fully recovered. New mortgage underwriting has been slowed by tight underwriting standards and still uncertain employment prospects for many individuals. Moreover, demographic changes have been driving the demand for mortgages. Millennials burdened by student loan debt have been reportedly reluctant to buy houses, while Baby Boomers are looking to downsize their living space.

At the same time, mortgage rates remain near historic lows. The 30-year fixed rate stood at 3.89% in January 2015, down from 4.59% a year earlier and not far above lows touched in 2013 (see Figure 1).

One consequence is that after half a decade of ultra-low rates, many homeowners have already refinanced, so the bulk of the mortgage market volume comes from new purchases.

Figure 1: 30-Year Fixed Mortgage Rates

30-year fixed mortgage rate	
January 2011	5.10%
January 2012	4.23%
January 2013	3.78%
January 2014	4.59%
January 2015	3.89%
January 2016	4.02%

Source: HSH mortgage rates, 30 years, January of each year listed

Private-Label RMBS

As a result, mortgage issuance is steady, but well below peak levels. While the supply of new mortgages has held steady, the quality and performance of these securities has gone up.

Tighter lending standards have meant fewer delinquencies and foreclosures. Rising home prices have buoyed the market. Today, mortgage- backed securities offer attractive yields, compared to US Treasuries, with lower-than-historical default risk.

Trends in securitization

Though the overall mortgage market has stabilized, the private-label residential mortgage-backed securities market is still moribund. The vast majority of the securitizations in the mortgage-backed market are agency-backed, underwritten by Fannie Mae, Freddie Mac, and Ginnie Mae (see Figure 2). This is partly a backlash against the events of 2006 and 2007, when markets were flooded with subprime non- agency mortgage-backed securities, many of which experienced very high losses.

Figure 2: Securitization Volumes

Year	Agency	Non-Agency
2010	$1.3 trillion	$5 billion
2011	$1.1 trillion	$5 billion
2012	$1.7 trillion	$11 billion
2013	$1.5 trillion	$34 billion
2014	$0.9 trillion	$52 billion
2015	$1.3 trillion	$45 billion

Source: Bank of America/Merrill Lynch US securitized products research conference

Originators are still making non-agency mortgages, but they have tended since the credit crisis to structure them as whole loans, rather than securitizing them. Hedge funds, insurance companies, and other large institutional investors have been heavy buyers of these whole loans, which provide greater transparency around the specifics of the loan, as well as much leverage over the terms of the deal.

Bringing investors back to the non-agency MBS market

The MBS market will likely always be dominated by agency-backed securities, and investors are still understandably reluctant to commit capital to a thinly traded market where private-label residential securitization structures and terms vary, and disclosure may be less than desired by some of the major investors. However, new initiatives in the market now may help reignite investor interest in private mortgage-backed securities.

For instance, the Structured Finance Industry Group (SFIG), comprised of investors, investment banks, commercial banks, accounting firms, rating agencies, servicers, master servicers, law firms, and trustees, is currently working on RMBS 3.0, a set of industry standards for private-label residential mortgage-backed securitizations that will make transactions more transparent and comparable.

The U.S. Department of the Treasury has responded by proposing a "benchmark transaction," a transaction with acceptable terms and significant size. Through a collaborative process: issuers, investors, servicers, trustees, and other market participants will identify structural reforms, roles, and responsibilities for each transaction party, and the protections necessary to bring more and larger private-label mortgage-backed securities investors back to the market.

Private-Label RMBS

The benchmark transaction would establish model documents and terms, making it easier for issuers to generate new securities and for investors to evaluate them. Issuers could still create custom structures for their securitizations by annotating this standard document with changes. As the Treasury puts it, "The benchmark would serve not as a one-size-fits all solution, but as a point of departure for future transactions."

Both SFIG and the Treasury can also build on the innovative approaches to transferring credit risk developed for the agency market, including Fannie Mae and Freddie Mac's credit-related transactions, (which shift credit risk to insurers), such as Fannie Mae's Madison Avenue deals and Freddie Mac's STACR transactions.

Cadwalader represented Freddie Mac in the development of the STACR notes which were designed to reduce Freddie Mac's exposure to single-family mortgage credit risk and to transfer that risk to investors.

Note: This article was adapted from "Private-Label Residential Mortgage-backed Securities – Development and trends for the MBS sector," by Wilmington Trust Corporation, a wholly owned subsidiary of M&T Bank Corporation, 2015.