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Legal Update
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Financial Reform and Securitization

Securitization reforms account for only a small portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] but the Act's impact on the securitization markets will be significant. In fact, some provisions are already beginning to affect the markets even before the Act has been signed. Mayer Brown has already published a detailed summary and analysis of the Act, which is available at http://www.mayerbrown.com/public_docs/Final-FSRE-Outline.pdf. In this Update, we provide more details and analysis relating to the portions of the Act that most directly affect asset-backed securities (ABS) and other structured finance products.

Credit Risk Retention

The Act requires the federal banking agencies,[2] the US Securities and Exchange Commission (SEC) and, for residential mortgage-backed securities (RMBS), the Secretary of Housing and Urban Development and the Federal Housing Finance Agency to prescribe regulations to require "securitizers"[3] to retain an economic interest in securitized assets. The Chairperson of the new Financial Stability Oversight Council is empowered to coordinate these joint rulemaking processes. Two of the specified agencies—the SEC and the Federal Deposit Insurance Corporation (FDIC)—had already published proposals on credit risk retention.[4] Besides summarizing the Act's requirements on credit risk retention,[5] we will note how the SEC's and the FDIC's pending proposals line up with those requirements.

The Act directs the specified agencies to require risk retention, generally at a level of not less than[6] 5 percent of the credit risk of the securitized assets and to specify the permitted forms and minimum duration of the retention. The Act also contemplates several important exceptions that either eliminate any retention requirement or permit regulators to specify lower or different retention requirements. The exceptions include:

- **Qualified residential mortgages.** Qualified residential mortgages are to be exempt from the risk retention requirements so long as they are not mingled with other assets that are not qualified residential mortgages in a securitized pool. The Act leaves the definition of "qualified residential mortgage" up to the regulators, subject both to some direction from Congress on factors that should be considered and to a prohibition on making the definition any broader than the definition of "qualified mortgage" in section 129C(c)(2) of the Truth in Lending Act, as amended by Title X of the Act. Also, resecuritizations will not be excluded from the risk retention requirements under this exception for qualified residential mortgages. As a condition to using the exception for qualified residential mortgages, an issuer will be required to certify as to the internal controls used to ensure that all of the securitized assets are qualified residential mortgages.
- **Other well-underwritten assets.** Assets other than qualified residential mortgages are to be subject to a reduced retention requirement if the originator meets underwriting standards to be prescribed by the agencies.
- **Commercial mortgages.** For commercial mortgage loans, the Act contemplates a separate set of requirements that may exempt a securitizer from any retention requirement if a qualifying third-party that performs due diligence on each of the underlying loans prior to issuance purchases the first-loss position and agrees to the same retention requirements that would otherwise apply to the securitizer. The Act also contemplates that the

permissible forms and amount of risk retention for commercial mortgage loans may differ from those for other assets. The rules on commercial mortgage loans may also establish standards for underwriting, as well as representations, warranties and enforcement mechanisms, with the apparent intention that these measures might reduce or eliminate the related retention requirement.

- **Government programs.** The Act contemplates total or partial exemptions for securitizations of assets issued or guaranteed by the United States or its agencies (but excluding Fannie Mae and Freddie Mac) and for assets issued, guaranteed or purchased by Farmer Mac or any other institution supervised by the Farm Credit Administration, as well as for ABS (whatever the underlying asset) issued by any state of the US or by political subdivisions or public instrumentalities of any state or territory and for qualified scholarship funding bonds.

The Act also permits the applicable agencies to provide other exemptions as they deem appropriate in the public interest and for investor protection. Besides contemplating exemptions for various asset classes, the Act generally requires the applicable agencies to differentiate among different asset classes[7] in the risk retention rules, including with separate underwriting standards that indicate low credit risk for each asset class. While requiring the agencies to be sensitive to differences between asset classes, the Act pushes for uniformity of treatment between banks and non-banks, saying that the risk retention rules should "apply, regardless of whether the securitizer is an insured depository institution."[8]

To ensure that entities subject to the retention requirements truly bear the credit risk of retained interests, the Act requires the agencies to prohibit securitizers from directly or indirectly hedging that risk. While the retention requirements relate primarily to securitizers, the Act also contemplates that the agencies may permit a securitizer to reduce any applicable retention requirement to the extent that the securitizer arranges for originators of the securitized assets (if different from the securitizer) to retain credit risk instead of the securitizer. Congress set an ambitious time frame for the agencies to propose retention rules (270 days after enactment of the Act) but requires the agencies to provide significant transition periods once the rules are finalized (one year for RMBS and two years for other ABS).[9]

The pending SEC and FDIC proposals on risk retention differ from what is contemplated by the Act in several important ways. Many market participants have suggested that these agencies should essentially withdraw those proposals in favor of the joint rule-making processes required by the Act. At a minimum, any risk retention requirements that either of the agencies adopt prior to the joint rulemaking should comply as closely as possible with the requirements of the Act. We have summarized the key existing differences in the table below.

	THE ACT	SEC PROPOSAL	FDIC PROPOSAL
RETENTION LEVEL	Five percent, subject to exceptions and asset class variations	Five percent	Five percent
FORM OF RETENTION	To be specified by rule	Vertical slice, except traditional transferor interest (of at least five percent) is a permitted substitute for credit or charge card receivable master trusts	Vertical slice or retained representative sample of the securitized assets

	THE ACT	SEC PROPOSAL	FDIC PROPOSAL
WHO MUST HOLD	Securitizer, except that: • rules can permit all or portion to be held by originator instead; and • rulemaking authority enables agencies to permit indirect holding through affiliates	Sponsor (defined similarly to "securitizer"), directly or through one or more affiliates	Sponsor (defined similarly to "securitizer")
DURATION	To be specified by rule	No specified termination date or amortization schedule	No specified termination date or amortization schedule
LEVEL PLAYING FIELD	Rules to apply regardless of whether the securitizer is a bank	Applies regardless of whether the securitizer is a bank (but only to shelf registrations)	Applies only to banks
ASSET CLASS DISTINCTIONS	Requires rules to differentiate among asset classes	No differentiation except for credit and charge card receivable master trusts	No differentiation on the basis of asset class
REQUIRED OR PERMITTED EXCEPTIONS	• Qualified residential mortgages • Other well-underwritten assets • Commercial mortgages • Government programs • Others in public and investors' interests	No exceptions (but limited to shelf registrations)	No exceptions
HEDGING	Requires the agencies to prohibit hedging the credit risk of required retentions; leaves room to permit interest rate and currency hedging, since neither constitutes "credit risk"; also permits the agencies to provide exceptions to the hedging prohibition	Measures the retention net of hedge positions directly related to the securities or exposures, which the SEC has indicated is intended to permit interest rate and currency hedging	Hedging prohibited, but the FDIC has indicated that interest rate and currency hedging is permitted

Disclosure and Reporting by ABS Issuers

The Act also amends the federal securities laws to add some special provisions relating to ABS.[10] First, section 15(d) of the Securities Exchange Act is amended to exclude ABS issuers from the provisions that allow issuers to discontinue periodic reporting if the related securities are held of record by fewer than 300 persons (although the SEC may adopt rules permitting ABS issuers to discontinue periodic reporting in more limited circumstances). This change renders unnecessary the SEC's pending proposal to require ABS issuers to waive the right to discontinue periodic reporting as a condition to using a shelf registration statement.

Second, the Act amends section 7 of the Securities Act to add two new paragraphs that establish special disclosure requirements for ABS issuers. New paragraph (c) requires the SEC to adopt regulations that will mandate disclosure of information for each tranche or class of ABS regarding the assets backing that security. In adopting these regulations, the SEC is required to:

- Set standards for the format of the data provided by ABS issuers, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes; and
- Require issuers to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including—
  - » data having unique identifiers relating to loan brokers or originators;
  - » the nature and extent of the compensation of the broker or originator of the assets backing the security; and
  - » the amount of risk retention by the originator and the securitizer of such assets.

While section 7 has historically dealt with the contents of registration statements and, thus, applied only to registered offerings, it appears that new paragraph (c) may have been intended to apply more broadly.

New paragraph (d) of section 7 clearly relates only to registration statements for ABS and directs the SEC to adopt rules requiring ABS registrants to perform a review of the assets underlying the subject ABS and to disclose the nature of that review.

Third, the Act directs the SEC to adopt regulations on the use of representations and warranties in the ABS market. In particular, these regulations must:

- Require nationally recognized statistical rating organizations (NRSROs) to include in any report accompanying an ABS credit rating a description of the representations, warranties and enforcement mechanisms available to investors in the ABS and how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities; and
- Require securitizers to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer so that investors may identify asset originators with clear underwriting deficiencies.

Conflicts of Interest

The Act generally prohibits underwriters, placement agents, initial purchasers and sponsors (including affiliates and subsidiaries) of ABS (including synthetic) from engaging, for a period ending one year after the closing date of the first sale, in any transaction that would involve or result in any "material conflict of interest" with respect to any investor in the ABS.[11] This provision was added in conference largely in response to disclosures and allegations made in the wake of the SEC's recent regulatory activities (and related Congressional hearings) relating to collateralized debt obligations tied to the performance of subprime RMBS. The SEC is required to issue regulations not later than 270 days after enactment to implement this provision.

The Act provides several exceptions to the general prohibition, including for certain risk-mitigating hedging activities, and for purchases or sales of ABS made pursuant to liquidity commitments or *bona fide* market-making activities.

More Rating Agency Reform

The Act requires additional regulation of NRSROs and increases their possible liability under the federal securities laws.[12] The additional regulations deal mostly with the internal workings of NRSROs and their oversight by the SEC. The changes with the most direct effects on market participants (other than the NRSROs themselves) are:

- Changes to the treatment of NRSROs under the securities laws, including:
  - » Withdrawal of the SEC's rule 436(g), which withdrawal opens up NRSROs to expert liability under the Securities Act if their ratings are referenced in a prospectus; there is concern that this may lead NRSROs to refuse to let their ratings be so referenced;
  - » Clarification that investors have a private right of action against NRSROs under the Securities Exchange Act (in the same fashion as those rights against registered public accounting firms or a securities analyst); and
  - » Removal of credit ratings from the safe harbor for "forward-looking statements" under section 21E of the Securities Exchange Act;

- An apparent mandate for federal agencies to conduct a review of their regulations and eliminate references to credit ratings.[13] While the SEC has taken considerable steps in this direction, numerous references to credit ratings remain in regulations issued by the SEC and the federal banking agencies, including many where there is no obvious substitute for the ratings references (particularly the risk-based capital rules for banks and the SEC's rule 2a-7, which regulates money market funds);
- A requirement that the SEC amend regulation FD to remove the exemption for rating agencies within 90 days of enactment; this may raise significant issues for sponsors who securitize a substantial portion of their assets;
- A requirement that NRSROs include a report on representations, warranties and enforcement activities in their credit rating reports (as noted above); and
- A mandate for the SEC to adopt rules requiring NRSROs to obtain and disclose certifications from any third party that the NRSRO hires to conduct due diligence services.

In addition, though the Act does not include the highly controversial "Franken Amendment," this may just be a deferral. The Act directs the SEC to study the feasibility of a system in which a public or private utility or a self-regulatory organization assigned NRSROs to determine the ratings of structured finance products (as was contemplated by the Franken Amendment) and report to Congress on the results of the study within 24 months after enactment of the Act. Arguably pre-judging the results of the study in part, the Act requires the SEC to implement this type of system following submission of the report unless the SEC determines that an alternative system would better serve the public interest and the protection of investors.

FDIC Receivership Authority for Systemically Important Non-Bank Financial Companies

The Act empowers the FDIC to act as receiver for "covered financial companies" that are determined to be systemically important in order to provide for their orderly liquidation under a new resolution scheme largely modeled on the receivership scheme for insured depository institutions.[14] The types of entities that may be subject to this new scheme include the following (but only if organized under US state or federal law):

- A bank holding company;
- A non-bank financial company supervised by the Federal Reserve Board (FRB);
- A company that is predominantly engaged in activities the FRB has determined to be financial in nature under section 4(k) of the Bank Holding Company Act; or
- A subsidiary of any of the foregoing that is predominantly engaged in activities the FRB has determined to be financial in nature under section 4(k).

Specifically excluded from the category are Farm Credit System institutions, governmental entities, Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

In the ABS context, it seems likely that issues will arise as to what types of legal structures are effective to isolate assets from sponsors that might be subject to this new resolution authority.

Elimination of the Private Investment Adviser Exemption

The Act eliminates the "private adviser exemption" to registration under the Investment Advisers Act and creates new recordkeeping requirements for registered advisers to "private funds" (meaning entities that avoid registration under the Investment Company Act by relying on section 3(c)(1) or 3(c)(7) of that Act).[15] While directed primarily at advisers to hedge funds, these changes would also affect any entity advising a securitization special purpose entity that relies on section 3(c)(1) or 3(c)(7) to avoid registration under the Investment Company Act. If an adviser to such an entity has been relying on the private adviser exemption to avoid registration under the Investment Advisers Act, that exemption will no longer be available. Banks organized under US law are otherwise excluded from the definition of "investment adviser," but any other unregistered entities advising entities of this type should reexamine the need for registration. It also appears that the new recordkeeping requirements relating to private funds will apply to registered advisers to securitization special purpose entities that rely on section 3(c)(1) or 3(c)(7). The Act provides a one-year transition period for these changes to the Investment Advisers Act.

Securitization and the Volcker Rule

Another set of issues relating to securitization special purpose entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act arise under the portion of the Act that embodies the so-called "Volcker Rule."[16] Besides substantially restricting proprietary trading by "banking entities,"[17] the Volcker Rule also prohibits (with some important exceptions) banking entities from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring a "hedge fund or a private equity fund." While the stated focus of this prohibition is hedge funds and private equity funds, Congress defined those categories primarily as issuers that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act (or similar funds identified in the implementing rules).

As a result, entities not ordinarily considered to be the market equivalent of hedge funds or private equity funds, but which rely on either 3(c)(1) or 3(c)(7), could be covered. For example, the ban may apply to some or all collateralized debt obligations or other bank loan funds. The Dodd-Frank Act includes what appears to be a blanket exception for a banking entity's sale or securitization of loans "in a manner otherwise permitted by law,"[18] which should help with some securitization special purpose entities that rely on these exemptions. However, issues may arise, particularly where some or all of the securitized assets are not loans.

Fortunately, this portion of the Act does not take effect until 12 months after the date of the issuance of final implementing rules (or two years after the date of enactment, if earlier).[19] The new Financial Stability Oversight Council is required to study and make recommendations for implementation within six months after enactment, following which the Federal banking agencies, the SEC and the Commodities Futures Trading Commission have nine months to consider the recommendations and adopt implementing rules. Given the clear intent to exclude securitizations from the prohibitions, we hope that the final rules will provide additional clarity as to any issues that arise.

Conclusion

Other provisions included in the voluminous Act are certain to affect some or all ABS market participants, but we have highlighted above the provisions with the clearest and most direct impacts. The provisions of the Act discussed in this Update will take effect one day after the Act is signed, except as described above for the changes relating to the private investment adviser exemption and the Volcker Rule. However, many of the Act's key provisions require rulemaking by federal agencies, rather than being self-executing. These rulemaking projects will take some time and will keep the agencies and market participants busy for the foreseeable future in the continuing efforts to reshape the regulatory framework for the ABS market.

Endnotes

1 The Act passed the House of Representatives on June 30. It appears the Senate is passing it as we finalize this Update. President Obama is expected to sign it promptly.

2 Defined as the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. The Office of Thrift Supervision is being eliminated by another Title of the Act.

3 The term "securitizer" is defined as: (i) an issuer of an asset-backed security or (ii) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Asset-backed securities is defined in the Act in a manner that is similar to, but broader than, the definition in Regulation AB, and the SEC has the authority to pull particular securities into the definition by rule.

4 See our updates at http://www.mayerbrown.com/publications/article.asp?id=8892&nid=6 and http://www.mayerbrown.com/publications/article.asp?id=9002&nid=6.

5 Section 941 (located in Subtitle D—Improvements to the Asset-Backed Securitization Process, of Title IX—Investor Protections and Improvements to the Regulation of Securities).

6 Although the "not less than" language would permit the regulators to specify requirements higher than 5 percent for some assets, it is broadly expected that 5 percent will be the highest requirement.

7 Specific asset classes identified in the Act are residential mortgages, commercial mortgages, auto loans, collateralized debt obligations and resecuritizations, though the agencies are permitted to identify others.

[8] Section 15G(c)(1)(D) of the Securities Exchange Act, as added by section 941 of the Act. However, the Act also contemplates that the exemptions, exceptions or adjustments to the risk retention rules may differentiate among different "classes of institutions". Section 15G(e)(1).

[9] The Act also requires two studies on risk retention: one by the Board of Governors of the Federal Reserve System, in consultation with the other federal banking agencies, and one by the Chairman of the new Financial Services Oversight Council.

[10] Sections 942, 943 and 945. In addition, section 944 of the Act deletes section 4(5) of the Securities Act, which exempted from registration certain mortgage-related transactions. To our knowledge, no significant market activity was relying on that exemption. The deletion appears to be predominantly a housekeeping matter.

[11] Section 621.

[12] Subtitle C—Improvements to the Regulation of Credit Rating Agencies, of Title IX—Investor Protections and Improvements to the Regulation of Securities.

[13] Section 939A.

[14] Title II—Orderly Liquidation Authority.

[15] Title IV—Regulation of Advisers to Hedge Funds and Others.

[16] Section 619.

[17] Banking entities are defined to include any insured depository institution, any company that controls an insured depository institution or that is treated as a bank holding company under the Bank Holding Company Act, and any subsidiary or affiliate of those entities.

[18] Section 619(g)(2).

[19] The Act provides additional time for banking entities to complete divestitures required under the final rules. Section 619(c)(2) and (3).

If you have any questions with regard to the Act, or any other topic addressed above, please contact the authors of this Update listed below, or any of the partners in the Securitization or Financial Services Regulatory & Enforcement practices. Please go to http://www.mayerbrown.com/securitization/ to learn more about our Securitization practice and to http://www.mayerbrown.com/financialservicesregulatory-andenforcement/overview/index.asp for Financial Services Regulatory & Enforcement.

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