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ALERT MEMORANDUM

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Credit Risk Retention: The New Proposal and its Implications

Including a special focus on the new Qualified Residential Mortgage definition, and the potential impact on the collateralized loan obligation and commercial mortgage backed securities markets

On August 28, 2013, the federal banking and housing regulatory agencies jointly re-proposed rules (the "Revised Proposal")[1] to implement Congress's mandate in Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd Frank") (codified at Section 15G of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") that sponsors of asset-backed securitizations retain a portion of the risk of assets that they securitize. Proponents of this mandate have argued that significant informational gaps and misaligned incentives between sponsors of and investors in residential mortgage-backed securities ("RMBS") led to and promoted excessive risk-taking in the origination of mortgages that were packaged into RMBS in the years leading up to the financial crisis. Lawmakers believed that "originate to distribute" business models adopted by some mortgage lenders – particularly non-bank lenders funded almost exclusively by the securitization of mortgages – with new loans originated for practically immediate sale to a securitization vehicle, created incentives for lenders to loosen underwriting standards because they would retain little or no post-securitization exposure to the underlying mortgages. Requiring sponsors to retain exposure to a portion of the credit risk otherwise borne by investors in securitizations is intended to better align the incentives of those transferring the assets to an asset-backed securities ("ABS") issuer and those investing in the ABS issuer's securities. While RMBS was clearly the market of greatest concern, Section 941 also required risk retention rules to be promulgated for other asset classes although with fewer specific prescriptions regarding the origination and underwriting of the underlying assets.

The agencies' first proposed rulemaking to implement Section 15G of the Exchange Act was the joint notice of proposed rulemaking (the "Original Proposal") published March 31, 2011.[2] Over 10,500 comment letters were submitted in response, many heavily criticizing core aspects of the rule. Although much of the public commentary on the proposal focused on its potential effect on the mortgage industry through the proposed definition of "qualified residential mortgage" (the securitizations of which would fall outside the credit risk retention mandate), the proposal applied to asset-backed securities generally and thus generated responses from all corners of the financial markets.

[1] Credit Risk Retention, Exchange Act Release No. 34-70277 (Aug. 28, 2013).

[2] Credit Risk Retention, 76 Fed. Reg. 24090 (Apr. 29, 2011).

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Due to the extensive comments in response to the rulemaking, the U.S. Securities and Exchange Commission ("SEC"), Office of the Comptroller of the Currency ("OCC"); Board of Governors of the Federal Reserve System ("Fed"); Federal Deposit Insurance Corporation ("FDIC"); Federal Housing Finance Agency ("FHFA"); and Department of Housing and Urban Development ("HUD") (together, the "Agencies") have issued the Revised Proposal and again invited public comment. Comments on the Revised Proposal are due to the Agencies by October 30, 2013 (although requests to extend this comment period have already been submitted).

If adopted, the Revised Proposal would become effective one year after publication of the final rules in the federal register in the case of securitization transactions collateralized by residential mortgages, and two years after publication in the case of securitization transactions collateralized by any other asset classes.

The Revised Proposal maintains much of the original framework of the originally proposed rules, but with two key modifications.

The Agencies have attempted to provide more flexibility to sponsors in how they retain the required credit risk. The Revised Proposal permits sponsors to hold any combination of "horizontal" and "vertical" slices of the securitization's ABS interests so long as the aggregate fair value is at least 5% of the fair value of all ABS interests. In other words, a sponsor may now retain its 5% of credit risk through a vertical slice constituting 3% of each class of interests issued by the ABS issuer and a horizontal slice constituting 2% of the fair value of all ABS interests. The Agencies also introduced flexible approaches to how the vertical and horizontal interests can be structured; for example, in order to avoid requiring a sponsor opting for the vertical interest approach to hold multiple securities, the Revised Proposal permits the creation of a single vertical interest security that would receive the same percentage interest in each class of ABS interest.

The other key change in the Revised Proposal is the requirement that risk retention be measured based on the fair value of the ABS interests, not their par value. This modification is intended to measure credit risk of the ABS interests in a manner more consistent with market practice, but presents new issues regarding the appropriate methods of determining fair value. The Agencies do not attempt to prescribe how fair value must be calculated, other than requiring it to be determined in accordance with generally accepted accounting principles; instead, the Revised Proposal imposes disclosure obligations on the sponsor so that investors will have information regarding the inputs and methods used by the sponsor to make such calculations.

The switch to fair value as the measure of credit risk has led the Agencies to incorporate new restrictions on cash flows to be paid to eligible horizontal interests. The Agencies found this necessary to limit how quickly a sponsor may recover the fair value of its initial investment so that distributions on the horizontal interest would not dilute the sponsor's retained risk. The main proposal to accomplish this would require sponsors to determine at the outset that the transaction would not result in the eligible horizontal interests receiving, as of any payment date, a greater percentage of the initial fair value of its horizontal interest than the percentage of principal paid on all other ABS interests. This restriction on cash flows would conflict with the

market practice for a number of securitization products and we would expect this aspect of the proposal to draw considerable comment.

The Revised Proposal includes specific compliance regimes for many product types; while the risk retention approaches may work for some markets, there are still significant obstacles in others.

There may be a range of reactions to the proposal across different securitization markets. The three markets discussed in this outline, RMBS, collateralized loan obligations, and commercial mortgage backed securities ("CMBS") provide an example of how the new rules may have different effects depending on the product.

The modification of the Qualified Residential Mortgage definition to match the Qualified Mortgage definition adopted by the Consumer Financial Protection Bureau in January of this year would significantly increase the number of residential mortgage loans that would be eligible for securitization without the sponsor being required to retain any credit risk. In addition, it provides much needed certainty to the residential mortgage market. At the same time, the inclusion of an alternative QRM proposal that retains a loan-to-value requirement, could create some lingering uncertainty. Overall, however, we expect the reaction to the new mortgage related rules to be generally positive.

The Revised Proposal was less encouraging for open market CLOs. The Agencies, despite significant criticism of their original proposal, maintain their position that CLO managers are "sponsors" under the statute and therefore are the appropriate parties to retain the required level of credit risk. This is likely to renew concerns about further consolidation, and reduced competition, among CLO managers as market participants consider whether they will have access to, or be inclined to allocate, the amount of capital required to manage CLOs if the current proposal is enacted as written. The Agencies' alternative proposal, exempting from risk retention CLOs that only own loans where the lead arranger retained 5% of the credit risk of the loan, would require significant modifications to the leveraged loan market. Accordingly, the Revised Proposal's treatment of CLOs will again be the subject of significant comment.

The market for CMBS transactions will, on the other hand, likely see the new proposals as an improvement over the original proposal, with some work left to be done. Agencies have made a number of changes to the rules specific to CMBS transactions that were responsive to industry comments and should make the regime more workable in the context of current market practice. Market participants may find it helpful that the sponsor has been given the ability to share the risk retention responsibility with the B-piece buyer, that the transfer restrictions on the credit risk retention interest originally purchased by the B-piece buyer have been relaxed, and certain modifications have been made to the role of the operating adviser. Despite these improvements, we expect there will certainly be areas of continued concern and comment, such as some of the disclosure requirements around the B-piece buyer and the rigid underwriting standards for Qualifying Commercial Real Estate Loans.

The following outline summarizes the main features of the Revised Proposal's general risk retention requirements, and discusses the key implications of the proposal for securitization market participants. We have highlighted specific issues and questions that the Revised

Proposal raises and that should be the subject of comment. We have also, where appropriate, discussed how participants in securitization markets may attempt to address certain proposed requirements.

The outline is structured in three general parts. First, we summarize and provide analysis of the general risk retention requirements, and including how the Agencies have modified the requirements from the Original Proposal. Second, we focus on the definition of QRM and the impact the new definition may have on mortgage markets. Finally, the outline goes into greater detail on the application of the credit risk retention requirements to the secondary mortgage market and the potential for a resurgent private-label securitization market, as well as its impact on two other securitization markets that have experienced increased activity over the past two years and which confront particularly unique issues in how to apply the risk retention rules – collateralized loan obligations and commercial mortgage-backed securities.

To facilitate review by readers already familiar with the broad principals of the Revised Proposal, we have highlighted in red italics the areas of our outline where we focus on key implications and observations.

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PART ONE: GENERAL REQUIREMENTS OF RISK RETENTION

I. General Overview of the Revised Proposal

a. Scope and Key Definitions – General

i. The Revised Proposal requires each "sponsor" of a "securitization transaction" that involves "the offer and sale of asset-backed securities" to retain five percent (5%) of the fair value of all "ABS Interests" in the issuing entity, determined in accordance with generally accepted accounting principles ("GAAP").[3]

ii. The risk retention requirement would apply regardless of whether the sponsor is an insured depository institution, a bank holding company or a subsidiary thereof, a registered broker-dealer, or other type of entity and regardless of whether the sponsor is a supervised entity.

iii. *As described below, the Agencies have not significantly modified the broad scope the proposed rule, though they have in certain cases made significant changes to how the rule would apply to specific products and markets.*

iv. *The use of "fair value" as the standard for measuring the required risk retention level is a significant modification from the proposed rule's requirement that five percent (5%) of the par value of all ABS Interests be retained.*

b. Sponsor and Securitization Transaction

i. A "sponsor" is "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."[4] This language tracks the second prong of the definition of "securitizer" under Section 15G of the Exchange Act, which is also substantially identical to the definition of "sponsor" in Regulation AB.[5] The Agencies continue to define "securitization transaction" as a "transaction involving the offer and sale of asset-backed securities by an issuing entity."[6]

ii. *These definitions are largely unchanged from those under the Original Proposal. Commenters on the Original Proposal sought to have specified parties (e.g., underwriting sales agents) expressly excluded from the definitions of securitizer or sponsor for risk retention purposes, but the Agencies have not made or adopted any such exclusions.*

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3 Proposed rule § __.4(b).

4 Id. § __.2.

5 See 15 U.S.C. 78o-11(a)(3)(B); 17 CFR 229.1101(l).

6 Proposed rule § __.2.

iii. *The requirement that the sponsor have directly or indirectly sold or transferred assets to the issuing entity has not been modified, despite the difficulty in applying this definition to managed securitizations such as collateralized loan obligations ("CLOs"). Rather than adopt a broader or more flexible definition of sponsor to address those markets, the Agencies have relied on a flexible interpretation of what it means to "indirectly transfer" assets. This is discussed in greater detail in Section VI.a below as it relates to CLOs and will likely be an area of significant comment on the Revised Proposal.*

c. Asset-Backed Security

i. Consistent with the Original Proposal, the Revised Proposal adopts the definition of "asset-backed security" that is found in section 3(a)(79) of the Exchange Act,[7] which is broader than the definition found in Regulation AB[8] and includes securities that are not required to be registered with the SEC under the Securities Act of 1933, as amended (the "Securities Act"),[9] such as CLOs and securities guaranteed by government sponsored enterprises.

ii. *Many commenters believed the scope of the Original Proposal to be too broad because it imposed risk retention requirements even in transactions that did not present the same issues as the asset-backed securities believed to have contributed to the financial crisis, such as those involving securities that represent full-recourse claims against credit-worthy entities beyond the pool of financial assets specifically pledged to secure an obligation. Despite significant comments on this point, the definition of asset-backed security has not been narrowed. As discussed below, in certain cases where the Agencies have perceived that the general risk retention regime may not be a precise fit for a particular type of securitization, it has proposed specifically tailored compliance regimes or narrow exceptions.*

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7 The term ''asset-backed security''(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 Commission, by rule, determines to be an asset-backed security for purposes of this §; 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. 15 U.S.C. § 78c(a)(79).

8 17 C.F.R. § 229.1101(c)(1).

9 See 15 U.S.C. § 77e.

d. ABS Interests

i. The Revised Proposal defines ABS Interests as "any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity" and excludes common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that are "issued primarily to evidence ownership of the issuing entity," and the payments (if any) on which are "not primarily dependent on the cash flows of the collateral." [10]

ii. ABS Interests also do not include "servicing assets," a new concept not part of the Original Proposal that would include any rights or other assets designed to assure the servicing, timely payment, or timely distribution of proceeds to security holders, or assets related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets, including proceeds of assets collateralizing the securitization transactions.[11] The Agencies suggest that "servicing assets" are similar to "eligible assets" under Rule 3a-7 under the Investment Company Act of 1940, as amended.[12]

iii. *Commenters to the Original Proposal had expressed concerns that the definition of "ABS Interests" would capture concepts not traditionally considered "interests" in a securitization, including non-economic residual interests, servicing and special servicing fees, and amounts payable under derivatives contracts. The exclusion of "servicing assets" is intended to accommodate the need of securitizations to hold assets and rights other than the principal collateral around which the deal is structured.*

iv. *Both Original Proposal and the Revised Proposal provide for a number of exemptions or specialized compliance rules available to transactions that qualify as particular securitization subtypes. Commenters indicated that the definitions of these subtypes were too narrow because they did not contemplate securitization issuers holding assets other than loans, receivables or other self-liquidating financial assets. The addition of the concept of "servicing assets", and the inclusion of this type of asset as something that, for example, a commercial mortgage-backed security ("CMBS") transaction may own and still qualify for the specialized compliance regime, is the Agencies' attempt to address those concerns.*

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[10] Proposed rule § __.2.

[11] Id.

[12] See 17 C.F.R. § 270.3a-7(b)(1).

e. Securitizer

i. Consistent with the Original Proposal, the Revised Proposal defines "securitizer" as either the sponsor or the "depositor of the asset-backed securities," if different from the sponsor.[13]

ii. *Although Section 15G of the Exchange Act imposes the risk retention requirements on securitizers, the proposed rule would impose the risk retention requirement only on sponsors and not on depositors of the asset-backed securities. No explanation for this deviation from the Exchange Act is provided.*

f. Originator

i. The Revised Proposal uses the same definition for "originator" as Section 15G of the Exchange Act and the Original Proposal: a person who "through the extension of credit or otherwise, creates a financial asset that collateralizes an ABS" and "sells the asset directly or indirectly to a securitizer."[14]

ii. *The definition refers to the person that "creates" a loan or other receivable. Only the original creditor under a loan or receivable (not a subsequent purchaser or transferee) would be treated as an originator under the proposed rules.*

II. General Risk Retention Requirement and Permissible Approaches

a. Combined Risk Retention Option Provides More Flexibility

i. The Revised Proposal would (with the limited exceptions discussed below) require sponsors to retain an "eligible vertical interest" in a securitization transaction, an "eligible horizontal interest" in a securitization transaction, or some combination thereof, the "fair value" of which equals at least five percent (5%) of the fair value of all "ABS Interests" in the issuing entity.[15]

ii. *The risk retention requirement of the Revised Proposal differs in two significant ways from the Original Proposal. First, it allows sponsors more flexibility in determining how it will retain the risk by choosing its own allocation between horizontal and vertical interests. A sponsor may hold an eligible horizontal interest with a fair value equal to five percent (5%) of the fair value of the aggregate ABS Interests held by the ABS Issuer, it may hold an eligible vertical interest with a fair value equal to five percent (5%) of the fair value of the aggregate ABS Interests issued by the ABS Issuer, or any combination of the two that, in the aggregate, sums to five percent (5%) of the fair value of the aggregate ABS Interests issued by the ABS Issuer. The Original Proposal only permitted the sponsor to hold a*

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13 Proposed rule § __.2.

14 Id. § __.2; 15 U.S.C. § 78o-11(a)(3).

15 Proposed rule § __.4(b).

combination of vertical and horizontal interests in compliance with the rigid requirements of the so-called "L-Shaped" option requiring the sponsor to retain not less than 2.5% of the par value of the securitization as a vertical slice and a horizontal slice with a par value of at least 2.564%. Second, as will be discussed in more detail below, the amount of credit risk retained is to be measured by "fair value" in accordance with GAAP.

iii. *The shift to a "fair value" metric is a response to comments to the Original Proposal that measuring retained credit risk based on the par value of ABS Interests would be unworkable, and objections to the related "premium capture" provision. "Fair value" as proposed by the Agencies, however, is not precisely defined and raises a number of questions more fully explored below. As a result, it is likely to attract significant comment.*

iv. *One objection to the Original Proposal was that adoption of the horizontal or L-shaped approach to risk retention could force sponsors to consolidate the ABS issues on its balance sheet, which would have a number of negative impacts. The Agencies note that the shift to a combination approach is in part designed to alleviate this concern. By providing flexibility to determine whether to hold more or less of a horizontal or vertical interest, the sponsor can adjust its exposure in a way that better suits its other constraints.*

v. *The Revised Proposal does not include the "representative sample" risk retention option from the Original Proposal, which permitted sponsors to satisfy its risk retention requirement by retaining some of the assets selected from the general pool that was to be securitized although they requested comment on whether it should be eliminated as an option. Many commenters found the original concept unworkable.*

b. Fair Value

i. The Agencies have proposed "fair value" as the metric for credit risk in order to address comments criticizing the use of "par value" in the Original Proposal. Fair value is not defined, other than that it should be determined in accordance with GAAP.[16]

ii. *Some commenters observed that "par value" of a particular security, particularly a subordinated tranche, does not have a clear enough relationship to the actual credit risk of a securitization to justify using it as the sole metric. The Agencies have not necessarily adopted this thinking in the same way; rather they state that "holding 5 percent of par value may cause sponsors to hold significantly <u>less</u> than 5 percent of the risk because the risk is not spread evenly throughout the securitization."[17] This was essentially the opposite of the position advanced by securitization market participants who observed that holding five percent (5%) of the most subordinate tranche of a securitization may in fact represent more*

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16 Proposed rule § __.4(b)(1).

17 Revised Proposal at 343 (emphasis added).

than five percent (5%) of the credit risk given that tranche's exposure to the earliest losses.

iii. *Many commenters were also critical of the premium capture reserve account concept the Agencies had suggested in order to limit the ability of a sponsor to use the pricing of its horizontal interest to dilute its true risk exposure. Because the Agencies believe the fair value measurement of credit risk will "help prevent sponsors from structuring around their risk retention requirement by negating or reducing the economic exposure they are required to maintain,"[18] they have eliminated the premium capture reserve account.*

iv. *Despite the Agencies' assertion that the use of a fair value measure is "more consistent with market practice," there is likely to be significant comment on how this new standard will in fact be implemented. The Agencies themselves observe that "fair value is a methodology susceptible to yielding a range of results depending on the key variables selected by the sponsor in determining fair value."[19] To address this potentially wide range of approaches, the Revised Proposal requires disclosure by the sponsor of key elements of its fair value methodology.*

v. *The Agencies' approach to implementing its fair value methodology places a great weight on disclosure of a sponsor's approach to making its fair value calculations. If the Agencies had attempted to prescribe the exact methods to calculate the fair value of ABS Interests across many different products in many different markets, that too would also solicit significant comment; however, the proposed approach of no guidance / robust disclosure may lead – at least initially – to very disparate approaches among market participants to the calculation of fair value. The Agencies may anticipate this – as noted they do admit that fair value calculations are susceptible to differing methodologies – but it does raise an issue as to how those differing methodologies will be reviewed and evaluated by the Agencies when evaluating compliance with the rule.*

c. Eligible Vertical Interest

i. An eligible vertical interest is defined as a single security or an interest in each class of ABS Interests issued as part of the securitization transaction that constitutes the same portion of the fair value of each class.[20] Compliance with this concept requires an interest in all classes regardless of the nature of the class, including whether the class of interests is an interest-only class, has a par value, is issued in certificated form, or whether the class was sold to unaffiliated investors.[21]

18 Id. at 44.

19 Id. at 47.

20 Proposed rule § __.4.

21 Id.

ii. A sponsor may also satisfy its risk retention requirements under the vertical option by retaining a "single vertical security."[22] A single vertical security would be an ABS Interest that entitles the holder to a specified percentage of the principal and interest paid on each class of ABS Interests in the issuing entity (other than such single vertical security).[23] The specified percentage of each class represented by the vertical security would be credited toward the sponsor's risk retention requirement.[24]

iii. *The Agencies introduced the concept of the single vertical security in response to concerns from commenters that holding a separate security for each class issued by the ABS Issuer would create a significant operational and administrative burden, including in connection with financial reporting. Holding a single vertical security would provide the sponsor with the same principal and interest payments as holding a portion of each security in the capital stack. The Agencies have requested comments on whether this solution does in fact achieve its goal or if a different approach may be more appropriate.*

d. Eligible Horizontal Interest

i. An eligible horizontal interest is an ABS Interest that (1) holds the most subordinated claim to payment of both principal and interest and (2) bears the first loss in the event of insufficient funds to repay the ABS obligations.[25] Although this holding can be in the form of multiple classes, the classes must be the most subordinate consecutive classes in the capital structure.[26]

ii. A sponsor would not be permitted to structure a transaction where the projected cash flows to the eligible horizontal interest would allow the sponsor to recover its fair value at a faster rate than all investors in the other ABS Interests would be repaid their principal. Sponsors would be required to compute the projected cash flows payable to the eligible horizontal interest relative to the "fair value" of the eligible horizontal interest and compare such cash flows to the expected principal payments to the rest of the ABS Interests relative to the "par value" of the ABS Interests, and determine that the latter exceed the former. The cash flow projection would be a one-time calculation performed before the closing of the transaction.[27]

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22 Id.

23 Id. § __.2.

24 Id. § __.4.

25 Id. § __.2.

26 Id. § __.4.

27 See id.

iii. The sponsor would have to certify to investors that it has performed the calculations required with respect to the eligible horizontal interest recovery percentages and that the expected payments will not result, on any payment date, in the holders of eligible horizontal interests having received a greater percentage of the fair value of their investment than the percentage of principal received by investors in the other ABS Interests. The sponsor's disclosure obligations are discussed in more detail below.[28]

iv. *This methodology raises a significant issue for comment – whether a comparison of distributions as a percentage of fair value to distributions as a percentage of par value is an appropriate comparison. At a basic level it appears to be comparing two entirely different economic concepts. The Agencies admit in proposing a fair value metric generally that par value is a less accurate portrayal of intrinsic value.[29] This acknowledgment then raises the question of whether this comparison perhaps overstates the constraints that are being placed on sponsors. This mismatch is likely to be an area that the Agencies will need to address further if it is to pursue this approach in the final rule.*

v. *Perhaps reflecting disagreement over whether the comparison of the percentage of fair value returned to the eligible horizontal interest to the percentage of principal returned to the other ABS Interests, the Agencies have also requested comment on an alternative approach to limiting distributions on eligible horizontal interests. In this alternative, the cumulative amount distributed to the eligible horizontal interest may not exceed "a proportionate share of the cumulative amount paid to all holders of ABS interests in the transaction."[30] The proportionate share is the percentage of ABS Interests made up by the eligible horizontal interest, measured by fair value at closing. For example, if at closing the fair value of the eligible residual interest equaled 5% of the fair value of all ABS Interests at closing, then at any time the cumulative amount paid to the holder of the eligible residual interest could not exceed 5% of cumulative amounts (exclusive of fees and expenses paid to service providers) paid to holders of all ABS Interests. Amounts in excess of the cap would be permitted to be placed in a reserve account for later distribution.*

vi. *This alternative approach avoids several of the drawbacks present in the main proposal. First, the cap on payments takes into account all amounts paid to holders of ABS Interests, whether principal, interest, excess spread or residual payments. Therefore the mismatch that may be present in the primary proposal when comparing the percentage of fair value recovered to the percentage of principal recovered, does not impact the alternative approach. This is particularly important for securitization structures where the ABS Interests do not receive principal repayments until much later in the life of the transaction. Second, this approach would permit larger payments to holders of the eligible horizontal interests and would also*

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28 See id. § __.4(b).

29 Revised Proposal at 342.

30 Id. at 59.

permit amounts to be set aside in a reserve account for later distribution if, on a given payment date, distributing such amounts would breach the cap. This may provide sponsors more flexibility to structure eligible horizontal interests in a way that generates a cash flow and a return more appropriate to the risk represented by the subordinated interest. The Agencies have specifically requested comment on whether they should adopt this alternative approach instead of the "fair value v. principal" approach discussed above.

e. Horizontal Cash Reserve Account

i. As an alternative to acquiring the eligible horizontal interest, the Revised Proposal would permit a sponsor to fund a cash reserve account at closing (the "Horizontal Cash Reserve Account" or "HCRA") in an amount equal to the fair value of the eligible horizontal residual interest.[31] The Horizontal Cash Reserve Account would have to satisfy all of the following criteria:

1. The HCRA is held by the trustee for the benefit of the issuing entity;

2. Amounts that could be withdrawn from the HCRA to be distributed to a holder of the HCRA would be restricted to the same degree as payments to the holder of an eligible horizontal interest; and

3. In order to determine permissible distributions from the HCRA, the sponsor would be required to comply with all calculation requirements that it would have to perform with respect to an eligible horizontal interest.[32]

f. Disclosure of Fair Value Methodologies

i. The Revised Proposal retains the disclosure obligations of the Original Proposal and adds additional required disclosures related to fair value and the risk retention framework. The sponsor would have to maintain records of all such calculations and certifications until three years after all ABS Interests are no longer outstanding.[33] Sponsors would be required to disclose to potential investors:[34]

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[31] For securitization transactions where the underlying loans or the ABS Interests issued are denominated in a foreign currency, the amounts in the account may be invested in sovereign bonds issued in that foreign currency or in fully insured deposit accounts denominated in the foreign currency in a foreign bank (or a subsidiary thereof) whose home country supervisor (as defined in § 211.21 of the Fed'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, provided the foreign bank is subject to such standards. See Proposed rule __.4(c)(2); Revised Proposal at 53.

[32] Proposed rule § __.4(c).

[33] Id. § __.4(e).

[34] Id. § __.4(d).

- For all transactions:

    - A description of the methodology used to calculate the fair value of all classes of ABS Interests;

    - The key inputs and assumptions used in measuring total fair value of the horizontal residual interest retained by the sponsor, including quantitative data, as applicable, with regard to the following:

        - Discount rates;
        - Loss given default (recovery);
        - Prepayment rates;
        - Defaults;
        - Lag time between default and recovery; and
        - The basis of forward interest rates used.

    - The reference data set or other historical information that would enable investors and other stakeholders to assess the reasonableness of the key cash flow assumptions underlying the fair value of the residual interest.

- For securitization transactions involving a horizontal interest:

    - The fair value of the eligible horizontal residual interest actually retained, and required to be retained, by the sponsor at closing (as both a percentage of the fair value of all ABS Interests and dollar amount);

    - The number of times over the previous five years that the actual payments made to the sponsor under previous eligible horizontal interest transactions (or with regard to the horizontal reserve cash account) exceeded the amounts projected to be paid to the sponsor; and

    - A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor.

- For securitization transactions involving a vertical interest:

    - Whether any retained vertical interest is retained as a single vertical security or as separate proportional interests in each class of ABS Interest;

    - In the case of a single vertical security, each class of ABS Interest in the issuing entity underlying the single vertical security at the closing of the securitization transaction and the percentage of each class of ABS Interests in the issuing entity that the sponsor would have been required to retain if the sponsor held the eligible vertical interest as a separate

proportional interest in each class of ABS Interest in the issuing entity;

- In the case of an eligible vertical interest retained as a separate proportional interest in each class of ABS Interest, the percentage of each class of ABS Interests that the sponsor will retain, and is required to retain, at closing; and

- The fair value amount of any single vertical security or separate proportional interests that will be retained (or was retained) by the sponsor at closing, and the fair value amount of the single vertical security or separate proportional interests required to be retained by the sponsor in connection with the securitization transaction.

ii. *Although not explicitly required by the Revised Proposal, the requirement that fair value be computed in accordance with GAAP, and that the approaches to such calculation be disclosed, does raise a question as to whether accountants comfort will be required in connection with these calculations, and whether the accountants' views of such calculations will need to be disclosed to investors. This would also raise questions regarding an accountant's liability for such comfort, both with respect to the ABS Issuer and to investors if the accountants' views are required to be disclosed. This is not addressed in the Revised Proposal.*

g. Restrictions on Allocating Risk to an Originator

i. The Revised Proposal permits a securitizer to allocate a portion of its risk retention obligation to an originator of the underlying assets if it has contributed at least 20 percent of the underlying assets in the securitized pool.[35] The Agencies do not want an originator retaining a disproportionate level of risk, consequently reducing the sponsor's risk share. Thus, the percentage of assets retained by the originator (as measured by fair value) may not exceed the percentage of the securitized assets it originated into the asset pool (as measured by unpaid principal balance).[36]

ii. The Revised Proposal requires that an originator acquire and retain its interest in the same manner and mix as would have been retained by the sponsor (including compliance with all disclosure requirements and hedging and transfer restrictions).[37] This means that the originator must acquire horizontal and vertical interests in the securitization transaction in the same proportion as the interests originally established by the sponsor. Finally, the Revised Proposal provides that the sponsor remains

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35 Id. § __.11(a).

36 Id.

37 Id.

responsible for any failure of an originator to abide by the transfer and hedging restrictions included in the proposed rule.[38]

iii. *The Revised Proposal maintains the structure of the Original Proposal by measuring the originator's exposure in relation to all of the ABS Issuer's assets and not just those the Originator has contributed. The Agencies have asked, however, whether a loan by loan allocation may be more appropriate and so this may remain an option for the final rule.*

III. Hedging, Transfer and Financing Restrictions for sponsors retaining risk

a. Section 15G(c)(1)(A) of the Exchange Act provides that the risk retention regulations shall prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk it is required to retain with respect to an asset.[39]

b. The Revised Proposal does permit sponsors to transfer their risk retention interests to majority-owned affiliates, defined as any entity that directly or indirectly, majority controls, is majority controlled by, or is under common majority control with, another entity ("majority control" meaning ownership of more than 50 percent of the equity of an entity or ownership of any other controlling financial interest in the entity as determined under GAAP).[40]

c. *The Original Proposal allowed sponsors to transfer their risk retention interest to a consolidated affiliate, as opposed to a majority-owned affiliate. The Agencies became concerned that accounting thresholds for consolidation may not ensure that losses experienced by a consolidated affiliate would have enough of an impact on a sponsor. Thus the Agencies have replaced the consolidated affiliate standard with a majority-owned affiliate requirement.*

d. The Revised Proposal also permits the majority-owned affiliate to retain the required risk interest as an initial matter, instead of the risk retention holding first being satisfied by the securitizer and subsequently transferred as required under the Original Proposal.[41]

e. The Revised Proposal prohibits a sponsor or any affiliate from hedging the credit risk the sponsor is required to retain under the risk retention rule.[42] As such, the sponsor may not purchase or sell a security or other financial instrument, or enter 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

[38] Id. § __.11(b).

[39] See 15 U.S.C. 78o-11(c)(1)(A).

[40] Proposed rule §§ __.12(a); __.2.

[41] Id. § __.3.

[42] Id. § __.12(b).

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 asset-backed securities"[43]; and

- "The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests . . . or one or more of the particular securitized assets that collateralize the asset-backed securities."[44]

f. Under the Revised Proposal, holding an index security would not be a prohibited hedge by the retaining sponsor 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 percent 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 was required to retain an interest pursuant to the proposal and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average of all instruments included in the index.[45]

g. The Revised Proposal preserves some ability for the sponsor or its majority-owned affiliate to obtain financing for the purchase of the ABS Interests being acquired to satisfy its risk retention obligations. There is a prohibition, however on a sponsor or any majority-owned affiliate pledging any ABS Interest that the sponsor is required to retain as collateral unless the obligation is with full recourse to the sponsor or a pledging affiliate.[46]

h. *The Revised Proposal also states that if the sponsor or affiliate were to pledge its interest in an eligible horizontal interest or eligible vertical interest, and following a default transfer such interest to the lender in satisfaction of the lien, such transfer would be in violation of the rule. This would also of course apply to any liquidation of that interest in a sale to a third-party. Therefore, even if the loan were full recourse to the sponsor (or its affiliate) the value of the collateral will be significantly reduced given the transfer restrictions imposed by the Revised Proposal.*

i. The Revised Proposal would not prohibit an issuing entity from engaging in hedging activities when such activities would be for the benefit of all ABS

[43] Id. § __.12(b)(1).

[44] Id. § __.12(b)(2).

[45] Id. § __.12(d)(2).

[46] Id. § __.12(e).

investors.[47] For example, a sponsor could hedge the 95 percent of the issuance that they are not required to hold under this rule; however, it could not hedge its five percent risk retention interest.

j. The transfer and hedging restrictions for all ABS other than residential mortgage backed securities and certain CMBS tranches would expire on or after the date that is the latest of:

i. the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization is reduced to 33 percent of the original unpaid principal balance as of the date of the closing of the securitization;

ii. the date on which the total unpaid principal obligations under the ABS Interests issued in the securitization is reduced to 33 percent of the original unpaid principal obligations at the closing of the securitization transaction; or

iii. two years after the date of the closing of the securitization transaction.[48]

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47 Revised Proposal at 175.

48 Proposed rule § __.12(f).

PART TWO: QUALIFIED RESIDENTIAL MORTGAGES AND POTENTIAL IMPACTS ON THE MORTGAGE INDUSTRY

IV. The Definition of "Qualified Residential Mortgage" and the Potential Impact on the Mortgage Industry

Asset backed-securities collateralized solely by "Qualified Residential Mortgages" ("QRMs") are exempt under Section 15G of the Exchange Act from the credit risk retention requirements.[49] Under Section 15G of the Exchange Act, the Agencies were delegated responsibility jointly to define QRM, taking into consideration underwriting and product features that historically resulted in lower risks of default. This authority was constrained by the statutory requirement that the QRM definition could be no less stringent than the "Qualified Mortgage" ("QM") definition under the Truth in Lending Act (as amended by Dodd-Frank and the regulations adopted thereunder, "TILA").[50] As a result, the QRM and QM standards were inextricably linked.

When the Original Proposal was released, banks, consumer groups, legislators, and many others were very critical because the Original Proposal included a QRM standard requiring a 20 percent down-payment and imposing other strict underwriting standards, such as credit history requirements and a total debt-to-income ("DTI") ratio not to exceed 36 percent. Many critics argued that the strict standards would deny many low- and moderate-income borrowers access to affordable mortgages.

The Consumer Financial Protection Bureau ("CFPB") issued its final QM rule in January 2013 (and further supplemented the final rule in May and July 2013).[51] These final QM standards are effective on January 10, 2014. Though these rules adopted significant product and underwriting requirements, the QM criteria were, in many respects, less stringent than the ones proposed for QRMs in the Original Proposal. The Agencies' issuance of the Revised Proposal confirmed expectations that the final proposed QRM standards would define QRMs as equivalent to QMs.[52] The Agencies recognized that defining QRMs with higher DTI ratios than the QM standard and with a 20 percent down payment requirement would lead to a bifurcation of the mortgage standards that would likely deprive both categories of sufficient liquidity to support a vibrant securitization market for both QRM and non-QRM loans.

The Agencies have also asked for comment on an alternative to the proposed QRM definition that would impose a 70% loan-to-value ("LTV") standard coupled with other, stricter underwriting requirements ("Alternative QRM"). The Alternative QRM approach also would preclude QRM treatment for loans that meet the CFPB's "temporary" standards noted below. The Alternative QRM reflects the ongoing debate within the Agencies about the relative importance of risk retention, the features controlling risk of default, and the degree of differentiation between the

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[49] 15 U.S.C. 78o-11(e)(4)(A).

[50] 15 U.S.C. 78o-11(e)(4)(C).

[51] See 78 Fed. Reg. 6407 (Jan. 30, 2013); 78 Fed. Reg. 35429 (Jun. 12, 2013) (exemptions and modifications for small creditors, community development lenders, and housing stabilization programs); 78 Fed. Reg. 44685 (Jul. 24, 2013) (corrections, clarifications, and amendments to Jan. 2013 rules, including clarifications to the eligibility standard of the temporary QM provision.).

[52] CFPB Releases Final Mortgage Rules: Ability-to-Repay and Qualified Mortgage Rule Sets New Mortgage Underwriting Standards, Cleary Gottlieb Steen & Hamilton Alert Memo dated January 30, 2013.

QRM and QM standards necessary to achieve sufficient liquidity to provide for an active securitization market for QRM and non-QRM loans.

a. Proposed QRM Standards

i. In summary, the definition of a QRM has been revised to define a QRM as a mortgage meeting the requirements set by the CFPB for a QM under TILA.[53] Most significantly, the new QRM proposal does not include any LTV standard or credit history requirements.

ii. As defined by the CFPB, a QM must generally have certain product characteristics and meet certain underwriting standards:[54]

- A QM cannot have a term longer than 30 years, must have regular periodic payments that are substantially equal, and cannot include negative amortization, interest-only payment and balloon payment features (which the CFPB views as particularly risky).
- Points and fees on the loan cannot exceed certain thresholds—which for loans above $100,000 are capped at 3% of the total loan amount.
- Among underwriting requirements, the borrower's employment status, income, assets, debt obligations, alimony and child support must be verified (with detailed guidance provided for the calculation of these amounts), and the loan must be underwritten on a fully-amortizing payment schedule and the maximum interest rate during the first five years.
- The borrower's total DTI ratio for recurring obligations cannot exceed 43% at the time of the consummation of the mortgage. The DTI ratio calculation includes all mortgage-related monthly payments on the covered transaction, any simultaneous loans known to the lender, and recurring obligations such as alimony, childcare expenses, monthly household expenses, and revolving account payments.
- Any closed-end loan secured by any dwelling may qualify as a QM. The QM requirements do not distinguish between purchases of principal dwellings and second or vacation homes. Both first-lien and subordinated lien mortgages would be eligible to comply with the QM requirements, but home equity lines of credit ("HELOC"), reverse mortgages, timeshares, temporary loans or "bridge loans of 12 months or less, would be expressly excluded.

iii. In recognition of mortgage market conditions, the CFPB also adopted a temporary rule that allows additional categories of mortgages to qualify as QMs (the "Temporary QM standards"). Mortgages that are eligible for purchase, insurance or guarantee by a Government Sponsored Enterprise

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[53] Proposed rule § __.13(a).

[54] See 12 C.F.R. § 1026.43.

("Enterprise"), HUD, the Veterans Administration, U.S. Department of Agriculture, or Rural Housing Service would also qualify as QMs as long as they meet the product (but not underwriting) requirements of a QM under the general QM definition. The Temporary QM standards for loans eligible for purchase or guarantee by an Enterprise expires when the Enterprise exits conservatorship. For the remaining federal agencies, the temporary definition expires when the agency has adopted its own QM definition. In any event, these special rules expire in January 2021.[55] As noted above and described below, the Agencies have also asked for comment on the Alternative QRM approach which would exclude these Temporary QM standards from QRM treatment.

iv. *The QRM standards in the Revised Proposal are significantly less restrictive than those in the Original Proposal. The QRM parameters will evolve as the CFPB clarifies or modifies the QM definition from time to time.*

v. *Most significantly, in line with the QM definitions, the Revised Proposal eliminates any LTV or down-payment requirement. The Original Proposal imposed maximum LTV ratios (80% in the case of a purchase transaction, 75% in case of a rate and term refinance, and 70% in the case of cash-out refinancings) for qualifying QRMs, as well as a requirement that the borrower put down at least a 20% minimum down-payment in a purchase transaction.*

vi. *In the Original Proposal, qualifying QRMs were limited to maximum front-end and back-end DTI ratios of 28% and 36% respectively. The QM definition allows a higher back-end DTI ratio of 43%, and imposes no front-end DTI requirement. The Revised Proposal adopts this lower standard.*

vii. *The Revised Proposal also dispenses with the credit history requirements contained in the Original Proposal. This responds as well to many comments critical of the effect the credit history requirements would have on mortgage lending.*

viii. *Under the Original Proposal, QRMs would be restricted to only closed-end credit transactions to purchase or refinance a one-to-four family property, at least one of which was required to be the principal dwelling of the borrower. Under the Revised Proposal, any closed-end loan secured by any dwelling may qualify as a QM, and therefore a QRM. These may include home purchase loans, second dwellings, vacation homes, and*

[55] The CFPB has also provided greater underwriting flexibility to institutions with less than $2 billion in assets and that originated 500 or fewer first lien covered transactions in the prior calendar year (including all affiliates). Loans originated by these small creditors are not required to comply with the 43% DTI threshold. However, these small creditors must hold QMs in portfolio for at least three years with certain exceptions (e.g. transfer to another qualifying small creditor, supervisory sales, and mergers and acquisitions). These institutions have also been provided with a two-year transition period in which they can originate balloon loans meeting certain criteria that would qualify as QMs, but such QMs again must be held in portfolio for three years. Balloon payment loans in rural or underserve areas by small creditors may also qualify as QMs.

home equity lines. Reverse mortgages, temporary or bridges with terms of 12 months or less, and timeshare plans continue to be ineligible.

ix. *The Original Proposal would have made subordinated liens ineligible for QRMs as well, but these restrictions have also been removed.*

b. Additional Requirements for Risk Retention Exemption under the Revised Proposal

i. In order to qualify for the exemption from credit risk retention, a few other conditions listed below must also apply:

- Resecuritizations of Exempt Asset-Backed Securities Not Exempt: Under the Revised Proposal, the exemption does not apply to resecuritizations that are collateralized by other asset-backed securities that are themselves collateralized solely by QRMs and servicing assets.[56]

- No Blended Pools with Non-QRMs: In order for the QRM exemption to apply, the underlying collateral cannot include both QRM and non-QRM loans.[57]

- Loans Currently Performing: Each QRM collateralizing the asset-backed security would be required to be currently performing, i.e., not 30 days or more past due in whole or in part on the mortgage at the closing of the securitization transaction.[58]

- Evaluation and Certification: The depositor for the securitization would be required to certify that it has evaluated the effectiveness of its internal supervisory controls to ensure that all of the collateral for the securities are QRMs.[59] The depositor is defined in the Proposal as the person that receives or purchases and transfers or sells the securitized assets to the issuing entity, including where the person is a trust. However, where there was not an intermediate transfer of the assets to the issuing entity from the sponsor, the sponsor would be deemed the depositor.[60]

  The depositor must also certify that its internal supervisory controls are effective. In order to do so, an evaluation would need to be done within 60 days prior to the cut-off date (or similar date) for establishing the composition of the collateral pool. The sponsor would have to

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56 Proposed rule § __.13(b)(1).

57 See Proposed rule § __.13(b)(2).

58 Id. §§ __.13(b)(3) and (a).

59 Id. § __.13(b)(4)(i).

60 Id. § __.2.

provide a copy of this certification to the investors prior to the sale of securities, the SEC and appropriate federal banking agencies.[61]

- Buy-Back Requirement: The Proposal also includes a requirement for the sponsor to repurchase mortgages that, after the closing of the securitization transaction, were determined to not comply with the QRM requirements due to inadvertent error. The repurchase has to be at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loans no later than 90 days after the determination that the loans do not satisfy the QRM requirements. The sponsor is required to notify the holders of the repurchase of such non-qualifying loans.[62]

c. Alternative QRM Proposal

i. The Revised Proposal also includes a proposal for an alternative QRM definition that is more stringent than the standard QRM definition.[63] The Alternative QRM (or "QM-plus") standards would require a qualifying mortgage to meet all of the product and underwriting criteria for QMs, while also reviving some of the product and underwriting characteristics from the Original Proposal.

ii. *The inclusion of an Alternative QRM proposal seems to have been driven by the continued regulatory debate over whether the QM definition set an appropriate standard for the elimination of risk retention. The Agencies seek comments on whether the following additional standards should be included in the Alternative QRM standards.*

iii. Maximum LTV Ratio: Under the QM-plus the mortgage could not have an LTV ratio that exceeds 70% (compared to 80% for purchase loans in the Original Proposal).

1. Junior liens would be permissible for non-purchase QRMs, but must be included in the LTV calculation. HELOC or similar credit plans must be included as fully drawn. The property price would be determined using an appraisal; the lower of the contract price and the appraisal would be used for purchase QRMs.

iv. Credit History: The borrower could not be 30 or more days past due on any debt obligation, and could not have been 60 or more days past due on any debt obligations within the preceding 24 months. Additionally, the borrower could not have gone through bankruptcy within the preceding 36 months, had personal property repossessed, had any one-to-four family property foreclosed upon, or engaged in a short sale or deed in lieu of foreclosure.

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[61] Id. §§ __.13(b)(4)(ii)-(iii).

[62] Id. § __.13(c).

[63] See Revised Proposal at 274-277.

v. Types of Residential Property: The dwelling securing the loan would be required to be a one-to-four family real property that constitutes the principal dwelling of the borrower. Other types of loans such as loans secured by boats used as residences and vacation homes would not be eligible under the QM-plus approach.

vi. Lien Category: Only first-lien mortgages would qualify as QRMs. "Piggyback loans" would also be excluded, as there could be no other liens existing at the time of the mortgage to the knowledge of the originator. For refinance QRMs, junior liens would be allowed but these would need to be included in the LTV calculations, notwithstanding the fact that they would have been taken into account in the DTI analysis as well.

vii. Temporary QMs Ineligible: Mortgages that would qualify as QMs under the Temporary QM standards (or the standards applicable to small creditors) would not under the Alternative QRM approach.

PART THREE: IMPACT ON SELECTED SECURITIZATION MARKETS

V. Impact on Selected Securitization Markets and Product Types: RMBS

a. *The vast majority of new mortgages are expected to be QMs as such loans are presumed to comply with the "ability-to-pay" pay requirements under TILA.* [64] *Under the Original Proposal, a large segment of QMs would not have qualified as QRMs because of the LTV requirement. The alignment of the QM and QRM standards in the Revised Proposal effectively eliminates risk retention for the vast majority of mortgages.*

b. *As a corollary to this obvious—but important—result, non-QM and non-QRM mortgages under the Revised Proposal likely would be specialty products as accommodations for preferred customers. The combination of potential liability under the "ability-to-pay" requirements and the required credit risk retention likely will make such mortgages higher cost and very unlikely to be securitized.*

c. *The new QRM standards in the Revised Proposal were perhaps pre-ordained given the vociferous opposition to the LTV requirements in the Original Proposal by industry, consumer groups and legislators. The CFPB's inclusion of non-structural mortgage requirements (such as the DTI standards) meant that there would be too few mortgages that were QMs but not QRMs under the Original Proposal to allow for any liquidity for the QM-eligible non-QRM market (where risk retention would be required). As a result, a viable market for such QM-eligible non-QRM mortgages was unlikely to develop. At the same time, the stringent QRM requirements in the Original Proposal would also have limited the size of the secondary market for mortgages that were both QM- and QRM-eligible. Separate QM and QRM requirements (as under the Original Proposal) would have also resulted in duplicative compliance burdens.*

d. *The alignment of the QM and QRM standards thus provides much needed clarity to the secondary mortgage market. The Revised Proposal likely will provide a more liquid market for development of a renewed private-label secondary mortgage market. In addition, duplicative, overlapping compliance burdens are avoided. Yet, the inclusion of the Alternative QRM standards introduces the potential for some confusion going forward. By lowering the LTV requirements from the Original Proposal in the Alternate QRM standards, the Agencies have attempted to make a push for a secondary market that would include a larger pool of mortgages that are QM-eligible but do not qualify as QRMs. However, the Alternative QRM is likely to face broad and strong opposition from many of the individuals, groups, and market participants who originally opposed the Original Proposal. Given these considerations, it would be difficult for the Agencies to adopt the Alternative QRM standards in the Revised Proposal.*

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[64] See TILA § 129C, 15 U.S.C. § 1639(c). TILA further provides that borrowers who bring actions within three years of the occurrence of a violation of the ability-to-pay requirements would be entitled to special statutory damages from the lender equal to the sum of all financing charges and fees, unless the lender could show that the violations were not material. Additionally, a consumer may assert a violation of the ability to pay requirements in a foreclosure proceeding (including against an assignee of the lender) "as a matter of defense by recoupment or setoff," and this defense is not time-limited. See TILA §§ 130(a) and (k), 15 U.S.C. §§ 1640(a) and (k).

e. *Notwithstanding the clarity provided by the Revised Proposal regarding the risk retention requirements, the future shape of the secondary mortgage market can only be resolved when the issue of the government's role in the market is decided. The Revised Proposal simply preserves the status quo for government-backed RMBS. The exemption for asset-backed securities that are guaranteed by the Enterprises from the risk retention requirements, and the inclusion of mortgages that qualify as QMs under the Temporary QM standards, are designed to avoid disrupting the existing housing market which remains dependent on government support. Before the secondary mortgage market can be revamped, the future roles of the Enterprises, Ginnie Mae and the Federal Housing Authority will have to be addressed.*

VI. Impact on Selected Securitization Markets and Product Types: CLOs

Open market CLOs differ significantly from the "originate to distribute" model to which the credit risk retention rules most directly correlate. The collateral supporting the ABS Interests issued by an open market CLO is a managed pool of commercial loans to operating companies originated by many different lenders. Balance sheet CLOs – transactions where an entity transfers loans it owns into a securitization vehicle in a true sale in order to remove the loans from its balance sheet – can be, and under the Revised Proposal are, treated similarly to originate to distribute structures. The fundamental difference in the structure and management of open market CLOs, however, posed a challenge in applying the mandate of Section 15G of the Exchange Act to this sector of the market.

The Original Proposal recognized that CLOs did not have an easily identifiable sponsor in the same way, for example, mortgage backed securitizations might. The Agencies decided, in a footnote, to name the CLO manager as the sponsor of CLOs and thus the party that would be required to "retain" the five percent (5%) of the credit risk of the deal. This decision received heavy criticism from the leveraged loan and CLO industry as they argued that the manager was not "transferring" loans or risk to the CLO because it never owned the loans or the risk; they merely selected the assets for purchase by the CLO. In addition, they had serious concerns over the potentially significant and negative effects such a rule could have on the market. This section will examine the new proposal and includes analysis on the degree to which the revised proposals would be less disruptive to CLOs than the Original Proposal.

a. CLO manager as Securitizer

i. As discussed above in Section I, the risk retention requirements are applicable to sponsors of securitization transactions. Under the Revised Proposal, these requirements would be applicable to collateralized loan obligation ("CLO") transactions, including to open market CLOs.

ii. An "open market CLO" is defined 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 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.[65] A "CLO Manager" is an investment advisor that manages a CLO.[66]

iii. *Open market CLOs differ from many other types of securitization transactions in that the issuer acquires its assets, primarily senior secured loans, from many different parties and that its portfolio is managed on an ongoing basis by the CLO manager. This structure does not have the kind of connection to a single originator or depositor that can be found in other securitization markets where concerns about an "originate to distribute" model might be more prevalent. As a result, some commenters to the Original Proposal asserted that CLOs should be exempt and that CLOs did*

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65 Proposed rule § __.9(a).

66 Id.

not have a "securitizer" or "sponsor" within the meaning of those terms under Section 15G of the Exchange Act or the definition proposed under the Original Proposal.

iv. The Agencies take the position that CLOs are subject to the requirements of Section 15G of the Exchange Act and that CLO managers of open market CLOs qualify as "sponsors" because their role in selecting the commercial loans that are acquired by CLOs and in managing the assets once they are acquired constitutes an indirect transfer of the assets by the CLO manager to the open market CLO. As a result, unless a CLO transaction is able to comply with the alternative methodology described below, a CLO manager would need to retain 5% of the credit risk of any CLO it managed.

v. *Notably, the Agencies did not address all of the statutory construction arguments raised in comment letters submitted with respect to the Original Proposal. Specifically, those submissions noted that CLO managers can be distinguished from securitizers in that they neither own nor control the assets acquired by the open market CLO, and therefore, cannot be described as "selling or transferring assets, either directly or indirectly"[67] to CLOs. In the Revised Proposal, the Agencies assert that a CLO manager indirectly transfers assets because it "selects" and "manages" the open market CLO's assets, which the Agencies view as "consistent" with a person that "organizes and initiates" the securitization transaction."[68] It is not clear how this addresses the argument that one cannot be said to transfer something that one does not itself own or control.*

vi. *Commenters had further noted that CLO managers and open market CLOs were not the cause of the financial crisis of 2008, and thus were not rightfully a target of either Dodd-Frank or Section 15G of the Exchange Act. While the Agencies did not suggest that open market CLOs or CLO managers bore any culpability in the financial crisis, they argued that CLO managers are among those intended to be covered by the risk retention requirements of Section 15G of the Exchange Act because they "determine the credit risk profile" of the assets held by a CLO. In addition, the Agencies stated their concern that a narrow reading of the statutory text would enable evasion of the risk retention requirements by permitting market participants in other securitization markets to simply employ an agent to select assets to be purchased and securitized.*

vii. *Commenters had also raised a number of practical objections to the imposition of the risk retention requirements to open market CLOs and CLO managers. In the first instance, because CLO managers do not originate the loans included as CLO collateral, they have no risk to "retain" and would, therefore, be required to deploy limited resources to purchase the necessary risk interest. For many CLO managers, acquiring such a risk position could pose an insurmountable barrier to participation in the*

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67 Id. § __.2.

68 Revised Proposal at 144.

CLO market. For others, it is an open question as to whether an investment adviser would find the allocation of necessary capital to be consistent with their business model. As a consequence, commenters warned that imposition of the risk retention requirements to mangers of open market CLOs would result in significant contraction of, and resultant reduction of competition within, the CLO market. In response to this concern, the revised rules create an alternative method of compliance available to open market CLOs. As further discussed below, however, this alternative method may be of limited value.

viii. *The Agencies rejected proposals made by commenters to recognize the management fees, and in particular the management fees that are subordinate in the priority of payments, as aligning the interests of CLO managers and to adopt an approach that might permit managers to satisfy the risk retention requirements without having to dedicate additional capital to acquire additional credit risk. SEC Commissioner Michael S. Piwowar, in his dissent to the proposal, made specific mention of this issue, stating that "[t]he reproposal also should have given further consideration to subordinated performance fees that have components dependent on the performance of the overall pool or on junior tranches. Such fees could potentially mitigate concerns about misaligned incentives between originators, securitizers, and investors. The reproposal points out that some commenters noted that securitizers of collateralized loan obligations often retain a small portion of the residual interest and that commenters asserted that securitizers retain risk through subordinated management and performance fees. The release requests comment on questions related to subordinated performance fees. Importantly, however, the reproposal does not allow for such fees to satisfy credit risk retention requirements in any asset class."*[69]

ix. *In describing the compliance regime for CMBS, the Agencies noted that some commenters were supportive of expanding the third-party risk retention approach to other asset classes. The Agencies declined to do so in the Revised Proposal, explaining that the negotiation by a third-party purchaser of a first-loss position is a common feature of CMBS transactions that is not present in other asset-classes. Commenters, however, may wish to explore whether the Agencies might be receptive to a third-party retaining the risk in a CLO transaction where such a party does take an active role in some aspects of the transaction, either initially or on an ongoing basis.*

x. *Another argument for a third-party option may be available from the Agencies' own interpretation of the statutory text. If the CLO manger is considered to be a "sponsor" of an open market CLO by virtue of selecting assets for purchase by the SPV, it may be worth exploring whether a third party equity investor that plays some role in approving selections of assets for purchase or sale by the SPV might also be a "sponsor." The Revised*

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[69] Statement of SEC Commissioner Michael S. Piwowar Regarding Joint Rule Reproposal Concerning Credit Risk Retention, available at http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539792894.

Proposal acknowledges that not all sponsors would be required to retain risk if there are multiple sponsors; however, the extent of involvement by such a third party investor would have to be explored.

xi. As discussed in Section IV, the Revised Proposal explicitly permits the required credit risk to be retained as an initial matter by a majority-owned affiliate of the sponsor. While the Original Proposal permitted transfers to certain affiliates, it appeared the sponsor would have to be the party to initially acquire the interest and, because of the financing restrictions, would have had to do so with its own capital. The Revised Proposal's definition of "majority-owned affiliate" includes any entity that directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the sponsor, where "majority control" means ownership of more than 50 percent of the equity of an entity, "or ownership of any other controlling financial interest in the entity."[70]

xii. *This modification may provide some additional flexibility for CLO managers whose affiliates have the required capital for such an investment. It is not uncommon for a portion of the most subordinate securities of a CLO to be purchased by an affiliate of the manager or a client managed by the CLO manager (or one of its affiliates). For CLO managers that already have a related entity that acquires all or a portion of the subordinated securities in CLOs it manages, there may be an opportunity to comply with the risk retention requirements through some modifications to the corporate structure of that purchaser and its relationship with the CLO manager in order to satisfy the majority control test. Nevertheless, there are still issues with respect to having clients or affiliates of the manager retaining the required risk, such as whether it would be consistent with the CLO manager's fiduciary or other regulatory responsibilities to permit such an affiliate to purchase an eligible horizontal residual interest in a deal it manages if the entity would need to agree not to transfer or hedge such interest other than in compliance with the rule.*

xiii. *It does appear that a CLO manager's majority-owned affiliate would also be permitted to provide secured financing to the CLO manager for the acquisition of the required interest. Because majority-owned affiliates may hold the required interest directly, a pledge of the eligible interests should also comply with the rule.*

xiv. *The Revised Proposal also does not address how compliance with the risk retention requirement might be affected should the CLO manager resign or be removed. It is a common feature of CLO transactions to provide investors with the rights to remove the CLO manager, or for the CLO manager to resign, and for a replacement manager to be engaged. If such circumstance were to occur in a CLO that complied with this rule through the original CLO manager's ownership of the required risk retention interest, it would appear that the replacement manager would need to acquire the required risk retention interest. If that is the case, parties will*

70 Proposed rule § __.2.

have to consider a number of issues including whether the removed manager could be compelled to sell its interest, and at what price; whether the replacement manager could acquire the required interest from existing investors; or perhaps whether the CLO would need to issue additional eligible horizontal interests to permit the CLO to comply (and whether the issuance of additional interests would trigger the new disclosure requirements under the rule).

xv. *If an open market CLO were to comply with risk retention by having the CLO manager retain either an eligible horizontal interest, an eligible vertical interest, or some combination thereof, all of the requirements and restrictions described above in Section II would apply.*

xvi. *The restrictions on distributions to the eligible horizontal interest described in Section II.d are not compatible with the current structure of subordinated notes in most open market CLOs. Under the Revised Proposal, investors in the eligible horizontal interest would not be able to recover its fair value at a faster rate than all investors in the other ABS interests would be repaid their principal. The most junior securities issued by an open market CLO, however, are generally entitled to receive payments of excess interest proceeds from the beginning of the deal and principal on the more senior notes is not paid until the deal exits the reinvestment period several years after closing. Under the Revised Proposal, the lack of principal payments on the senior notes would appear to prevent the distribution of any amounts to the holders of the subordinate securities; thus it seems the current proposal would require the economics of CLO securities to be modified considerably if it was going to comply with risk retention by having a sponsor retain an eligible horizontal interest under the current proposal.*

xvii. *There may be more flexibility for CLOs under the alternative proposal for restricting cash flows on the eligible horizontal interest, which takes into account all amounts paid to the other ABS Interests, not just the repayment of principal. The more senior securities issued by open market CLOs do receive payments of interest from the beginning of the deal, and so there would be some room for distributions to the holder of the most subordinate securities that would most likely serve as the eligible horizontal interest. Structurers of CLOs will need to consider whether the current payment rules would be compatible with the rules of the alternative proposal, and if so there may be a preference among CLO market participants for this alternative approach (to the extent the normal risk retention rules are going to apply to open market CLOs).*

b. Alternative Method of Compliance – "CLO-eligible tranches of leveraged loans"

i. The Revised Proposal includes a compliance alternative specifically directed at open market CLOs that shifts the risk retention burden from

CLO managers or another sponsor of the CLO to the originators of the loans that the CLO would acquire.[71]

ii. A sponsor of an open market CLO transaction will be deemed to satisfy the risk retention requirements if:

1. the assets held by the open market CLO consist solely of CLO-eligible loan tranches and servicing assets;

2. the governing documents of the open market CLO require that the CLO's assets consist solely of CLO-eligible loan tranches and servicing assets;

3. the open market CLO does not invest in ABS Interests or credit derivatives other than for hedging purposes;

4. the assets purchased by the open market CLO prior to the issuance of its ABS Interests are acquired in open market transactions[72] on an arms-length basis; and

5. the CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS Interests.[73]

iii. *The requirement that the CLO manager not receive any fee or gain at the time of issuance is not described in the supplementary information describing the rule; it appears for the first time in the Revised Proposal in the text of Section __.9(b), and so the Agencies provide no guidance as to the rationale for this restriction. This is unfortunate because for the purposes of this alternative compliance regime (but not with respect to the definition of sponsor) "CLO manager" is defined to include affiliates of the investment adviser that are also managed by the investment adviser, and thus this requirement could preclude such an affiliate that has provided the equity for the warehouse period from receiving a payout of the gain on the assets during the warehouse period and prevent the CLO manager from receiving a fee for its services during the warehouse period. The possibility of economic upside is an important incentive for investors willing to provide first loss protection during the period of time that the CLO is acquiring assets pre-closing and the accumulation of assets during that*

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[71] Proposed rule § __.9. Note that "balance sheet" CLOs, where more than 50% of the loans owned by the CLO have been originated by a single source, would not be able to avail themselves of this alternative compliance method, and the sponsors of such transactions would be required to comply with the ordinary risk retention requirements under § __.3.

[72] "Open market transaction" means (1) either 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. Id. § __.9(a).

[73] Id. § __.9(b).

period is important to the ability of most CLOs to accumulate assets for the transaction.

iv. Under the proposed rules, a CLO-eligible loan tranche is a term loan of a syndicated commercial credit facility that has the following features:

1. the lead arranger of the facility has retained a minimum interest of five percent (5%) of the face amount of the tranche, and will retain such interest, until it is repaid or defaults and will comply with the restrictions described above in Section IV on its ability to hedge, transfer and pledge this interest;

2. holders of the tranche must have voting rights under the applicable loan documents at least with respect to material amendments or waivers (*e.g.*, adverse changes money terms, changes pro rata provisions, changes to voting provisions, and waivers of conditions precedent); and

3. certain material terms of the credit agreement or other similar agreements are not less advantageous to the borrower than the terms of other tranches of comparable seniority in the credit facility.[74]

v. In order for a CLO-eligible loan tranche to qualify as having a "lead arranger," there must be a financial institution that has played a primary role in the structuring, underwriting and distribution in the primary market of the CLO-eligible loan tranche and that has also, among other requirements, taken an allocation of the related credit facility of at least 20 percent of the aggregate principal balance of the facility at closing. [75]

vi. *In the Revised Proposal, the Agencies note that the purpose of this alternative compliance mechanic is to "allocate risk retention to the parties that originate the underlying loans and that likely exert the greatest influence on how the loans are underwritten." The Agencies further argue that the revised rules "align the incentives of the party most involved with the credit quality of these loans – the lead arranger – with the interests of investors."*

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[74] Id. § __.9(c).

[75] "Lead arranger" means, "with respect to a CLO-eligible loan tranche, an institution that: (1) is active in the origination, structuring and syndication of commercial loan transactions (as defined in § __.14) and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche; (2) has taken an allocation of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20 percent of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group at origination has taken a greater allocation; and (3) is identified at the time of origination in the credit agreement and any intercreditor or other applicable agreements governing the CLO-eligible loan tranche; represents therein to the holders of the CLO-eligible loan tranche and to any holders of participation interests in such CLO-eligible loan tranche that such lead arranger and the CLO-eligible loan tranche satisfy the requirements of this §; and covenants therein to such holders that such lead arranger will fulfill the requirements of clause (i) of the definition of CLO-eligible loan tranche". Id. § __.9(a).

vii. *The Agencies argue that sponsors of open market CLOs would be able to negotiate that lead arrangers retain the necessary risk interest (as well as, presumably, obtain the other terms for an entity to qualify as a "lead arranger") at the time of origination. There are several potential obstacles to this. First, for reasons related to the application of the U.S. Income Tax Code, open market CLOs managed by U.S. collateral managers are required to comply with operating guidelines that restrict the degree to which they are able to cause the CLO issuer to be engaged in active negotiation of loan facilities. Therefore, it may be unrealistic to expect CLO managers to be able to actively seek inclusion of the required terms in particular loan facilities. Second, a portion of loans acquired by open market CLOs are acquired in the secondary market after the terms are already established and very difficult (if not impossible) to change. The Agencies appear to recognize that obtaining such provisions in a loan following origination would not be practical.*

viii. *The viability of the Agencies' proposal would therefore depend on lead arrangers including in their credit facilities at origination tranches specifically designed for open market CLOs and including the types of lender rights and other provisions necessary to qualify under the rule. This is a significant assumption and the Revised Proposal provides no analysis of whether the Agencies have determined that the market views the creation of such "CLO-eligible tranches" to be economically feasible. There is also no discussion of input from financial institutions active in this market as to whether this is a change that lenders would embrace. Further, if there are CLO managers willing and able carry the required risk to satisfy the rule (and particularly if those CLO managers drive another round of consolidation in that sector), the benefits to arrangers of creating CLO-eligible loan tranches would decrease.*

ix. *Accordingly, it is not at all clear that this alternative compliance mechanic will provide meaningful relief to the market, and we would expect there to be significant comment on the viability of this proposal.*

x. *Moreover, there may be interesting questions raised as to whether the Agencies are attempting to utilize their rulemaking authority to modify the behaviors of participants in a market that functions separately from, although with some connection to, the securitization market for leveraged loans. This alternative compliance regime's focus on practices related to the underlying assets and their originators is similar to Congress's decision in the mortgage market to call on agencies to define a category of loans – QRMs - the securitization of which would be exempt from risk retention. The difference between those two cases, however, is that the Agencies were specifically mandated to take that step in the mortgage market, but not in the leveraged loan market. Notably, nearly a third of the Agencies' requests for comment with respect to the open market CLO compliance alternative focus on the role and function of a "lead arranger," suggesting that they may recognize the need for additional feedback in this area.*

xi. *The Agencies have invited comment on a number of aspects of its alternative proposal, including whether a transition period would be*

appropriate during which CLOs would be permitted to invest in assets other than CLO-eligible loan tranches, and if so how long. While a transition period would likely be helpful, commenters may find it difficult to judge how long the leveraged loan market would need to fully adapt to the new requirements, and the Agencies example of a two year period may not be sufficient.

xii. *The CLO manager may still have significant risk retention related responsibilities under the alternative compliance regime. The Agencies have sought comment on which party to the CLO should be responsible for ensuring that lead arrangers comply with their obligation to retain an interest in CLO-eligible tranches, and whether the CLO manager should nevertheless be required to retain some small portion of the most subordinate tranche in a CLO that owns only CLO-eligible loans.*

c. Implications for Current CLO Transactions

i. Under the Revised Proposal, the effective date of the proposed risk retention rules as applied to CLOs would be two years following the adoption of the final rule, and so current deals and those that are completed prior to the effective date would not, at closing, be subject to the risk retention requirements.

ii. *The Revised Proposal does not explain, however, whether and how it would apply to a CLO existing prior to the effective date that, post effective date, undergoes a refinancing, issues new classes of securities or undergoes a repricing of existing classes of securities, all of which are now common features of CLOs.*

iii. *The Revised Proposal applies the risk retention requirements to any "securitization transaction" which is defined as a transaction "involving the offer and sale of asset-backed securities by an issuing entity." Thus whether the actions of a CLO issuer in modifying its existing securities or issuing new securities (whether to replace existing securities, or raise additional funds) pulls within the rule a CLO issuer existing prior to the effective date will turn on whether such event is viewed as a "securitization transaction" separate from the original issuance of the CLO securities.*

iv. *Despite the prevalence of these features in CLO transactions, the release does not shed a lot of light on the term "securitization transaction" beyond the language of the rule, and thus this may be an area of significant comment and which would benefit from further exposition in the publication of a final rule.*

v. *As discussed above, changes in CLO managers during the life of a CLO will also present interpretive challenges under the Revised Proposal. It will be important for the final rule to consider how its mandates can be reconciled with a market practice that is designed to give investors additional protections.*

d. Exemption for Securitization of Seasoned Loans and Qualifying Commercial Loans

i. In addition to the alternative compliance method discussed above, the proposed rules include an exemption from the risk retention requirement for securitization transactions collateralized solely (other than servicing assets) by "seasoned loans" which have not been modified since origination and which have not been delinquent for thirty days or more.[76] A "seasoned loan", with respect to asset-backed securities backed by assets other than mortgage loans, is any loan that has been outstanding and performing for the longer of 2 years or until its principal balance has been reduced to 33% of its original principal balance.[77]

ii. *In the Revised Proposal, the Agencies explain that risk retention requirements are less relevant for seasoned loans, as the primary purpose of the risk retention requirements – the insurance of sound underwriting – is not as well promoted by risk retention late in the life-cycle of a loan. Underwriting deficiencies are more likely to cause delinquencies within a relatively short period following the origination of a loan.*

iii. *The "seasoned loan" exemption may prove of limited value to CLOs, as historically, CLOs have relied on assets consisting primarily of new or recently originated loans. Commenters may wish to consider, however, if the Revised Proposal should be modified such that CLOs that contain a percentage of seasoned loans, either at issuance or over time as the deal matures[78], should be subject to reduced risk retention requirements. The Agencies have adopted a similar approach with respect to securitizations of Qualifying Commercial Real Estate Loans.*

iv. The Revised Proposal retains its exemption from the risk retention requirements for qualifying commercial loans with only modest changes to the criteria a commercial loan needs to satisfy in order to meet the definition.

v. *This exemption is not expected to apply to current CLOs for a number of reasons, including that its definition of qualifying commercial loan is so narrow as to exclude most commercial loans in the market and securitizations of qualifying commercial loans would only qualify if they did not include any reinvestment period, which of course is a main feature of CLOs.*

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76 Id. § __.19(b)(7)(i).

77 Id. § __.19(b)(7)(ii).

78 As discussed below in Section VII.e, it is unclear whether the seasoned loan exception applies only to loans that meet the seasoning requirements prior to their being contributed to a securitization pool, or if they may become seasoned after the origination of the securitization.

VII. Impact on Selected Securitization Markets and Product Types: CMBS

The CMBS securitization market is particularly sensitive to a mandatory risk retention regime. In that market, commercial mortgage loans are pooled in typically a REMIC trust that issues a series of bonds varying in yield and payment priority. The bonds are rated from investment grade to sub-investment grade, and there is usually an unrated class that is subordinate to the lowest rated bond class. The purchaser of the lowest rated and unrated bond classes, commonly known as the "B-piece", generally sets underwriting standards for the commercial real estate loans that comprise the pool. Recently, there has been a fairly robust secondary market for these high yielding B-pieces. The proposed risk retention rules place limitations on the sale of B-pieces that could result in a reduced demand for such risky investments. Under the proposed rules, sponsors who are unable to sell as a B-piece all or a portion of the risk required to be retained under the rules would be required to retain any such unsold portion for its own account. In a market where loans are originated with the intent to be quickly moved off of the originator's balance sheet and into a securitization pool, any requirement that an originator or sponsor retain the riskiest portion of these loans is a fundamental change in the workings of CMBS securitizations.

a. Modifications to risk retention by third-party purchaser rules, including each purchaser's due diligence obligations; Operating Advisor rules

i. The revised rules expand the ability of a sponsor to satisfy all or a portion of its risk retention obligations via the sale of an eligible horizontal residual interest to a so-called B-piece buyer by permitting such sales to up two such B-piece buyers[79] (under the Original Proposal, such obligations could be sold to only a single B-piece buyer).

ii. *While the ability to sell the eligible horizontal residual interest to two purchasers gives a sponsor greater flexibility in the sale of B-pieces, it may not go far enough. The Agencies do not believe that it is appropriate to permit the sale to more than two B-piece buyers, as it could dilute the incentive to monitor the credit quality of the loan comprising a CMBS securitization pool.*

iii. The interest held by each B-piece buyer is required to be pari passu, such that neither B-piece buyer's losses would be subordinate to the other B-piece buyer's losses.[80]

iv. *Given the way the market currently works, some would argue that having the ability to tranche a B-piece into senior and subordinate components would be more valuable, in terms of salability, than increasing the number buyers to whom B-pieces can be sold.*

v. A B-piece buyer is required to purchase its interest in cash and may not obtain third-party financing, directly or indirectly, from any person that is a

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[79] Id. § __.7(b)(1).

[80] Id.

party to, or an affiliate of, a party to the securitization transaction (except for investors).[81]

vi. *While the limitations on financing the purchase of a B-piece are consistent with the Original Proposal, the Agencies commentary confirms that a B-piece buyer may obtain financing from a person that is a party to the securitization for purposes other than purchasing the B-piece.*

vii. *The prohibition on obtaining financing "indirectly" from a person that is a party to the securitization may be a little too vague in an industry where there is a relatively small number of players. The Agencies' commentary attempts to provide clarity by giving examples such as a parent-subsidiary relationship or a subsidiary-subsidiary relationship under a parent company; however, leaves open the possibility that "indirect" may be more broadly interpreted.*

viii. A sponsor's risk retention obligations may be satisfied entirely through such sales to B-piece buyers, or a sponsor may share a portion of such obligations by retaining a vertical interest.[82]

ix. *The ability of the sponsor to retain a portion of the retention obligation could make B-piece buyers more willing to assume a portion of the risk retention obligations.*

x. *Since the five percent (5%) risk retention threshold is larger than the typical B-piece, the ability of the sponsor to retain a portion of the retention obligation allows it to size a B-piece to the market. Even if B-piece buyers have an appetite for a larger piece of the first loss risk, enlarging the B-piece is likely to result in a demand for higher returns, with a commensurate increase in commercial mortgage loan coupons.*

xi. As in the Original Proposal, a B-piece buyer would be required to review the credit risk of the loans in a securitization pool, including, at a minimum, the underwriting standards, collateral and expected cash flows of each loan in a securitization pool; however, the revised rules make it clear that, in the event there are two B-piece buyers, each would be required to conduct such a review independently.[83]

xii. *The scope of diligence in the revised rules is largely consistent with current market practice.*

xiii. *The requirement that each B-piece buyer conduct its own diligence is consistent with current market practice for B-piece buyers that purchase their interest at the origination of the CMBS securitization.*

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81 Id. § __.7(b)(3).

82 Id. § __.7(b). See also id. § __.4(b)(1).

83 Id. § __.7(b)(4).

xiv. The revised rules remove the prohibition on B-piece buyers having control rights related to servicing, but instead require that an operating advisor, acting in the best interest of investors as a collective whole, be appointed for all securitizations in which risk retention obligations are retained all or in part by a B-piece buyer.[84]

xv. *"Acting in the best interest of the collective whole" may be easier said than done. The interests of senior and subordinate debt holders vary greatly as a loan becomes distressed. Since the market downturn, these opposing interests played out dramatically in so-called mortgage/mezzanine structures, with subordinate debt holders motivated to postpone liquidation of a defaulted loan as long as possible and senior debt holders favoring quick asset liquidation. It's easy to imagine a degree of paralysis in the abilities of the operating advisor, as most decisions regarding the disposition of a distressed loan will adversely affect one class of investor at the expense of another.*

xvi. *It is interesting to note that an operating advisor is required in every instance in which a sponsor transfers all or any part of its risk retention obligation to a B-piece buyer, even where the special servicer is not affiliated with the B-piece buyer. While it appears that this was the tradeoff the Agencies believed necessary to be comfortable with permitting B-piece buyers to have control rights related to servicing, in instances where the B-piece buyer and the special servicer are not affiliated, such requirement doesn't serve the Agencies' stated purpose of limiting the ability of B-piece buyers to manipulate cash flows through special servicing.*

xvii. The operating advisor cannot be affiliated with any other party to the securitization transaction and, other than its fee as advisor, have any direct or indirect financial interest in the securitization transaction While not mandating minimum levels of experience, expertise or financial strength, the revised rules require that transaction documents provide for such standards.[85]

xviii. *Operating advisors are not a new concept for CMBS. An operating advisor first appeared in a CMBS securitization in connection with the Treasury Department's TALF program. Since then, the addition of operating advisors has become a more regular feature in CMBS securitizations where the B-piece buyer and the special servicer are affiliates.*

xix. *Some rating Agencies are already indicating that they will offer assessments of operating advisors, once the rules are finalized. While a standardization of the qualifications of the operating advisor has not yet occurred, one could expect that a tangible set of qualifications could manifest from such assessments.*

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[84] See Id. § __.7(b)(6).

[85] Id.

xx. Consistent with the Original Proposal, the operating advisor must be consulted in connection with any major investing decision related to the servicing of the loans in a securitization pool; however, under the revised rules, such consultation is only applicable after the eligible horizontal residual interest held by B-piece buyers has a principal balance of 25% or less of its initial principal balance and only applies to special servicers, who take over administration of the loan from the primary servicer once a loan goes into default.[86] The revised rules require that the operating advisor have adequate and timely access to information and reports necessary to fulfill its duties.[87] In addition, the operating advisor is responsible for reviewing the actions and calculations of the special servicer and issuing a report to investors regarding the performance of the special servicer.[88]

xxi. *The limitation of the operating advisor's role, until the B-piece buyer's interest is reduced to 25% or less of its initial principal balance, should make B-piece buyers more likely to continue investing in first loss pieces, as B-piece buyer's status as "controlling holder" is an essential factor in their willingness to take on such risk.*

xxii. While the Original Proposal permitted the operating advisor to recommend that the servicer be replaced, the revised rules grant this authority only in connection with the removal and replacement of the special servicer and then only with the affirmative vote of a majority of certificate holders (with a quorum requirement of just five percent (5%) of the outstanding principal balance of all certificate holders).[89] Any such recommendation for removal must be based on a determination by the operating advisor that both the special servicer has failed to comply with a standard required of it and its replacement would be in the best interest of the investors as a collective whole.[90]

xxiii. *The fact that the new rules limit the operating advisor's ability to recommend removal of the special servicer, as opposed to the master servicer, should help to preserve the ongoing value of a master servicer's servicing rights, which are typically purchased from the sponsor of a securitization.*

xxiv. *While the quorum requirement is quite low, giving investors an approval right over the replacement of the special servicer is responsive to industry comments to the Original Proposal.*

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86 Id. § __.7(b)(6)(iv).

87 Id. § __.7(b)(6)(v).

88 Id.

89 Id. § __.7(b)(6)(vi)(B).

90 Id. § __.7(b)(6)(vi)(A).

b. Modifications to the 95% commercial loans rule

i. The requirement that 95% of a securitization transaction be collateralized by commercial real estate loans (with the remaining five percent (5%) comprised of other types of assets) has been replaced with the requirement that such transactions be collateralized with commercial real estate loans and "servicing assets."[91] As discussed in Section I.d above, Servicing assets are "rights or other assets designed to assure the timely distribution of proceeds to ABS Interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets."[92]

ii. *The elimination of the strict percentage allocation should remove any concern that a particular securitization trust could run afoul of the rules by inadvertently holding more than five percent (5%) of servicing assets. In addition, it appears that "servicing assets" is defined in a manner broad enough to cover the non-loan assets routinely held in a CMBS securitization.*

c. Disclosure obligations

i. Disclosure requirements in connection with a sale of risk retention obligations to a B-piece buyer are largely unchanged in the revised rules and include:

- Name, form of organization, relevant experience of each B-piece buyer and any other information regarding each B-piece buyer that is material to investors;
- The fair value of the eligible horizontal residual interest that will be retained by each B-piece buyer, together with the purchase price paid by each B-piece buyer;
- A description of the material terms of the eligible horizontal residual interest retained by each B-piece buyer;
- A description of the material terms of any transaction documents applicable to the operating advisor, including compensation paid to the operating advisor; and
- The representations and warranties concerning the securitized loans, a schedule of loans that do not comply with such representations and warranties and the factors involved in including such noncomplying loans in the securitization pool.[93]

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[91] Id. § __.7(b)(2).

[92] Id. § __.2.

[93] Id. § __.7(b)(7).

ii. *The required disclosure of the purchase price paid by B-piece buyers could be problematic to such buyers, as it is contrary to current practice and could reveal their pricing parameters to competitors. Such disclosure could affect the prices paid for B-pieces and result in a smaller number of investors willing to purchase such first-loss risk.*

iii. *The required disclosure of the operating advisor's compensation is likely to cause a standardization of the fees paid to operating advisor, similar to how servicing fees in CMBS securitizations have become relatively standard.*

d. Changes to the holding period / transfer requirements

i. The revised rules eliminate the requirement that a sponsor or B-piece buyer retain the eligible horizontal residual interest for the life of the securitization. Instead, a sponsor or B-piece buyer may transfer an eligible horizontal residual interest at any time after the 5-year anniversary of the closing of the securitization, so long as such transfer is to a party that satisfies the requirements of a B-piece buyer under the rules (including the requirement that it conduct an independent review of the credit risk of the loans in the securitization pool).[94]

ii. *Although the Agencies refer to these adjustments to the holding period and transfer requirements as the introduction of a "sunset" provision, at best, it is a partial sunset that lifts the absolute ban on transfers, but retains other requirements that would continue to apply to transferees.*

iii. *While a 5-year sunset is a substantial improvement on the prior absolute prohibition on transfers, it is likely to have a negative impact on the CMBS market. Certain investors currently active in purchasing B-pieces might decide to no longer make such investments, either because they see the ability to freely transfer such investments as valuable or need the ability to transfer such investments due to fiduciary or contractual obligations. In any event, the prohibitive transfer rules are likely to result in a demand for a higher yield by B-piece buyers, which will be reflected in mortgage loan coupons.*

iv. *Given that a transferee is required to perform the same credit risk review as the initial holder of the B-piece, it is unclear what the five-year hold period accomplishes. While the Agencies assert that the currently proposed hold period would avoid a structure in which the initial holder of the B-piece uses less demanding underwriting procedures, it is reasonable to believe that the requirement that any transferee conduct its own full credit analysis would provide an adequate check on initial underwriting standards.*

v. *As described below, it is unclear whether the "seasoned loan" exception has any impact on holding period and transfer requirements.*

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[94] Id. § __.7(b)(8).

- **vi.** *It is unclear whether the new rules intend to provide an exception to the restrictions on hedging a B-piece position. While the agency commentary states that they are proposing "an exception to the transfer and hedging restrictions of the proposed rule" they then go on to describe only an exception to the transfer restrictions. Section __.7(b)(8)(ii)(A) of the new rules provides an exception to the prohibition on the "transfer" of an "eligible horizontal residual interest", but is silent with respect to hedging transactions. Except for the reference in the agency commentary, it appears that the prohibitions on hedging remain unchanged from the Original Proposal.*

- **vii.** The new rules maintain the requirement that a sponsor monitor a B-piece buyer's compliance with the rules regarding the purchase and ownership of an eligible horizontal residual interest by a B-piece buyer and to notify investors if a B-piece buyer no longer complies with those rules.[95]

- **viii.** *Aside from the argument that sponsors are not well situated to perform such a monitoring function, the ability for a B-piece buyer to transfer its interest after five years is likely to complicate the monitoring function further. Such a monitoring function adds what may turn out to be an onerous burden on sponsors that will definitely increase the costs of originating a CMBS securitization. As with the other costs associated with the implementation of the rules, monitoring costs could place an upward pressure on commercial mortgage loan coupons.*

e. Potential exemptions for certain CMBS transactions

- **i.** The new rules do not exempt any category or CMBS securitizations as "non-conduit" transactions. The new rules do, however, provide an exemption for any securitization transaction that is collateralized solely by "seasoned loans" (i.e., loans that have been outstanding and performing for the longer of two years or the period until the outstanding principal balance has been reduced to 33% of the original principal balance) that have not been modified since origination and have never been delinquent for 30 or more days.[96]

- **ii.** *Commenters had argued that single asset transactions, single borrower transactions, large loan transactions with 10 loans or less and large loan transactions having only an investment-grade component should be exempt from risk retention rules, as prospective investors would have the ability to scrutinize each loan in such smaller pools.*

- **iii.** *Historically, most CMBS originators contribute their loans to a securitization well within one-year of origination, so the seasoned loan exemption appears to be of limited value in the current CMBS market. An obvious issue with taking advantage of such exemption at the time of securitization is that by the time the two-year holding period has elapsed,*

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95 Id. § __.7(c).

96 Id. § __.19(b)(7).

most loans would be ineligible for a securitization in a REMIC trust, as such a securitization requires a two-year defeasance lockout, and the industry standard in CMBS loan documentation permits defeasance after the sooner of three years from the closing date of the loan and two years from the start-up date of the securitization.

iv. *It is unclear whether the seasoned loan exception applies only to loans that meet the seasoning requirements prior to their being contributed to a securitization pool, as the new rule excepts "any securitization transaction that is collateralized solely by . . . seasoned loans"[97] but does not indicate whether the loans need to be seasoned at the time of the origination of the securitization or if they may become seasoned after the origination of the securitization. If loans can become seasoned while in a securitization pool, the result would be that, once all of the loans in the pool become seasoned (which is not a certain outcome), the initial risk retention rules, including the five-year hold period, would no longer apply and B-pieces could thereafter be freely traded.*

f. Securitizations of Qualifying Commercial Real Estate Loans

i. The new rules retain the concept of exemptions for Qualifying Commercial Real Estate Loans, with several modifications that are favorable to the CMBS market. A key modification is that loans to Real Estate Investment Trusts ("REITs") and loans with so-called "opco/propco" structures common to hotels and certain other asset classes are no longer excluded from the definition of "Commercial Real Estate Loans".[98]

ii. The new rules maintain underwriting standards for Qualifying Commercial Real Estate Loans that are largely similar to the Original Proposal and cover the areas of (i) ability to repay (expressed as a required minimum debt-service coverage ratio, an exclusion of floating rate loans unless fully convertible to fixed rate and an exclusion of non-amortizing loans or loans that amortize over a period of greater than 25 years), (ii) loan-to-value ratio (no greater than 65%), (iii) collateral valuation and (iv) risk management and monitoring. [99]

iii. Under the initial proposal, in order to qualify for an exemption from the risk retention rules, all of the loans in a securitization pool were required to meet the underwriting standards applicable to Qualifying Commercial Real Estate Loans. Under the new rules, securitization pools may contain a mixture of qualifying and non-qualifying loans, with the sponsor's five percent (5%) risk retention requirement being reduced by a percentage equal to the ratio of the unpaid principal balances of qualifying loans to the total unpaid principal balance of all loans in the pool; however, such

97 Id.

98 See Revised Proposal at 221-222.

99 See Proposed rule § __.17.

percentage may not exceed 50% (i.e. the risk retention requirement may never be reduced below 2.5%).[100]

iv. *The value of the exemption in the Original Proposal was extremely limited, as only a small percentage of loans would meet such stringent underwriting standards under current market practices. While the new rules make the Qualifying Commercial Real Estate Loan exception functional, it is likely to have little current value to the CMBS market as underwriting standards have historically been well below the standards required for such exception.*

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Banking and Financial Institutions," "Real Estate" or "Structured Finance" in the Practices section of our website (http://www.clearygottlieb.com).

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