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Overview of the Proposed Credit Risk Retention Rules for Securitizations

The SEC and various banking and housing regulators have issued a much anticipated set of proposed rules requiring securitization sponsors to retain a portion of the credit risk in the assets that they securitize. In this memorandum, we summarize the proposed rules, discuss a number of provisions that are problematic or unclear and offer a preliminary analysis of the impact of these rules on the securitization market.

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Introduction

On March 29, 2011, the US Securities and Exchange Commission (the "SEC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC" and, together with the Federal Reserve and the FDIC, the "Federal Banking Regulators"), the Department of Housing and Urban Development and the Federal Housing Finance Agency (collectively, the "Agencies") issued a massive set of proposed rules requiring securitization sponsors to retain an economic interest in the assets that they securitize (the "Proposed Rules").[1] The Agencies are required to adopt credit risk retention rules by Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] According to the Agencies, the Proposed Rules are intended to "provide a sponsor with an incentive to monitor and control the quality of the assets being securitized and help align the interests of the sponsor with those of investors in the ABS."

The Proposed Rules require the sponsor of a securitization transaction to retain credit risk equal to at least 5% of the aggregate credit risk of the assets backing that securitization transaction.[3] The Proposed Rules provide sponsors with multiple options for satisfying the risk retention requirement. The Proposed Rules also contain a number of important exemptions from the risk retention requirement, including exemptions for Fannie Mae and Freddie Mac and for securitization transactions backed by residential mortgages, auto loans, commercial loans and commercial real estate loans that meet stringent underwriting criteria. For ease of reference, the basic terms of the Proposed Rules are presented in a chart attached as Exhibit A to this memorandum.

The Proposed Rules, if adopted, will affect nearly every type of asset-backed securitization transaction, including both registered public offerings under the Securities Act of 1933 (the "Securities Act") and private offerings, regardless of whether these private offerings are conducted in reliance on Rule 144A or another "safe harbor" from the registration requirements of the Securities Act. In addition, the Proposed Rules apply to "asset-backed securities" as that term is broadly defined in the Securities Exchange Act of 1934 (the "Exchange Act"), as amended by Section 941(b) of the Dodd-Frank Act (these asset-backed securities being referred to as "Exchange Act ABS"). [4] Exchange Act ABS encompasses a wider variety of securities (e.g.,

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1 The Proposed Rules are available at: http://www.fdic.gov/news/board/29Marchno2.pdf.

2 Section 941(b) of the Dodd-Frank Act is codified in Section 15G of the Securities Exchange Act of 1934.

3 In its report pursuant to Section 946 of the Dodd-Frank Act (available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf), the Financial Stability Oversight Council stressed that "one size fits all" was not appropriate and recommended that various forms of risk retention be considered (e.g., incentive management fees). Unfortunately, the Proposed Rules do not provide a wide variety of options that provide meaningfully different methods for satisfying the risk retention requirement. Although the Proposed Rules contain a number of options, most of those options involve combinations of the vertical slice and horizontal slice methods of risk retention.

4 The term "asset-backed security" is defined in Section 3(a)(77) of the Exchange Act as "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

collateralized debt obligations) than does the definition of "asset-backed security" in Regulation AB, the SEC's principal rule regarding securitization disclosure.[5]

Deadline for Comments and Rulemaking Timeline

Comments on the Proposed Rules are due by June 10, 2011.[6] Although Section 941(b) of the Dodd-Frank Act requires final credit risk retention rules (the "Final Rules") to be adopted by April 15, 2011, it is likely that the Final Rules will not be adopted until the summer of 2011 or later.

Compliance Date

Sponsors of Exchange Act ABS backed by residential mortgages must comply with the Final Rules beginning on the date that is one year after the date that the Final Rules are published in the *Federal Register*. Sponsors of Exchange Act ABS backed by assets other than residential mortgages must comply with the Final Rules beginning on the date that is two years after the date that the Final Rules are published in the *Federal Register*.

Base Risk Retention Requirement

The Proposed Rules require the securitization sponsor[7] to retain at least 5%[8] of the ABS interests issued by the issuing entity as part of a "securitization transaction."[9] The Proposed Rules do not specify a higher risk retention standard for any particular class or type of Exchange Act ABS.

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obligation, (iii) a collateralized bond obligation, (iii) a collateralized bond obligation, (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [SEC] by rule determines to be an asset-backed security for purposes of this section." Section 3(a)(77) of the Exchange Act provides that the term asset-backed security "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."

5 Item 1101 of Regulation AB defines asset-backed security as "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases." The definition of asset-backed security in Regulation AB contains a number of further limitations that can cause securities that otherwise meet the above description to fall outside the definition of asset-backed security under Regulation AB (e.g., limits on the amount of delinquent assets in the securitized pool and limits on the prefunding and revolving periods).

6 Comments on the Proposed Rules that have been submitted to the SEC are available at http://www.sec.gov/comments/s7-14-11/s71411.shtml.

7 The Proposed Rules define "sponsor" as "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." This definition corresponds with the definition of "sponsor" in Regulation AB and in the Dodd-Frank Act.

8 The Agencies note that the 5% risk retention requirement is a "regulatory minimum" and that the sponsor, originator or other party to a securitization transaction may retain, or be required to retain, additional exposure to the credit risk of the securitized assets beyond that required by the Proposed Rules, either on its own initiative or in response to the demands of the market.

9 The Proposed Rules define "securitization transaction" as "a transaction involving the offer and sale of [Exchange Act ABS] by an issuing entity."

However, the Agencies have requested comment as to whether a higher risk retention standard should be imposed for particular classes or types of Exchange Act ABS.[10]

The Proposed Rules do not require that the originator (unless the originator is also the sponsor) retain any portion of the ABS interests. Therefore, in the view of the Agencies, the Proposed Rules do not "raise the types of concerns about credit availability that might arise if certain originators, such as mortgage brokers or small community banks (that may experience difficulty obtaining funding to retain risk positions), were required to do so."[11] However, the Proposed Rules do provide the sponsor with the flexibility to allocate some portion of the retained risk to originators.[12]

ABS Interests. As noted above, the minimum risk retention is measured by reference to the "ABS interests" issued by the issuing entity.[13] The Proposed Rules define "ABS interest" as:

- including "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" but
- excluding "common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests: (i) that are issued primarily to evidence ownership of the issuing entity; and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity."

Therefore, each class of Exchange Act ABS, as well as the residual interest, issued by the issuing entity is an ABS interest. Of course, the issuing entity may have other obligations, such as the obligation to pay servicing fees, the obligation to make indemnity payments and the obligation to make payments to an interest rate swap counterparty. Absent clarification from the Agencies, these sorts of obligations are likely also ABS interests because the ability of the issuing entity to satisfy those obligations is primarily dependent on the cash flows of the collateral owned or held by the issuing entity.

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10 If a higher risk retention standard should be established, the Agencies have requested comment as to the factors that the Agencies should take into account in determining that higher standard (*e.g.*, whether the amount of credit risk should be based on expected losses or a test based on the interest rate spread relative to a benchmark index).

11 The Agencies also noted that "mandatory allocation of risk retention to the originator ... also could pose significant operation and compliance problems, as a loan may be sold or transferred several times between origination and securitization and, accordingly, an originator may not know when a loan it has originated is included in a securitization transaction."

12 For a discussion of this allocation option, see below under "*Allocation of Risk Retention between Sponsor and Originator*."

13 Section 941(b) of the Dodd-Frank Act requires the Agencies to adopt rules requiring sponsors to retain an interest in "a portion of the credit risk" for any asset that it securitizes. The Proposed Rules are not obviously consistent with this principle in that the Proposed Rules measure risk retention as a portion of the total ABS interests, rather than as a portion of the true credit risk associated with the securitized assets. The Loan Syndications and Trading Association used the following example to illustrate this point: "Historical data shows that a $100 million portfolio of single-B loans has a 10-year cumulative default probability of 27%. Suppose the loss given default on those loans is 50 cents (a very conservative estimate). Thus, the expected loss on the portfolio is $13.5 million ($100 million * 27% * 50%). Five percent of that expected loss is $675,000. In contrast, the NPR would require a sponsor to hold $5 million. The numbers are nowhere close." *See LSTA Week in Review – Market Recap* (April 1, 2011) (available at: http://www.lsta.org/WorkArea/showcontent.aspx?id=13040).

The Proposed Rules do not specify a method of measuring the amount of each class of ABS interest. Therefore, the sponsor is required to determine the aggregate dollar amount of ABS interests. As described below, in some circumstances, the sponsor will be required to disclose to investors and certain Agencies the material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity, including those pertaining to any estimated cash flows and the discount rate used.

Determining the "Par Value" of ABS Interests. In various contexts as described below, the Proposed Rules require the sponsor to determine the "par value" of ABS interests. [14] With respect to an ABS interest in the form of a security with a face value or an outstanding principal balance, the par value of that security would equal that face value or outstanding principal balance. However, the Proposed Rules do not provide guidance as to how to calculate par value in the context of ABS interests, such as a residual interest or servicing fee interest, that do not have a face value or outstanding principal balance. As noted below under "*Disclosure to Investors and Certain Agencies*," the sponsor must disclose its material assumptions and methodologies in determining the dollar amount of the various ABS interests.

Presumably, one method of calculating the par value of a residual interest is as the excess of the par value of the securitized assets over the par value of the ABS interests senior to the residual interest. The Proposed Rules also suggest that a sponsor may utilize a discounted cash flow method or similar method to determine the par value of the residual interest and other ABS interests that do not have a face value or an outstanding principal balance. Indeed, under the Proposed Rules, the required disclosure of material assumptions and methodologies used by the sponsor in calculating the par value of ABS interests must include "those pertaining to any estimated cash flows and the discount rate used."

Contingent Obligations. The Proposed Rules provide little guidance as to how to calculate the value of ABS interests consisting of contingent obligations, such as indemnity payment obligations. The Proposed Rules do not seem to prevent a sponsor, in developing its own methodology for determining the value of contingent ABS interests, from concluding that the value of contingent ABS interests is zero if the related contingent liability is not probable and reasonably estimable.

Obligations Under Interest Rate Swaps. The Proposed Rules also provide little guidance as to how to calculate the value of the ABS interests consisting of the payment obligations of the issuing entity under an interest rate swap or other derivative. With respect to an interest rate swap, the payment obligation of the issuing entity is typically defined to be the fixed rate swap payment owed to the swap counterparty, net of any floating rate swap payment owed by the swap counterparty to the issuing entity. The fixed rate under an interest rate swap is normally set so that the expected present value of the fixed rate swap payments equals the expected present value of the floating rate swap payments. In other words, on the closing date, the expected net present value of all payments to be exchanged in the future under an interest rate swap is zero. Therefore,

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[14] In contrast, CRD Article 122a uses the term "nominal value" as the standard for measuring risk retention under that provision. For a comparison of the Proposed Rules and CRD Article 122a, see "*Evaluating Compliance with CRD Article 122a*."

in the typical case, a sponsor should have the flexibility to value at zero the ABS interest consisting of the issuing entity's net swap payment obligation to the swap counterparty.

Permissible Forms of Risk Retention: Five Options

The Proposed Rules do not mandate any particular form of risk retention. Rather, the Proposed Rules provide the following five options for satisfying the risk retention requirement:[15]

(1) a vertical slice option;

(2) a horizontal slice option;

(3) a horizontal cash reserve fund option;

(4) an "L" shaped option (combining the vertical and horizontal options); and

(5) a representative sample option.

The Proposed Rules provide additional options for risk retention for revolving asset master trusts, eligible ABCP conduits and CMBS transactions. Those additional options are described separately under "*Permissible Forms of Risk Retention: Additional Options for Particular Types of Securitization Transactions*."

Each of the five options for satisfying risk retention requires the sponsor to retain the risk at the closing of the securitization transaction. Following the closing, the sponsor is subject to certain prohibitions on hedging, transferring or financing the retained risk as described below under "*Prohibitions on the Hedging, Transfer or Financing of the Retained Risk*."

VERTICAL SLICE OPTION

A sponsor can satisfy the risk retention requirement by retaining at least 5% of each class of ABS interests in the issuing entity issued as part of the securitization transaction. This minimum retention requirement applies, regardless of the nature of the class of ABS interest (e.g., senior or subordinated) and regardless of whether the class of ABS interests has a par value, was issued in certificated form or was sold to unaffiliated investors.

As noted above, the Proposed Rules do not specify a method for measuring the amount of each class of ABS interests. The Agencies have indicated that regardless of the method of measurement, the amount retained by the sponsor utilizing the vertical slice option "should equal at least five percent of the par value (if any), fair value, and number of shares or units of each class."[16]

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15 A sponsor may choose only one of the five options for any one securitization transaction.

16 Although it is not clear, presumably it is the intent of the Agencies that the sponsor must also retain at least 5% of the ABS interests as calculated in accordance with the sponsor's method of measurement, if such method of measurement yields a value that is different than par value or fair value. It is also not clear how the sponsor can retain at least 5% of the "number of shares or units of each class" with respect to a class of ABS interests that is held as a global security by The Depository Trust & Clearing Corporation or similar clearance and settlement system.

HORIZONTAL SLICE OPTION

A sponsor can satisfy the risk retention requirement by retaining an "eligible horizontal residual interest" in an amount that is equal to at least 5% of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction. An eligible horizontal residual interest is an ABS interest that:

- is allocated all losses on the securitized assets (other than losses that are first absorbed through the release of funds from a premium capture cash reserve account, if such an account is required to be established as described below under "*Mandatory Premium Capture Cash Reserve Account*") until the par value of such ABS interest is reduced to zero;
- has the most subordinated claim[17] to payments of both principal and interest by the issuing entity;[18] and
- until all other ABS interests in the issuing entity are paid in full,[19] is not entitled to receive any payments of principal made on a securitized asset; provided, however, an eligible horizontal residual interest may receive its current proportionate share of scheduled payments of principal[20] received on the securitized assets in accordance with the transaction documents.

Under the cash flow waterfall used in many existing securitization transactions, the holder of the residual interest is not prevented from receiving principal prepayments. Rather, the issuing entity distributes all of the principal and interest collections received by it during the related collection period. To the extent any remaining collections are available at the bottom of the waterfall, those remaining collections are released to the holder of the residual interest, without regard to whether those collections consist of interest, scheduled principal payments or principal prepayments on the securitized assets. If the Proposed Rules are adopted in their present form, securitization transactions utilizing this method of distributing collections will need to be restructured to track scheduled principal payments and to release to the sponsor, as the holder of the residual interest, principal collections equal to no more than the eligible horizontal residual interest's proportionate share of those scheduled principal payments.

As noted above, the Proposed Rules provide little guidance as to the permitted methods of calculating the par value of ABS interests, such as residual interests, that do not have a face value or unpaid principal balance. The use of a "par value" standard in measuring the eligible

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17 Thus, "expected loss notes" or similar subordinated tranches held by the sponsor (or the originator as described below under "*Allocation of Risk Retention between Sponsor and Originator*") would not qualify unless they are fully subordinated to all other interests.

18 The residual interest is typically not entitled to any payment of interest from, or return of principal by, the issuing entity. Presumably, the Agencies intended that the eligible horizontal residual interest have the most subordinated claim to payments of principal and interest collections on the securitized assets that are distributable from time to time by the issuing entity.

19 As noted above, the definition of ABS interests is very broad and includes the obligation of the issuing entity to pay servicing fees and even the contingent obligation to make indemnity payments. Thus, as a practical matter, it may be difficult to determine when all other ABS interests have been paid in full.

20 According to the Agencies, the prohibition of unscheduled principal payments to the eligible horizontal residual interest is designed to ensure that unscheduled payments would not accelerate the payoff of the eligible horizontal residual interest before other ABS interests.

horizontal residual interest creates uncertainty as to what the Proposed Rules might permit. For example, in a transaction structure with securitized assets that generate significant excess spread, it is unclear whether that excess spread could be effectively capitalized in the form of an eligible horizontal residual interest calculated by the sponsor to have a par value greater than the excess of the par value of the securitized assets over the par value of the senior ABS interests.

HORIZONTAL CASH RESERVE FUND OPTION

In lieu of retaining an eligible horizontal residual interest as described above under the horizontal slice option, the sponsor may, at closing of the securitization transaction, establish and fund, in cash, a horizontal cash reserve account in an amount equal to at least 5% of the par value of all ABS interests in the issuing entity. The horizontal cash reserve account must meet all of the following conditions:

- the account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;
- amounts held in the account are invested only in U.S. Treasury bills or deposits that are fully insured by the FDIC;
- until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved:
    - amounts in the account shall be released to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest; and
    - no other amounts may be withdrawn or distributed from the account except that:
        - amounts in the account may be released to the sponsor or any other person due to the receipt by the issuing entity of scheduled payments of principal on the securitized assets, provided that such release of scheduled principal may not exceed the proportion of the current balance in the account to all ABS interests in the issuing entity;[21] and
        - interest earned on the account may be released once received by the account.

"L" SHAPED OPTION

A sponsor can satisfy the risk retention requirement using a combination of the vertical slice option and the horizontal slice option (or horizontal cash reserve account in lieu of the horizontal slice option). Specifically, a sponsor can satisfy the risk retention requirement if, at the closing of the securitization transaction, the sponsor:

- retains not less than 2.5% of each class of ABS interests in the issuing entity; and

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[21] Specifically, the release must not exceed the product of (a) the amount of scheduled payments of principal received by the issuing entity and for which the release is being made and (b) the ratio of the current balance in the horizontal cash reserve account to the aggregate remaining principal of all ABS interests in the issuing entity.

- retains an eligible horizontal residual interest in the issuing entity (or establishes and funds a horizontal cash reserve account) in an amount equal to at least 2.564%[22] of the par value of all ABS interests other than the vertical portion of such ABS interests that the sponsor is required to retain as described in the above bullet point.

REPRESENTATIVE SAMPLE OPTION

General Requirements. A sponsor can satisfy the risk retention requirement by retaining ownership of a representative sample of the pool of assets that are designated for securitization and draws from such pool all of the securitized assets for the securitization transaction, [23] provided that:

- at the time of issuance of the Exchange Act ABS, the unpaid principal balance of the assets comprising the representative sample retained by the sponsor is equal to at least 5.264%[24] of the unpaid principal balance of all the securitized assets; and
- the sponsor complies with the additional requirements described below.

Construction of the Designated Pool. The "designated pool" with respect to any securitization transaction consists of the securitized assets and the assets comprising the representative sample. Under the Proposed Rules, prior to the sale of Exchange Act ABS, the sponsor must identify a designated pool of assets:

- that consists of a minimum of 1,000 separate assets;[25]
- from which the securitized assets and the assets comprising the representative sample are drawn; and
- that contains no assets other than securitized assets or assets comprising the representative sample.

Note that, other than the minimal requirements described above, a sponsor is free to use whatever method it wishes in identifying assets from its overall managed pool for inclusion in the designated pool. However, all of the assets selected for inclusion in the designated pool will necessarily be required to meet the various eligibility requirements specified in the securitization transaction documents.

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22 The horizontal component is measured at 2.564% in order to cause the dollar amount retained under the horizontal component to equal the dollar amount retained under the vertical component. For example, if the par value of all ABS interests is $100, 2.5% (or $2.50) of that total amount would have to be retained under the vertical component and 2.564% (or $2.50) of the remaining $97.50 would have to be retained under the horizontal component to yield a total risk retention of 5% (or $5.00).

23 The representative sample option may be a useful alternative for a sponsor that might lose sale treatment if it retains an ABS interest in a securitization transaction.

24 5.264% is the percentage of the securitized assets that is required in order for the representative sample to equal 5% of the aggregate unpaid principal balance of the assets comprising the designated pool (*i.e.*, the pool consisting of the securitized assets and the representative sample assets).

25 Thus, the representative sample option is not a viable option for CMBS transactions or securitizations of large commercial loans.

Construction and Testing of the Representative Sample. Prior to the sale of the Exchange Act ABS, the sponsor must:

- select from the assets that comprise the designated pool a sample of such assets using a random selection process that does not take account of any characteristic of the assets other than the unpaid principal balance of the assets; and
- determine, using a statistically valid methodology, that, for each material characteristic of the assets in the designated pool,[26] including the average unpaid principal balance of all the assets, the mean of any quantitative characteristic,[27] and the proportion of any characteristic that is categorical in nature,[28] of the sample of assets randomly selected from the designated pool is within a 95 percent two-tailed confidence interval of the mean or proportion, respectively, of the same characteristic of the assets in the designated pool.[29]

Sponsor Policies, Procedures and Documentation. The Proposed Rules require the sponsor to maintain documentation that clearly identifies the assets in the representative sample. In addition, the Proposed Rules require that the sponsor have in place, and adhere to, policies and procedures for:

- identifying and documenting the material characteristics of assets included in the designated pool;
- selecting assets randomly and testing the random pool in accordance with the requirements described above;
- maintaining, until all ABS interests are paid in full, documentation that clearly identifies the assets included in the representative sample; and
- prohibiting, until all ABS interests are paid in full, assets in the representative sample from being included in the designated pool of any other securitization transaction.

Agreed-upon procedures report. Prior to the sale of the Exchange Act ABS, the sponsor has obtained an agreed-upon procedures report. The independent public accounting firm providing

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26 Other than the unpaid principal balance of the assets, the Proposed Rules do not define the set of "material characteristics" with respect to the designated pool. The Agencies note that the set of material characteristics depends on the types of assets being securitized and that such material characteristics might include the geographical location of the property securing the loan, the debt-to-income ratio of the borrower, and the interest rate payable on the loan.

27 Although the Proposed Rules do not define "quantitative characteristic," the Agencies consider the interest rate payable on the loan and the borrower's debt-to-income ratio to be examples of quantitative characteristics.

28 Although the Proposed Rules do not define what characteristics are "categorical in nature," the Agencies consider the geographic location of the property securing a loan to be an example of a categorical characteristic.

29 For example, if the mean of a quantitative characteristic, such as the interest rate payable on the loans, in the designated pool is 6% and the standard deviation is 2%, then the mean of the interest rate payable on the loans in the representative sample must be between 2% and 10% (*i.e.*, within two standard deviations of the mean of that characteristic in the designated pool). In the event that a random selection yields a sample pool in which the mean interest rate payable on the loans in the sample is outside of the 2% to 10% interval, the Agencies have indicated that the sponsor must repeat the random sampling process "as necessary" in order to achieve a random sample that falls within the prescribed 95% confidence interval. It is not clear whether the sponsor is prohibited from conducting further random selections after the sponsor conducts a random selection that yields a qualifying random sample. The flexibility to conduct further random sampling may be necessary in order to ensure that the pool of securitized assets does not exceed any overconcentration limits or similar limits as specified in the transaction documents.

the agreed-upon procedures report must at a minimum report on whether the sponsor has policies and procedures that require the sponsor to comply with the various requirements described above.[30]

Servicing. Until such time as all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved:

- servicing of the assets included in the representative sample must be conducted by the same servicer and under the same contractual standards as the servicing of the securitized assets;[31] and
- the individuals responsible for servicing the assets included in the representative sample or the securitized assets[32] must not be able to determine whether an asset is owned or held by the sponsor or owned or held by the issuing entity.

Sale, Hedging or Pledging. Until such time as all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved, the Proposed Rules require that the sponsor:

- comply with the restrictions described below in "*Prohibitions on the Hedging, Transfer or Financing of the Retained Risk*" with respect to the assets in the representative sample;
- not remove any assets from the representative sample; and
- not cause or permit any assets in the representative sample to be included in any designated pool or representative sample established in connection with any other issuance of Exchange Act ABS.

DISCLOSURE TO INVESTORS AND CERTAIN AGENCIES

Each of the five options for satisfying risk retention requires that the sponsor provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the Exchange Act ABS[33] and, upon request to the SEC and its applicable Federal Banking Regulator, if any, the following disclosure in written form under the caption "Credit Risk Retention":

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30 Sponsors will need to carefully consider the nature of their disclosures about this report in light of Rule 193 under the Securities Act (dealing with disclosure concerning due diligence reviews and expert liability for certain third parties). For a discussion of Rule 193, see the Mayer Brown Legal Update: *"SEC Adopts Final Rules Related to Issuer Due Diligence Review of Assets and Disclosure of Underwriting Exceptions in Public Offerings of Asset-Backed Securities"* (February 2, 2011) at: http://www.mayerbrown.com/publications/article.asp?id=10381&nid=6.

31 The servicing agreement in many securitization transactions prohibits the servicer from taking certain actions, such as lowering the interest rate on a loan in the securitized pool, but provides that the sole remedy for the breach of such a provision is the purchase of that loan from the issuing entity by the servicer. This limited remedy provides the servicer with the flexibility that is occasionally required to restructure a troubled loan. It is unclear whether the servicer would be prohibited in all cases from breaching such a covenant with respect to a loan in the representative sample.

32 It is not clear whether the "individuals responsible for servicing the assets" refers (i) only to the persons who are responsible for dealing directly with the obligors on the assets, or (ii) to the persons who are responsible for dealing directly with the obligors on the assets and to persons in management, such as the senior officer in charge of securitization.

33 The Proposed Rules do not offer any guidance as to what constitutes a "reasonable period of time" prior to the sale of the Exchange Act ABS. Other than the requirement that the disclosures be in writing and appear under the caption "Credit Risk Retention," the Proposed Rules also do not specify the means by which the disclosures must be delivered to investors. Therefore, absent future rulemaking in the context of the anticipated amendments to Regulation AB or otherwise, it appears that sponsors have the flexibility to provide the written disclosures separately from the statutory prospectus or the offering memorandum.

- the material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used; and
- the additional option-specific disclosure as described in the table below:

OPTION	ADDITIONAL DISCLOSURES
Vertical Slice	The amount (expressed as a percentage and dollar amount) of each class of ABS interests in the issuing entity that the sponsor will retain (or did retain) at the closing of the securitization transaction, and the amount (expressed as a percentage and dollar amount) of each class of ABS interests in the issuing entity that the sponsor is required to retain under the terms of the vertical slice option.
Horizontal Slice	The amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest the sponsor will retain (or did retain) at the closing of the securitization transaction, and the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that the sponsor is required to retain under the terms of the horizontal slice option. A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor.
Horizontal Cash Reserve Fund	The dollar amount to be placed (or placed) by the sponsor in the horizontal cash reserve account and the dollar amount the sponsor is required to place in such an account under the terms of the horizontal cash reserve fund option. A description of the material terms of the horizontal cash reserve account.
"L" Shaped	The same written disclosure as is required under the vertical slice option and the horizontal slice option or the horizontal cash reserve fund option, as applicable.
Representative Sample	The amount (expressed as a percentage of the designated pool and dollar amount) of assets included in the representative sample and to be retained (or retained) by the sponsor, and the amount (expressed as a percentage of the designated pool and dollar amount) of assets required to be included in the representative sample and retained by the sponsor pursuant to the representative sample option. A description of the material characteristics of the designated pool, including the average unpaid principal balance of all the assets, the means of the quantitative characteristics and proportions of categorical characteristics of the assets, appropriate introductory and explanatory information to introduce the characteristics, the methodology used in determining or calculating the characteristics, and any terms or abbreviation used. A description of the policies and procedures that the sponsor used for ensuring that the process for identifying the representative sample complies with the requirements of the representative sample option and that the representative sample has equivalent material characteristics as required by the terms of the representative sample option.

OPTION	ADDITIONAL DISCLOSURES
	Disclosure concerning the assets in the representative sample must be provided in the same form, level and manner as the sponsor provides pursuant to rule or otherwise, concerning the securitized assets.[34]

In addition to the disclosures required to be made in advance of the time of sale, at the end of each distribution period as specified in the transaction documents governing the Exchange Act ABS, a sponsor using the representative sample option is required to provide, or cause to be provided, to the holders of the Exchange Act ABS and, upon request, to the SEC and its appropriate Federal Banking Regulator, if any, a comparison of the performance of the pool of securitized assets included in the securitization transaction for the related distribution period with the performance of the assets in the representative sample for the related distribution period.

Permissible Forms of Risk Retention: Additional Options for Particular Types of Securitization Transactions

The Proposed Rules also provide a set of additional options for particular types of transactions. Those options are:

- a seller's interest option for securitization transactions involving revolving asset master trusts;
- an originator-seller horizontal slice option for eligible ABCP conduits; and
- a third-party purchaser horizontal slice option for CMBS.

These additional options are non-exclusive—in other words, a sponsor engaging in any of the foregoing types of securitization transactions may satisfy its risk retention obligation using one of the five standard options described above. These additional options were provided by the Agencies in an apparent attempt to accommodate the special structuring and other considerations that may make the use of the five standard options impractical for particular types of securitization transactions.

REVOLVING ASSET MASTER TRUSTS

A sponsor can satisfy its risk retention requirement if, at the closing of the securitization transaction and until all ABS interests in the issuing entity are paid in full, the sponsor retains a

34 Thus, the Proposed Rules appear to require that the same assortment of pool stratification tables that appear in the prospectus or offering memorandum concerning the securitized assets (e.g., the geographic distribution table) must also be provided separately in the prospectus or offering memorandum for the assets in the representative sample. Moreover, if loan-level data about the securitized assets is provided to investors, whether required by rule or otherwise, the Proposed Rules appear to require that loan-level data about the assets in the representative sample must also be provided to investors.

seller's interest of at least 5% of the unpaid principal balance of all the assets owned or held by the issuing entity; provided that:

- the issuing entity is a revolving asset master trust;[35] and
- all of the securitized assets are loans or other extensions of credit that arise under revolving accounts.[36]

The Proposed Rules define the term "seller's interest" as an ABS interest:

- in all of the assets that:
  - are owned or held by the issuing entity; and
  - do not collateralize any other ABS interests issued by the issuing entity;
- that is *pari passu* with all other ABS interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event (as defined in the transaction documents); and
- that adjusts for fluctuations in the outstanding principal balances of the securitized assets.[37]

According to the Agencies, the definition of seller's interest is intended to be consistent with market practices. However, market participants may be concerned that structural features common to credit card securitizations, including the method of allocating principal collections to investors on a "fixed" basis during scheduled amortization, may cause the typical seller's interest not to be fully pari passu with other ABS interests. In addition, all receivables held by a master trust are typically pledged for the benefit of investors, so it is unclear whether the requirement that the seller's interest "not collateralize any other ABS interests" would technically be met by the typical seller's interest.

ELIGIBLE ABCP CONDUITS

General Requirements. The Proposed Rules provide for a special option for the risk retention for sponsors of "eligible ABCP conduits." Under this option, a sponsor[38] of an eligible ABCP

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35 The Proposed Rules define a "revolving asset master trust" as an issuing entity that is a master trust established to issue more than one series of Exchange Act ABS, all of which are collateralized by a single pool of revolving securitized assets that are expected to change in composition over time.

36 Credit card accounts and dealer floorplan loans are the two most prominent examples of revolving accounts.

37 In many master trust transactions, if the minimum seller's interest requirement is not met, collections allocated to the seller's interest may be trapped in a trust account. It is unclear whether the reference to securitized assets would include cash trapped for purposes of satisfying the minimum seller's interest requirement.

38 There is also a strong argument that the bank or other entity that is thought by the market to be the sponsor of an ABCP Conduit is not a "sponsor" within the meaning of the proposed rules. Although such an entity can be described as organizing or initiating a securitization transaction, it does not do so "by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." As we have discussed, the originator-sellers are the entities that through an intermediate SPV transfer the securitized assets to the issuing entity. Further, the language in the Proposed Rules tracks the language in the Dodd-Frank Act. It is therefore difficult to see how this impediment could be varied by regulation.

conduit would be able to satisfy its retention obligation if the originator-seller[39] in its underlying customer transaction with the conduit retains a 5% horizontal residual interest in each intermediate SPV that transferred asset interests to the ABCP conduit, which horizontal interest would be in the same form and amount required for a horizontal slice as described above under "*Horizontal Slice Option.*" The special rule for ABCP transactions is not exclusive, and a sponsor is free to use any other method available under the Proposed Rules to satisfy its retention obligation.[40]

In order to qualify as an eligible ABCP conduit, the ABCP conduit must be bankruptcy remote and satisfy the following criteria:

- the interests issued by each customer's SPV to the conduit must be collateralized solely by the assets originated by a single originator-seller;
- all such interests must be transferred to one or more ABCP conduits or retained by the originator-seller; and
- the ABCP conduit must have 100% committed liquidity coverage for the ABCP from a bank, a bank holding company or a savings and loan company.

In addition, the sponsor of the ABCP conduit must have established policies and procedures governing the assets permitted to be transferred to the conduit, must have approved each originator-seller and their assets, and must otherwise be responsible for administering and monitoring the conduit.

Disclosures. Importantly, as noted below under "*Disclosure to Investors and Certain Agencies,*" the Proposed Rules would require the sponsor to disclose the names of each originator-seller to prospective ABCP investors and, upon request, to the SEC and its applicable Federal Banking Regulator, together with a description of the form, amount and nature of the retention held by each originator-seller. The Proposed Rules would also impose some new duties and obligations on the sponsor to monitor the originator-seller's compliance with its retention obligations and to notify ABCP investors of an originator's failure to comply.

These disclosures under the Proposed Rules would represent a dramatic change in the current practices of virtually all multi-seller ABCP conduits, which have typically never disclosed the names of their customers to ABCP investors. The Proposed Rules also raise some technical issues that would affect the execution and structure of many ABCP transactions.

For example, as proposed, the Proposed Rules would require all interests issued by each intermediate SPV to be supported solely by the assets of a single originator-seller, which is defined to mean the entity that creates the receivables and sells them to the SPV. In many

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39 The Proposed Rules define "originator-seller" as an entity that creates assets through one or more extensions of credit and sells those assets (and no other assets) to an intermediate SPV, which, in turn, sells interests collateralized by those assets to one or more ABCP conduits.

40 Sponsors of multi-seller ABCP conduits typically provide program credit enhancement at the conduit level in the form of a letter of credit, subordinated loan, structured liquidity or other form of enhancement, which potentially could be used under the horizontal slice option to satisfy the sponsor's retention obligation. However, depending on the form and terms of the particular program-level credit enhancement, there may be some modifications required to be made at the conduit level to satisfy certain of the technical requirements of the Proposed Rules.

instances, ABCP conduit transactions involve multiple originators, most commonly affiliated originators. In addition, many ABCP conduit facilities are provided in connection with M&A transactions and portfolio acquisitions where the acquired receivables are being financed under the facility. As currently drafted, the receivables acquired by an originator-seller would not satisfy the ABCP retention rule because they were not originated by the originator-seller.

Another issue under the Proposed Rules is that all asset interests must be transferred by the SPV to one or more ABCP conduits or retained by the originator-seller. This requirement would appear to preclude club deals where one or more members of the club may be a bank or transactions structured with parallel or back-up purchase commitments provided by the bank sponsor or the liquidity banks.

It is likely that these technical issues will be raised in the comment letters submitted by the various industry groups and others, and it is hoped the regulators will be receptive to such comments. The larger issues regarding the disclosure of the sellers may prove to be more difficult given the desire for more transparency in the capital markets today. However, the Proposed Rules seem to contain adequate protections to ensure compliance and monitoring of each originator-seller's retention obligation, such that disclosure of sellers in the interest of monitoring such compliance is not necessary or desirable in the context of an ABCP conduit transaction because the conduit sponsor has the duty and obligation under the Proposed Rules to monitor such compliance.

Commercial Paper and the Definition of "Security." Section 941(b) of the Dodd-Frank Act requires the Agencies to prescribe risk retention requirements applicable to sponsors that issue "asset-backed securities" as defined in Section 3(a)(77) of the Exchange Act. Consistent with that mandate, the base risk retention requirement in the Proposed Rules requires sponsors of transactions "involving the offer and sale of asset-backed securities" to retain an economic interest in the securitized assets.

The term "asset-backed security" as defined in Section 3(a)(77) of the Exchange Act includes within it the term "security" as that term is separately defined in Section 3(a)(10) of the Exchange Act. By operation of those definitions, if a note is not a security under Section 3(a)(10), then it is not an asset-backed security under Section 3(a)(77).

The definition of security in Section 3(a)(10) of the Exchange Act excludes "any note, draft, bill of exchange, or banker's acceptance *which has a maturity at the time of issuance of not exceeding nine months*, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited" (emphasis supplied). Although a comprehensive review of the definition of security is beyond the scope of this memorandum, we note that there appears to be no authority that limits the broad exclusion of commercial paper and other short-term notes from the definition of security, other than a number of court decisions that limit the types of commercial paper that fall

within the carveout.[41] However, all of those cases relate to alleged fraud under the Federal securities laws.[42]

In previous rulemakings under Dodd-Frank Act provisions relating to asset-backed securities, such as the implementation of final rules regarding asset repurchases pursuant to Section 943 of the Dodd-Frank Act, the regulators did not adopt rules specifically tailored to ABCP conduits or otherwise assert that a commercial paper note issued by an ABCP conduit is an asset-backed security. However, because the Proposed Rules contain risk retention proposals specifically relating to ABCP conduits, the Agencies appear to have taken the position that asset-backed commercial paper is an asset-backed security. As explained in the statutory analysis above, the better view is that asset-backed commercial paper having a maturity of less than nine months is not an asset-backed security under the Exchange Act and, therefore, the Agencies may lack the statutory authority to enact risk retention rules for ABCP conduits.

CMBS

A sponsor may satisfy the risk retention requirement if a third party purchases an eligible horizontal residual interest in the issuing entity in the same form, amount and manner as would be required of the sponsor above under "*Horizontal Slice Option*" and all of the following conditions are met:

- **Composition of collateral.** At the closing of the securitization transaction, at least 95 percent of the total unpaid principal balance of the securitized assets in the securitization transaction are commercial real estate loans.[43]
- **Source of funds.** The third-party purchaser:
  - pays for the eligible horizontal residual interest in cash at the closing of the securitization transaction; and
  - does not obtain financing, directly or indirectly, for the purchase of such interest from any other person that is a party to the securitization transaction (including, but not limited to, the sponsor, depositor or an unaffiliated servicer), other than a person that is a party to the transaction solely by reason of being an investor.

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41 In order to avoid the antifraud provisions of the Federal securities laws, commercial paper must not only have a maturity of less than nine months, but must also be (1) prime quality negotiable commercial paper, (2) of a type not ordinarily purchased by the general public, that is (3) paper issued to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve Banks. *See, e.g., Securities and Exchange Commission v. American Board of Trade, Inc.*, 751 F.2d 529 (Second Cir. 1984). Put another way, even in the application of the antifraud provisions of the Exchange Act, most commercial paper would not be considered a security under Section 3(a)(10) of the Exchange Act.

42 There are numerous court decisions in support of the proposition that the Federal securities laws may be read flexibly in order to effectuate the remedial purposes of the antifraud provisions therein. However, the Proposed Rules are not designed or intended to function as antifraud provisions.

43 The Proposed Rules define commercial real estate loans as loans secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50% or more) of repayment for which is expected to be derived from (i) the proceeds of the sale, refinancing, or permanent financing of the property or (ii) rental income associated with the property other than rental income derived from any affiliate of the borrower. The term commercial real estate loan does not include (i) a land development and construction loan (including 1-to-4 family residential or commercial construction loans), (ii) any other land loan, (iii) a loan to a REIT or (iv) an unsecured loan to a developer.

- **Third-party review.** The third-party purchaser conducts a review of the credit risk of each securitized asset prior to the sale of the Exchange Act ABS in the securitization transaction that includes, at a minimum, a review of the underwriting standards, collateral and expected cash flows of each commercial real estate loan that is collateral for the Exchange Act ABS.
- **Affiliation and control rights.** Subject to various exceptions, the third-party purchaser is not affiliated with any party to the securitization transaction (including, but not limited to, the sponsor, depositor or servicer) other than investors in the securitization transaction and does not have control rights in connection with the securitization transaction (including, but not limited to, acting as a servicer for the securitized assets) that are not collectively shared with all other investors in the securitization.

Under the Proposed Rules, the retaining sponsor is responsible for compliance with the requirements described above. The Sponsor is required to maintain and adhere to policies and procedures to monitor the third-party purchaser's compliance with the requirements and, under certain circumstances, is required to notify holders of the ABS interests of noncompliance by a third-party purchaser.

Hedging, transfer and pledging. The third-party purchaser must comply with the hedging and other restrictions as described below in "*Prohibitions on the Hedging, Transfer or Financing of the Retained Risk*" as if it were the retaining sponsor with respect to the securitization transaction and had acquired the eligible horizontal residual interest as described above under "*Horizontal Slice Option*."

DISCLOSURE TO INVESTORS AND CERTAIN AGENCIES

Each of the special transaction-specific options for satisfying risk retention require that the sponsor provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the Exchange Act ABS and, upon request to the SEC and its applicable Federal Banking Regulator, if any, the following disclosure in written form under the caption "Credit Risk Retention":

TRANSACTION TYPE	DISCLOSURES
Revolving Asset Master Trusts	The amount (expressed as a percentage and dollar amount) of the seller's interest that the sponsor will retain (or did retain) at the closing of the securitization transaction and the amount (expressed as a percentage and dollar amount) that the sponsor is required to retain. A description of the material terms of the seller's interest. The material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used.

TRANSACTION TYPE	DISCLOSURES
ABCP Conduits	Each originator-seller that will retain (or has retained) an eligible horizontal residual interest in the securitization transaction, including a description of the form, amount (expressed as a percentage and as a dollar amount), and nature of such interest. Each regulated liquidity provider that provides liquidity support to the eligible ABCP conduit, including a description of the form, amount, and nature of such liquidity coverage.
CMBS	The name and form of organization of the third-party purchaser. A description of the third-party purchaser's experience in investing in CMBS. Any other information regarding the third-party purchaser or the third-party purchaser's retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction. A description of the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that will be retained (or was retained) by the third-party purchaser, as well as the amount of the purchase price paid by the third-party purchaser for such interest. The amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest in the securitization transaction that the sponsor would have been required to retain as described above in "Horizontal Slice Option." A description of the material terms of the eligible residual horizontal interest retained by the third-party purchaser. The material assumptions and methodology used in determining the aggregate amount of ABS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used. In addition, the representations and warranties concerning the securitized assets, a schedule of any securitized assets that are determined do not comply with such representations and warranties, and what factors were used to make the determination that such securitized assets should be included in the pool, notwithstanding that the securitized assets did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions were not material.

Mandatory Premium Capture Cash Reserve Account

In most securitization transactions, the outstanding principal amount of the securitized assets exceeds the par value of the Exchange Act ABS being issued. However, some securitization transactions include classes of Exchange Act ABS that are backed by the excess interest expected to be generated from the securitized assets (“Excess Spread ABS Interests”).[44] In the Agencies' view, by monetizing excess spread before any unexpected losses can be realized, sponsors that issue Excess Spread ABS Interests would be able to at least partially offset the credit risk that they are otherwise required to retain.

In order to adjust for this perceived negation of risk retention, the Proposed Rules require the sponsor to establish and fund a “premium capture cash reserve account” if, as described more fully below, the proceeds of the sale of the ABS interests to third parties exceeds a certain percentage of the par value of the ABS interests. This account is designed to serve as “first loss” credit enhancement for the transaction. The requirement to establish and fund this account is in addition to the credit risk that the sponsor is otherwise required to retain under the Proposed Rules.

In the Agencies' view, securitization transaction structures involving the monetization of excess spread through the issuance of interest-only strips and securities sold at a premium to par create incentives to maximize securitization scale and complexity and encourage aggressive underwriting. The Agencies have stated their expectation that the premium capture cash reserve account requirement will result in few, if any, securitizations that are structured to monetize excess spread at closing.

Maintenance of Account. Under the Proposed Rules, the account is required to be held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity. Amounts in the account may be invested only in United States Treasury securities with maturities of one year or less and FDIC-insured deposits.

Use of Funds in the Account. Amounts in the account are required to be used to make payments on ABS interests on any payment date on which the issuing entity has insufficient funds to satisfy an amount due on an ABS interest prior to the allocation of any losses to any other ABS interests.[45] In other words, the account is intended to cover losses on the securitized assets before such losses are allocated to any other interest or account in the securitization transaction.

Requirement and Calculation. Under the Proposed Rules, the retaining sponsor shall, at the closing of the securitization transaction, cause to be established and funded, in cash, a premium capture cash reserve account in an amount equal to the difference, if a positive amount, between:

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44 Premium tranches (*i.e.*, tranches selling for greater than par) and interest-only tranches are examples of this type of Exchange Act ABS.

45 Interest income is not required to be retained in the account.

- the gross proceeds (adjusted as described below under "*Adjustment to Gross Proceeds to Prevent Evasion*"), net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties, received by the issuing entity[46] from the sale of ABS interests in the issuing entity to persons other than the retaining sponsor; and
- 95%[47] of the par value of all ABS interests in the issuing entity if the retaining sponsor utilized one of the following risk retention options:
  - the vertical slice option;
  - the horizontal slice option;
  - the horizontal cash reserve fund option;
  - the "L" shaped option; or
  - the special option for revolving asset master trusts;[48] or
- 100%[49] of the par value of all ABS interests in the issuing entity if the retaining sponsor utilized one of the risk retention options:
  - the representative sample option;
  - the special option for ABCP conduits; or
  - the special option for CMBS.

Adjustment to Gross Proceeds to Prevent Evasion. The Agencies noted that the sponsor could evade the premium capture requirement by retaining an Excess Spread ABS Interest at closing and then selling it later to a third-party investor. The Agencies also noted that the sponsor could evade the premium capture requirement by retaining an Excess Spread ABS Interest (even until maturity) in cases where the retention of that Excess Spread ABS Interest, coupled with the position of that Excess Spread ABS Interest in the waterfall, provide the sponsor with the economic equivalent of the benefits of having sold that Excess Spread ABS Interest to a third party.

In order to address these concerns, the Proposed Rules state that the gross proceeds received by the issuing entity from the sale of ABS interests to third parties must include the par value, or if an ABS interest does not have a par value, the fair value, of any ABS interest that is directly or indirectly transferred to the retaining sponsor in connection with the closing of the securitization transaction and that:

- the retaining sponsor does not intend to hold that ABS interest until maturity; or

46 In many securitization structures, the depositor, rather than the issuing entity, receives the proceeds of the sale of ABS interests to third persons. The omission of a reference to the depositor is likely a drafting oversight.

47 According to the Agencies, the 95% of par value amount is designed to take into account the 5% interest that the sponsor is required to retain in the issuing entity under the related options.

48 If the seller's interest is considered an ABS interest, it is unclear how the sponsor would calculate the par value of the seller's interest at closing, as the seller's interest is not separately issued for a particular series.

49 According to the Agencies, the 100% (rather than 95%) of par value amount is used because the related options do not require the sponsor itself to retain any of the ABS interests issued in the transaction and, accordingly, potentially all of such ABS interests could be sold to third parties.

- represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal payments received by the issuing entity and that has priority of payment of interest (or principal, if any) senior to the most subordinated class of ABS interests in the issuing entity.[50]

To avoid double-counting, the gross proceeds calculation would not include any ABS interest that is an interest-only tranche or that otherwise does not have a par value and that:

- is held by a sponsor that is relying on the vertical slice option or the "L" shaped option; and
- the sponsor is required to retain pursuant to the vertical slice option or the vertical slice component of the "L" shaped option.

Disclosures. A sponsor that is required to establish and fund a premium capture cash reserve account must provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the Exchange Act ABS and, upon request, to the SEC and its appropriate Federal Banking Regulator, if any, the following disclosure in written form under the caption "Credit Risk Retention":

- the dollar amount required to be placed in the account pursuant to this section and any other amounts the sponsor will place (or has placed) in the account in connection with the securitization transaction; and
- the material assumptions and methodology used in determining the fair value of any ABS interest in the issuing entity that does not have a par value and that was used in calculating the amount required for the premium capture cash reserve account as described above in "*Adjustment to Gross Proceeds to Prevent Evasion*."

Allocation of Risk Retention

ALLOCATION OF RISK RETENTION IN SECURITIZATION TRANSACTIONS WITH MULTIPLE SPONSORS

If a securitization transaction has multiple sponsors,[51] the Proposed Rules require that one of the sponsors comply with the risk retention requirements. However, each sponsor would remain responsible for ensuring that at least one of the sponsors complies with the risk retention requirements.

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50 If the sponsor is also the servicer, the contractual right of the sponsor, as servicer, to receive the servicing fee may be the type of contractual right described in this provision. If so, the fair value of that servicing fee right would need to be included in the gross proceeds calculation.

51 The term "sponsor" refers to a party that "organizes and initiates" a securitization transaction by transferring assets either directly or indirectly to the issuing entity. Although many transactions involved multiple originators that transfer assets directly or indirectly to the issuing entity, most transactions have only one party that "organizes and initiates" the securitization transaction. It is unclear what sorts of transactions have multiple sponsors for the purpose of this provision.

The Proposed Rules do not impose any criteria or requirements as to which of the multiple sponsors must be designated as the sponsor required to comply with the risk retention requirements. However, in their request for comment, the Agencies have asked:

- whether all sponsors should be required to retain credit risk in some proportional amount;
- whether the sponsor selling the greatest number of assets, or assets with a particular attribute, should be required to retain the risk; and
- whether the proposed rules should only allow a sponsor that has transferred a minimum percentage (e.g., 10%, 20% or 50%) of the total assets into the trust to retain the risk.

ALLOCATION OF RISK RETENTION BETWEEN SPONSOR AND ORIGINATOR

A sponsor that chooses to satisfy the risk retention requirement under the vertical slice option or the horizontal slice option may offset the amount of its risk retention by the amount of the ABS interests or eligible horizontal residual interest, respectively, acquired by an originator of the securitized assets if:

- At the closing of the securitization transaction:
  - the originator acquires and retains a vertical slice of each ABS interest, or an eligible horizontal residual interest, from the sponsor in the same manner as would have been retained by the sponsor under the vertical slice option or horizontal slice option, respectively, as described above;
  - the proportion of the total dollar amount of the ABS interests or eligible horizontal residual interests retained by the originator does not exceed the proportion of the total securitized assets originated by the originator;[52]
  - the originator acquires and retains at least 20% of the aggregate risk retention amount otherwise required to be retained by the sponsor under the vertical slice option or the horizontal slice option, respectively, as described above;[53] and
  - the originator purchases the ABS interests or eligible horizontal residual interest from the sponsor at a price that is equal to the amount by which the sponsor's required risk retention is reduced by virtue of the allocation of the risk retention requirement to the originator as described above, by payment to the sponsor in the form of:
    - cash; or

52 According to the Agencies, proportional risk allocation would prevent sponsors from circumventing the purpose of the risk retention obligation by transferring an outsized portion of the obligation to an originator that may be seeking to acquire a speculative investment.

53 According to the Agencies, this 20% minimum standard is designed to ensure that the originator retains risk in an amount sufficient to function as an actual incentive for the originator to monitor the quality of all the assets being securitized and to which it would retain some credit risk exposure.

- a reduction in the price received by the originator from the sponsor or depositor for the assets sold by the originator to the sponsor for inclusion in the pool of securitized assets.

- In addition to the disclosures described above in connection with the vertical slice option and the horizontal slice option, the sponsor must provide, or cause to be provided, to potential investors a reasonable period of time prior of the sale for the Exchange Act ABS and, upon request, to the SEC and its applicable Federal Banking Regulator, if any, in written form under the caption "Credit Risk Retention," the name and form of organization of any originator that will acquire and retain (or has required and retained) an interest in the transaction, including a description of the form, amount (expressed as a percentage and dollar amount) and the nature of the interest, as well as the method of payment for such interest.
- The originator complies with the hedging and other restrictions described below under "*Prohibitions on the Hedging, Transfer or Financing of the Retained Risk*."

The Proposed Rules make clear that the retaining sponsor is responsible for compliance with the requirements described above. The retaining sponsor is required to maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance by each originator that is allocated a portion of the sponsor's risk retention obligations with the requirements described above. In addition, if the sponsor determines that any such originator no longer complies with any of the above requirements, the sponsor must promptly notify the holders of the ABS interests of that noncompliance by the originator.

Although the Proposed Rules limit the originator allocation option to sponsors that choose the vertical slice option or the horizontal slice option, the Agencies have requested comment on whether the Final Rules should permit allocation to originators under other risk retention options, such as the "L" shaped option. The Agencies have also sought comment on a wide variety of other aspects of the proposed originator allocation rules, including whether the Final Rules should prohibit the sponsor from allocating any portion of its risk retention obligation to an originator.

Prohibitions on the Hedging, Transfer or Financing of the Retained Risk

Prohibitions on Transfer. A retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain under the Proposed Rules to any person other than an entity that is and remains a consolidated affiliate. The term "consolidated affiliate" means, with respect to a sponsor, an entity (other than the issuing entity[54]) the financial statements of which are consolidated with those of:

- the sponsor under applicable accounting standards; or

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54 The issuing entity is carved out of the definition of consolidated affiliate in order to ensure that the issuing entity could engage in hedging activities itself because such activities would be for the benefit of all investors.

- another entity the financial statements of which are consolidated with those of the sponsor under applicable accounting standards.

This definition of consolidated affiliate includes a sister entity of the sponsor, if the financial statements of the sister entity and the financial statements of the sponsor are consolidated with those of a common parent.

In what may be a drafting oversight, the Proposed Rules do not clearly permit a consolidated affiliate of the sponsor (such as the depositor in a "two-step" structure) to be the initial holder of the required retained interest. Rather, the Proposed Rules contemplate that the retained interest will be initially held by the sponsor and that the sponsor can then transfer that interest to a consolidated affiliate. The Agencies noted that the reason the Proposed Rules permit the transfer of a retained interest by the sponsor to a consolidated affiliate is that "the required risk exposure would remain within the consolidated organization and, thus, would not reduce the organization's financial exposure to the credit risk of the securitized assets." In light of this purpose, the Agencies should clarify this provision to permit the retained interest to be (i) held by the sponsor or any of its consolidated affiliates and (ii) freely transferrable among the sponsor and each of its consolidated affiliates.

In addition, unless clarified in the Final Rules, the prohibition on transfer by the sponsor could be construed to prevent the sponsor from engaging in certain business or asset divestitures. For example, a bank that is the sponsor of a mortgage securitization program might later decide to sell its mortgage business to another bank. In that case, the sponsor bank may not be able to transfer the retained risk (or transfer its equity interest in the depositor or other consolidated affiliate that holds the retained risk) to the purchasing bank, as the purchasing bank would not be a consolidated affiliate of the sponsor bank.

Prohibitions on Hedging by Sponsor or its Consolidated Affiliates. A retaining sponsor and its consolidated affiliates may not purchase from, or sell a security or other financial instrument to, or enter into an agreement, 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 (i) the credit risk of one or more particular ABS interests, assets, or securitized assets that the retaining sponsor is required to retain or (ii) one or more of the particular securitized assets that collateralize the Exchange Act ABS; and
- the security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of (i) one or more of the particular ABS interests, assets, or securitized assets that the retaining sponsor is required to retain or (ii) one or more of the particular securitized assets that collateralize the Exchange Act ABS.

Prohibitions on Hedging by the Issuing Entity. The issuing entity in a securitization transaction may not purchase from or sell a security or other financial instrument to, or enter into an agreement, derivative or position with, any other person if:

- payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular interests, assets or securitized assets that the retaining sponsor for the transaction is required to retain; and
- the security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the retaining sponsor to the credit risk of one or more of the particular interests or assets that the sponsor is required to retain.[55]

Permitted Hedging Activities. The following activities are not considered prohibited hedging activities by a retaining sponsor, a consolidated affiliate or an issuing entity:

- hedging the interest rate risk (which does not include the specific interest rate risk, known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests, assets or securitized assets required to be retained or one or more of the particular securitized assets that underlie the Exchange Act ABS; or
- purchasing or selling a security or other financial instrument or entering into an agreement, derivative or other position with any third party where payments on the security or other financial instrument or under the agreement, derivative or position are based, directly or indirectly, on an index of instruments (such as the subprime ABX.HE index) that includes Exchange Act ABS if:
  - any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10% of the dollar-weighted average of all instruments included in the index; and
  - all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor was required to retain and that are included in the index represent, in the aggregate, no more than 20% of the dollar-weighted average of all instruments included in the index.

Prohibitions on Non-Recourse Financing. Neither a retaining sponsor nor any of its consolidated affiliates may pledge as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) any interest or asset that the sponsor is required to retain under the Proposed Rules unless that obligation is with full recourse to the sponsor or consolidated affiliate, respectively.

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55 The Agencies have indicated that, in the case of a sponsor that uses the vertical slice option, an issuing entity may obtain a financial guaranty insurance policy that covers up to 95% of each tranche, but not the 5% portion of each tranche required to be retained by the sponsor. It is unclear whether a sponsor that uses the vertical slice option may benefit from other forms of credit enhancement arranged by the issuing entity, such as private mortgage insurance under which the issuing entity is a beneficiary.

Exemptions from the Risk Retention Requirement

The Proposed Rules include several important exemptions from the risk retention requirements for particular types of securitization transactions. Those exemptions fall into four categories: (1) Exchange Act ABS guaranteed by Fannie Mae or Freddie Mac ("GSE Exemption"), (2) Exchange Act ABS backed by residential mortgages, commercial real estate mortgages, commercial loans and auto loans that meet specified underwriting standards ("Qualifying Asset Exemption"), (3) certain resecuritization transactions ("Resecuritization Exemption") and (4) various other exemptions required by Section 941 of the Dodd-Frank Act ("Other Statutory Exemptions").

In addition to the exemptions described in the Proposed Rules, the Proposed Rules also exempt any additional types of securitized assets or securitization transactions for which exemptions may be provided by the Agencies from time to time. The Proposed Rules also include a safe harbor that excludes certain foreign transactions from the risk retention requirements. The foreign transaction safe harbor is discussed separately under "*Safe Harbor for Certain Foreign Related Transactions*."

GSE EXEMPTION

For so long as Fannie Mae and Freddie Mac operate under the conservatorship or receivership of the Federal Housing Finance Agency, the Proposed Rules exempt securitization transactions in which Fannie Mae or Freddie Mac fully guarantees the timely payment of principal and interest on all ABS interests issued by the issuing entity in that securitization transaction. This exemption also applies to any limited-life regulated entity operating with capital support from the United States and succeeding to the charter of either Fannie Mae or Freddie Mac pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

The exemption for Fannie Mae and Freddie Mac is one of the more controversial aspects of the Proposed Rules. Among other concerns raised by market participants, the exemption provides Fannie Mae and Freddie Mac with a significant funding cost advantage over sponsors of private-label RMBS that are required to retain risk under the Proposed Rules. This funding cost advantage has the potential to frustrate the recovery of private sector-based mortgage financing in the United States. In the view of the Agencies, the exemption is warranted because (1) the charters of Fannie Mae and Freddie Mac help to ensure asset quality by placing limitations on the types of mortgages that those entities may securitize and (2) Fannie Mae and Freddie Mac are already exposed to the entire credit risk of the mortgages that collateralized the securities that they issue because they guarantee the payment of principal and interest on those securities. In any event, the exemption provided to Fannie Mae and Freddie Mac under the Proposed Rules is

likely to remain highly controversial and may even lead to legislation that eliminates that exemption.[56]

QUALIFYING ASSET EXEMPTION

General Terms. The Proposed Rules create an exemption from the risk retention requirements for securitization transactions in which the ABS interests are backed by qualifying assets meeting specified underwriting criteria.[57] The exemption for each qualifying asset type requires that all of the securitized assets included in the securitization transaction consist of qualifying assets of that asset type.[58] The exemption also requires a certification by the depositor as described below.

Each type of qualifying asset is summarized in the table below.[59] The specified underwriting criteria for each asset type are summarized in Exhibit B to this memorandum. The preliminary impression of most market participants is that the specified underwriting criteria are far too restrictive and inflexible to provide sponsors with meaningful access a qualifying asset exemption.

QUALIFYING ASSET TYPE	DESCRIPTION OF ASSET TYPE
Qualified Residential Mortgage	Closed-end credit transaction to purchase or refinance a one-to-four family property at least one unit of which is the principal dwelling of a borrower that is not: • Made to finance the initial construction of a dwelling; • A reverse mortgage; • A temporary or "bridge" loan with a term of 12 months or less, such as a loan to purchase a new dwelling where the borrower plans to sell a current dwelling within 12 months; or • A timeshare plan. Meets all of the underwriting criteria specified in the Proposed Rules.

56 Rep. Scott Garrett (R-NJ) is sponsoring a bill called "*The GSE Credit Risk Equitable Treatment Act of 2011*" that would amend the Exchange Act to ensure mortgages held or securitized by Fannie Mae or Freddie Mac and asset-backed securities issued by those entities are treated in a manner consistent with other mortgages and asset-backed securities for purposes of the credit risk retention requirements.

57 The Agencies have requested comment as to whether categories of qualifying assets in addition to those described below should be exempted from risk retention. In addition to advocating for an expansion of the list of qualifying assets that are entitled to full exemption, some market participants have suggested that sponsors that do not qualify for the exemption from retention for qualifying asset types as described below be provided an alternative set of more flexible criteria which, if met, would allow the sponsor to retain less than 5% of the credit risk.

58 Note that this limitation would require many sponsors to maintain separate securitization programs – one for qualifying assets and one for non-qualifying assets.

59 The Dodd-Frank Act permits "exemptions, exceptions or adjustments" to otherwise required risk retention where these would "ensure high-quality underwriting standards" and (1) encourage appropriate risk management practices, (2) improve access of consumers and businesses to credit on reasonable terms or (3) are otherwise in the public interest. It is unlikely that the exemptions described below are the only ones possible that satisfy the specified criteria.

QUALIFYING ASSET TYPE	DESCRIPTION OF ASSET TYPE
Qualifying Commercial Loan	Secured or unsecured loan to a company or an individual for business purposes, other than any: • Loan to purchase or refinance a one-to-four family residential property; • Loan for the purpose of financing agricultural production; or • Loan for which the primary source (50% or more) of repayment is expected to be derived from rents collected from persons or firms that are not affiliates of the borrower. Meets all of the underwriting criteria specified in the Proposed Rules.
Qualifying Commercial Real Estate Loan	Loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50% or more) of repayment for which is expected to be derived from: • The proceeds of the sale, refinancing, or permanent financing of the property; or • Rental income associated with the property other than rental income derived from any affiliate of the borrower. Does not include: • A land development and construction loan (including one-to-four family residential or commercial construction loans); • Any other land loan; • A loan to a REIT; or • An unsecured loan to a developer. Meets all of the underwriting criteria specified in the Proposed Rules.

QUALIFYING ASSET TYPE	DESCRIPTION OF ASSET TYPE
Qualifying Auto Loan	Loan to an individual to finance the purchase of, and is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport- utility vehicle, pickup truck, or similar light truck for personal, family, or household use. Does not include any: • Loan to finance fleet sales; • Personal cash loan secured by a previously purchased automobile; • Loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes; • Lease financing; or • Loan to finance the purchase of a vehicle with a salvage title. Meets all of the underwriting criteria specified in the Proposed Rules.

Depositor Certification. Under the Proposed Rules, the depositor must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets are qualified assets and has concluded that its internal supervisory controls are effective. The evaluation of the effectiveness of the depositor's internal supervisory controls must be performed as of a date within 60 days of the cut-off date or similar date for establishing the composition of the pool of securitized assets. The sponsor must provide, or cause to be provided, a copy of the depositor certification to potential investors a reasonable period of time prior to the sale of the Exchange Act ABS and, upon request, to the SEC and its applicable Federal Banking Regulator, if any.

Buy-Back Requirement. Under the Proposed Rules, a sponsor that has relied on a qualifying asset exemption as described above does not lose that exemption if, after the closing of the securitization transaction, it is determined that one or more of the securitized assets was not a qualifying asset as described above, provided that:

- The depositor complied with the certification requirement as described above;
- The sponsor repurchases the non-qualifying asset from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on that asset no later than 90 days after the determination that the asset is not a qualifying asset; and
- The sponsor promptly notifies, or causes to be notified, the holders of the Exchange Act ABS of any asset included in the securitization transaction that is required to be repurchased by the sponsor as described above, including the principal amount of such repurchased asset and the cause for such repurchase.

RESECURITIZATION EXEMPTION

The Proposed Rules provide a very narrow exception for resecuritization transactions. Specifically, the Proposed Rules exempt any securitization transaction that:

- Is collateralized solely (other than cash and cash equivalents) by existing Exchange Act ABS issued in a securitization transaction for which the credit risk was retained as required under the Proposed Rules (or that was exempted from the risk retention requirements); [60] and
- Is structured so that it involves the issuance of only a single class of ABS interests that provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class.[61]

OTHER STATUTORY EXEMPTIONS

Exemption for Federally Guaranteed Mortgages. The Proposed Rules exempt any securitization transactions that are collateralized solely (excluding cash and cash equivalents) by residential, multifamily or health care facility mortgage loan assets if the Exchange Act ABS or the securitized assets are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than Fannie Mae, Freddie Mac and the Federal Home Loan Banks).

Exemption for Securitization of Farm Loans. The Proposed Rules exempt any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by loans or other assets made, insured, guaranteed or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

Exemption for State Issuances of Exchange Act ABS. The Proposed Rules exempt any Exchange Act ABS that is issued or guaranteed by any State of the United States, by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements pursuant to Section 3(a)(2) of the Securities Act.

Exemption for Qualified Scholarship Funding Bonds. The Proposed Rules exempt any Exchange Act ABS that meets the definition of a "qualified scholarship funding bond." A qualified scholarship funding bond is defined under Section 150(d)(2) of the Internal Revenue Code as a bond issued by a corporation that is:

- a corporation not for profit established and operated exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965; and
- organized at the request of the State or one or more political subdivisions thereof or is requested to exercise such power by one or more political subdivisions and required by its

60 Thus, resecuritizations of Exchange Act ABS created prior to the effective date of the Final Rules would not be eligible for this exemption.

61 Thus, traditional senior/sub resecuritization transactions would not be eligible for this exemption.

corporate charter and bylaws, or required by State law, to devote any income (after payment of expenses, debt service and the creation of reserves for the same) to the purchase of additional student loan notes or to pay over any income to the United States.

Exemption for Other Government-Backed Exchange Act ABS. The Proposed Rules exempt any Exchange Act ABS that are:

- collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States;
- collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States (other than those referred to above under "*Exemption for Federally Guaranteed Mortgages*"); or
- fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States.

Securitization transactions involving the issuance of Exchange Act ABS that are either issued, insured, or guaranteed by, or are collateralized by obligations issued by, or loans that are issued, insured, or guaranteed by, Fannie Mae, Freddie Mac, or a Federal home loan bank do not on that basis qualify for this exemption.

Safe Harbor for Certain Foreign Related Transactions

One of the most challenging aspects of the rulemaking process under the Dodd-Frank Act is determining the extent to which new rules apply to foreign issuers or to transactions that otherwise take place overseas. For example, in adopting Rule 15Ga-1 under the Exchange Act (requiring securitizers to file a report containing information about repurchase activities as a result of breaches of representations and warranties), the SEC declined to provide any safe harbor or similar guidance as to the extent to which Rule 15Ga-1 applies to foreign entities. Instead, the SEC asserted that Rule 15Ga-1 extends to any securitizer "over whom the SEC has jurisdiction."

Although limited in nature, the Proposed Rules contain a helpful safe harbor for securitization transactions sponsored by a foreign entity in which a limited proportion of the securitized assets are acquired from certain U.S. originators and with respect to which a limited proportion of the Exchange Act ABS is sold to U.S. persons. Specifically, the Proposed Rules provide that the risk retention requirements do not apply to a securitization transaction if all of the following conditions are met:

- the securitization transaction is not required to be and is not registered under the Securities Act;
- no more than 10% of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests sold in the securitization transaction are sold to U.S. persons or for the account or benefit of U.S. persons;

- neither the sponsor of the securitization transaction nor the issuing entity is:
  - chartered, incorporated or organized under the laws of a U.S. jurisdiction;
  - an unincorporated branch or office (wherever located) of an entity chartered, incorporated or organized under the laws of a U.S. jurisdiction; or
  - an unincorporated branch or office located in a U.S. jurisdiction of an entity that is chartered, incorporated or organized under the laws of a jurisdiction other than a U.S. jurisdiction; and
- if the sponsor or issuing entity is chartered, incorporated or organized under the laws of a jurisdiction other than a U.S. jurisdiction, no more than 25% (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from:
  - a consolidated affiliate of the sponsor or issuing entity that is chartered, incorporated or organized under the laws of a U.S. jurisdiction; or
  - an unincorporated branch or office of the sponsor or issuing entity that is located in a U.S. jurisdiction.

The Proposed Rules state that the safe harbor described above is not available with respect to any transaction or series of transactions that, although in technical compliance with the requirements stated above, is part of a plan or scheme to evade the requirements of the Proposed Rules. In such cases, compliance with the risk retention provisions under the Proposed Rules is required.

Overall Impact of the Risk Retention Rules on the Market for Asset-Backed Securities

When enacted as required by the Dodd-Frank Act, the risk retention rules will be the most far-reaching substantive regulations ever applied to the market for asset-backed securities. It is impossible to predict the full extent of the impact of those rules. However, it is quite easy to foresee that the risk retention rules will contribute to the creeping transformation of securitization from a vibrant tool for credit creation and financial disintermediation into a burdensome and expensive form of secured financing.

The Proposed Rules, if adopted in their present form, may have consequences that extend beyond the market for asset-backed securities. Retention of risk in an amount and in forms not otherwise required by the free market creates a financial cost, and that cost will inevitably fall on consumers in the form of a higher cost of credit. Also, by proposing to exempt Fannie Mae and Freddie Mac from any risk retention requirement, the Proposed Rules threaten to inhibit the current public policy objective of weaning the residential mortgage and real estate markets off of financing provided by government-sponsored entities.

While one can debate the premise of risk retention, the fact is that the Dodd-Frank Act requires that there be risk retention rules. The Proposed Rules are the culmination of what was clearly a substantial effort by the Agencies to comply with this rulemaking directive. Looking on the bright side, the Proposed Rules contain clear indications that the Agencies were sensitive to the impact of risk retention on securitization sponsors. The Proposed Rules provide sponsors with a number of reasonably viable options from which to choose in order to satisfy the risk retention requirements and permit recourse financing and non-credit hedging of the retained risk. The Proposed Rules also offer a variety of exemptions that, while not particularly useful in their current form, may be modified by the Agencies in the Final Rules after consideration of the many comments that they will undoubtedly receive. Hopefully, the Agencies and the securitization industry can work together through the comment process to arrive at Final Rules that permit securitization to continue to be an efficient engine for credit creation.

Exhibit A - Summary of Risk Retention Requirements[62]

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
1. The Five Basic Risk Retention Options					
A. Vertical Slice Option	At least 5% of each class of ABS interests in the issuing entity	N/A	Sponsor	The amount of each class of ABS interests that sponsor will retain at closing and that sponsor is required to retain; the material assumptions and methodology used	
B. Horizontal Slice Option	At least 5% of the "par value" of all ABS interests in the issuing entity	Eligible horizontal residual interest[63]	Sponsor	Amount of interest retained and required to be retained; other material terms of the retained interest; the material assumptions and methodology used	May require substantial waterfall restructuring for sponsors who retain the residual
C. Horizontal Cash Reserve Fund Option	Cash reserve account in same amount as 1.B. above[64]	Cash reserve fund	Sponsor	Similar to 1.B.	In present form, not likely to be economically attractive

62 This summary is provided for ease of reference and is not intended to be comprehensive. This summary is qualified in all respects by the more detailed discussion contained in the accompanying memorandum.

63 An eligible horizontal residual interest requires that: (i) all losses in the securitized assets be allocated to that residual interest until its par value is reduced to zero (except for losses absorbed by a premium capture reserve account), (ii) such interest has the most subordinated claim to both principal and interest; and (iii) until all other ABS interests in the issuing entity are paid in full, it is not entitled to receive any payments of principal made on a securitized asset, provided that it can receive its "current" proportionate share of scheduled payments of principal.

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
D. L-Shaped Risk Option	At least 2.5% of each class of ABS interests in the issuing entity, plus an eligible horizontal interest equal to at least 2.564% of the par value of all ABS interests in the issuing entity other than the 2.5% interest referred to above	N/A	Sponsor	Similar to 1.B.	
E. Representative Sample Option	An unpaid principal balance of assets comprising the representative sample equal to at least 5.264% of the unpaid principal balance of all of the securitized assets in the securitization transaction	A pool of assets randomly chosen from the pool of assets to be securitized[65]	Sponsor	Before sale, the amount of assets included in the representative sample and the amount required to be retained; the material characteristics of the designated pool; policies and procedures used to ensure compliance; confirmation of receipt of agreed upon procedures report; and material assumptions and methodology used After sale, a comparison of the performance of the pool securitized with the pool retained	The sponsor must have in place policies and procedures and document them The sponsor must obtain an agreed upon procedures report from an independent accountant There are servicing requirements Assets in the retained pool must not be pledged or hedged as such assets may not be removed from the pool and they cannot be used as part of the retained pool for another pool of assets securitized

64 The account must be held by a trustee (or similar entity), with amounts invested only in U.S. Treasuries with maturities of one year or less, or insured deposits, released only to satisfy payments on ABS interests in the issuing entity when there are insufficient funds otherwise from any source (provided that, such funds may be released to make scheduled payments of principal in ratable amounts).

65 The sponsor must follow specific rules for random selection as provided in the Proposed Rules.

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
2. Additional Options for Particular Types of Transactions					
A. Revolving Asset Master Trusts	A seller's interest of at least 5% of the unpaid principal balance of all the assets owned or held by the issuing entity, provided that the assets arise under revolving accounts	N/A	Sponsor	The same as item 1.B. above, plus the material terms of the seller's interest	
B. Eligible ABCP Conduit	A minimum 5% "interest" in each intermediate SPV established by or on behalf of an originator-seller	Horizontal risk retention	Originator-Seller instead of the Sponsor	Sponsor shall disclose to investors in ABCP the name of each originator-seller, the form, amount and nature of each interest retained; the name of each regulated liquidity provider including form, amount and nature of each liquidity facility; and notice of non-compliance of any originator-seller	Not clear how the originator-seller retains an interest in the SPV itself that does not create a true sale issue unless stock in an LLC would constitute the required retained interest Disclosures seem impractical
C. ABCP Conduit, Whether or Not Eligible	At least 5% of the par value of all ABS interests issued by the ABCP Conduit	Eligible horizontal retained interest	Sponsor[66]	The amount of the eligible horizontal retained interest that the sponsor will retain at closing and the amount it is required to retain; the material terms of the	Query whether the letter of credit usually issued by a sponsor, or the reimbursement obligation issued by the ABCP Conduit in connection therewith,

66 The sponsor of an ABCP Conduit is normally thought to be a bank or other entity that sets up and manages the Conduit. But note that this entity does not appear to meet the definition of "sponsor" in the proposed rule as it does not "[sell] or [transfer] assets, either directly or indirectly, including though an affiliate, to the issuing entity." Nonetheless, the Agencies make the bald assertion that "the sponsor of an ABCP conduit satisfies the definition of 'sponsor' under the proposed rules." See footnote 82 of the Proposed Rules.

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
				retained interest	meets the requirement of an "ABS interest"
D. CMBS	See item 1.B. above	Eligible horizontal retained interest	A third party purchaser	Sponsor discloses to investors, name, etc of third party purchaser, experience of third party purchaser; other material information on third party purchaser; description of what third party purchases; what sponsor would have had to purchase if it had satisfied the retention requirement; and the terms of third party purchaser's interest; representations and warranties	Third party purchaser must comply with hedging and pledging requirements Retaining sponsor responsible for compliance of third party purchaser There are also extensive rules on composition of collateral, source of funds, periodic reviews, affiliation and control rights
3. Important Related Provisions					
A. Premium Capture Cash Reserve Account	The positive difference, if any, between (x) gross proceeds from sale of ABS interests in the issuing entity sold to persons not the sponsor and (y) 95% or 100%, as applicable, of the par value of all ABS interests in the issuing	Cash collateral account invested only in T-Bills or FDIC-insured deposits	Trustee or other similar party on behalf of issuing entity	To investors, (i) amount deposited in, and required to be deposited in, deposit account; and (ii) material assumptions and methodology used	The calculations are quite complicated and losses must be allocated to the premium account before to horizontal, L-shaped, ABCP, CMBS third party, originator risk retention options and certain other risk options

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
	entity issued as part of the securitization[67]				
B. Allocation of Risk Retention to Originators (other than Eligible ABCP Conduit originators)	As agreed with sponsor (but subject to limitations)	May be used to offset vertical or horizontal options chosen by a sponsor Originator acquires interests "from the sponsor" in the same manner as sponsor would retain itself Originator can only satisfy retention requirement in same proportion as unpaid principal balance of assets it originated and transferred to securitization has to total principal balance of securitization; provided the originator is disqualified unless the ratio exceeds 20%	Originator	Same as for sponsor plus information on originator and its retained interest	Sponsor is responsible for compliance; hedging and pledging restrictions apply to originator similarly as to sponsor
4. Exemptions from the Risk Retention Requirement for the GSEs					
A. Fannie Mae and Freddie Mac[68]	Zero	N/A	N/A	N/A	Highly controversial

67 If relying on the vertical slice option, the horizontal slice option, the horizontal reserve fund option , the L-shaped option or the special option for revolving asset master trusts, 95% of par value; if relying on any other option, 100% of par value.

68 So long as operating under the conservatorship or receivership of the FHFA.

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
B. Limited Life Regulated Entity succeeding to Fannie Mae or Freddie Mac and operating with capital support from the United States	Zero	N/A	N/A	N/A	Highly controversial
5. Exemptions from the Risk Retention Requirement for Qualifying Asset Types					
A. Qualified Residential Mortgages	Zero	N/A	N/A	N/A	Current underwriting criteria too restrictive to make this a generally useful exemption
B. Qualified Commercial Loans	Zero	N/A	N/A	N/A	Current underwriting criteria too restrictive to make this a generally useful exemption
C. Qualified Commercial Real Estate Loans	Zero	N/A	N/A	N/A	Current underwriting criteria too restrictive to make this a generally useful exemption
D. Qualified Auto Loans	Zero	N/A	N/A	N/A	Current underwriting criteria too restrictive to make this a generally useful exemption
6. Other Exemptions from the Risk Retention Requirements					
A. <u>Resecuritizations</u>. Any resecuritization	Zero	N/A	N/A	N/A	Extremely narrow exemption

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
of Exchange Act ABS, where that Exchange Act ABS meets the retention requirement and the resecuritization is structured as single tranche pass-through of principal and interest.					
B. Securitizations of Federally Guaranteed Mortgages. Any securitization transactions that are collateralized solely by residential, multifamily or health care facility mortgage loan assets if the Exchange Act ABS or the securitized assets are insured or guaranteed as to the payment of principal and interest by the U.S. or an agency of the U.S. (other than Fannie Mae, Freddie Mac and the Federal Home Loan Banks).	Zero	N/A	N/A	N/A	
C. Securitizations of Farm Loans. Any securitization	Zero	N/A	N/A	N/A	

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
transaction that is collateralized solely by loans or other assets made, insured, guaranteed or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.					
D. **<u>State Issuances of Exchange Act ABS</u>.** Any Exchange Act ABS that is issued or guaranteed by any State, by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act.	Zero	N/A	N/A	N/A	
E. **<u>Qualified Scholarship Funding Bonds</u>.** Any Exchange Act ABS that meets the Internal Revenue Code definition of					

CATEGORY	RETENTION LEVEL	FORM OF RETENTION	WHO MUST HOLD	DISCLOSURE	COMMENTS
"qualified scholarship funding bond."					
F. <u>Other Government-Backed Securities</u>. Other securitizations effectively collateralized by assets or by obligations of the U.S. or an agency thereof or assets fully insured or guaranteed by the U.S. or an agency thereof.[69]	Zero	N/A	N/A	N/A	

69 As even FELP loans are not fully guaranteed by the federal government, most student loans will not qualify for an exemption and will be subject to the 5% risk retention requirement. Note, however, that the Proposed Rules do provide an exemption for qualified scholarship funding bonds. Only certain not-for-profits can take advantage of this exemption.

Exhibit B - Summary of Specified Underwriting Criteria

ASSET TYPE	DESCRIPTION OF SPECIFIED UNDERWRITING CRITERIA[70]
Qualified Residential Mortgages	Secured by a first lien No subordinate liens at the time of closing Maturity of 30 years or less Detailed protocol for obtaining credit history Detailed protocol for verifying income Regularly scheduled principal and interest payments – no negative amortization or deferral of payments Fees and points equal to 3% or less than the total loan amount Debt to verified income ratio < 36% LTV<80% (75% for refinances with no cash out / 70% for cash out refinancing) 20% down payment Requires mortgage documents (not merely the servicing agreement) to contain detailed default mitigation provisions Requires the servicer to abide by certain loss mitigation policies, including requirement to initiate mitigation efforts within 90 days after borrower becomes delinquent
Qualifying Commercial Loans	Detailed protocol for verifying financial condition of corporate borrower as of the end of borrower's two most recent fiscal years Detailed protocol for analyzing the corporate borrower's ability to service its debt obligations over the next few years Financial ratio tests: total liabilities ratio of 50% or less; leverage ratio of 3% or less and debt service coverage ratio of 1.5 or greater Term of loan does not exceed 5 years Loan must be secured; lender must have first priority security interest Loan documents must contain certain terms, including as to the payment of fees and taxes, maintenance of the lender's security interest and maintenance of collateral insurance
Qualifying Commercial Real Estate Loans	Detailed protocol for determining the borrower's the ability to repay, including minimum debt to service coverage ratio Fixed interest rate required in most cases Loan must prohibit deferral of principal or interest by borrower Minimum combined loan to value < 65% Specified environmental risk assessment and mitigation strategies required

70 The underwriting criteria specified in the Proposed Rules are extensive and very detailed. A comprehensive review of those criteria is well beyond the scope of this memorandum. Readers who are interested in the underwriting criteria for a particular asset type should review the specific terms of the Proposed Rules.

ASSET TYPE	DESCRIPTION OF SPECIFIED UNDERWRITING CRITERIA[70]
	Loan documentation must include various covenants as to security interests and other matters
Qualifying Auto Loans	Only for loans to individuals to finance the purchase of, and secured by a first lien on, a new or used passenger car or other passenger vehicle for personal, family or household use Debt to verified income ratio < 36% (verified using tax documents and other documents) 20% down payment (cash or trade-in), plus tax, title and registration fees Borrower credit history (safe harbor: two credit reports within 90 days): Not more than 30 days past due on any debt Not more than 60 days past due over past 24 months 36-month look-back for bankruptcy, collection judgments, foreclosures or repossessions Maximum 5 year term for new vehicles Not more than 5 years past model year for used vehicles Lender or subsequent holder must have physical possession of the title Fixed interest rate, straight line, no deferrals

BONUS MATERIALS

Implications for Banks Relying on the FDIC Safe Harbor

On September 27, 2010, the FDIC adopted a new safe harbor (the "FDIC Safe Harbor") relating to the treatment of securitizations in the case of a receivership or conservatorship of an insured bank.[71] The FDIC Safe Harbor currently contains a 5% minimum risk retention requirement for all securitization transactions. The risk retention requirements contained in the FDIC Safe Harbor are significantly different from the risk retention requirements contained in the Proposed Rules. However, the FDIC Safe Harbor states that, upon the effective date of the Final Rules, the risk retention rules for all securitizations as currently provided in the FDIC Safe Harbor will be superseded by the risk retention requirements as provided in the Final Rules.

The FDIC Safe Harbor contains a separate requirement, applicable only to securitizations of residential mortgage loans, that a reserve fund equal to at least 5% of the cash proceeds of the securitization be established in order to secure the sponsor's obligation to repurchase assets for breaches of representations and warranties. This requirement of the FDIC Safe Harbor is not impacted by the effectiveness of the Final Rules and will continue to apply to residential mortgage loan securitizations conducted in reliance on the FDIC Safe Harbor.

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71 For a discussion of the FDIC Safe Harbor, see the Mayer Brown Legal Update: *"FDIC Adopts New Securitization Safe Harbors"* (October 1, 2010) at: http://www.mayerbrown.com/publications/article.asp?id=9751&nid=6.

Implications for the CDO, CLO and Loan Market

The Proposed Rules do not afford much latitude to collateralized loan obligation transactions ("CLOs") for avoiding the risk retention requirements. In addition, there remain some questions regarding how CLOs can comply with the Proposed Rules and, more importantly, whether certain CLOs need to comply with the Proposed Rules. The three primary areas in question are: (i) whether the collateral manager of a CLO is or should be the "sponsor" for purposes of the Proposed Rules; (ii) whether the exemptions for "qualifying commercial loans" or "qualifying resecuritizations" can be meaningfully applied to CLOs; and (iii) whether the proposed safe harbor for foreign-related transactions can be utilized by certain CLOs. Of course, since CLO collateral managers usually do not originate the underlying collateral but instead acquire such collateral in secondary markets, it is not clear that the Proposed Rules, which are intended to curb perceived failures of the "originate-to-distribute" model, should even apply to CLOs. This view is supported by the vast majority of academic research,[72] which almost universally has found that adverse selection and/or moral hazard is not evident on the syndicated leveraged loan markets since arranging agent banks usually retain a substantial position in the related credit facilities and have reputational risk regarding such facilities.

COLLATERAL MANAGER AS SPONSOR

The Proposed Rules simply state, without providing any supporting analysis, that for CLOs the "sponsor" would "usually" be the collateral manager of such CLO.[73] Presumably the lack of supporting analysis for this conclusion indicates that the Agencies either do not appreciate the effect of the risk retention requirements on the varied interests of the participants in a CLO transaction or do not believe those consequences are meaningful. Of course, the Dodd-Frank Act did direct the Agencies, when considering exemptions, exceptions or other exclusions, to consider the impact thereof on available credit to businesses on reasonable terms and we expect industry and trade representative groups to stress the past importance of CLOs to the syndicated leveraged loan markets and that, absent an effective exemption or the availability of the foreign-transaction safe harbor (discussed in more detail below), the Proposed Rules will inhibit CLOs and reduce the extent of their participation in syndicated leveraged loan markets, adversely effecting liquidity, pricing and possibly even commercial terms available to borrowing businesses.

The first area of inquiry is which CLO participant should be the sponsor and whether it is appropriate for such party to undertake such obligation. While attributing the risk retention obligation to the collateral manager may be an appropriate "default" treatment in a substantial number of CLOs simply because there is no other "sponsor", and, for many (perhaps even the vast

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72 See, for example, "Securitization Without Adverse Selection: The Case of CLOs" Effi Benmelech, Jennifer Dlugosz and Victoria Ivashina, Manuscript, Harvard University, August 11, 2010. Recent (and highly controversial) contrary research (See "Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit" Antje Berndt and Anurag Gupta, Working paper, Tepper School of Business, Carnegie Mellon University, November 2008), was soundly discredited by the Loan Syndications and Trading Association (the **"LSTA"**) (See, "LSTA Comments on 'Moral Hazard'" available at: http://www.lsta.org/content.aspx?id=4598).

73 See footnote 42 of the Proposed Rules.

majority of) CLOs there is no originator and no other party transfers the collateral to the CLO, while in other CLOs this obligation may more appropriately be placed with another party to such CLO. For example, some CLO transactions are initiated through a "reverse inquiry" whereby an equity investor selects the collateral manager and directs the collateral manager as to the type of collateral in which the CLO would invest and the related governing CLO portfolio leverage and other parameters; in this case, it may be more appropriate for such investor to be the "sponsor" that must retain the risk. In other CLO transactions, namely balance sheet CLOs by banks and other financial institutions, it may be more appropriate for the bank to retain the risk (even if a third-party collateral manager is appointed to manage the CLO underlying collateral).[74] Relatedly, the Proposed Rules do not clearly provide for incentive fees and similar measures as effective risk retention (even though this possibility was recognized in the Financial Stability Oversight Council study on the macro-economic effects of risk retention requirements[75]). While the CLO's obligation to pay such a fee is an "ABS Interest" under the Proposed Rules, it would not appear to meet other requirements for permissible horizontal slice retention (namely, that it be the most subordinate interest and be reduced by losses).

Further, even if a CLO collateral manager retained risk under one of the permissible forms, the prohibition on hedging that retained risk may have a draconian effect on the collateral manager's other business interests. Certain collateral managers have multiple consolidated affiliates (i.e., investment funds) with differing investment objectives. If one of these investment funds has objectives which require the collateral manager (or its consolidated affiliate) to "short" underlying CLO collateral, such consolidated affiliate could be prohibited from engaging in such activity if the hedge "materially relates" to required risk retention or the collateral manager may be in violation of the risk retention requirements.

The Proposed Rules will likely curb CLO activity substantially and, as a result, stifle the participation of CLOs in the secondary market for commercial loans and materially reduce available credit for business.[76]

QUALIFYING COMMERCIAL LOANS

Although the Proposed Rules provides an exemption from the risk retention requirements if a securitization transaction is comprised of "qualifying commercial loans," the requirements for qualifying commercial loans are not practical for most CLOs other than perhaps balance sheet CLOs by banks. The two primary conditions[77] for the qualifying commercial loan exemption that make it impractical for CLOs to comply are (i) the transaction is "collateralized solely (excluding

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74 Typically, in these "balance sheet" CLOs, the bank will have an affiliate act as the collateral manager, but in other transactions, an unaffiliated company may act as collateral manager and so retention of risk by such party may be inappropriate.

75 See, "Macroeconomic Effects of Risk Retention Requirements," The Financial Stability Oversight Council, January 2011, available at: http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf.

76 See, "The Impact of Risk Retention on CLOs and Other Means of Aligning Incentives," LSTA, November 8, 2010, available at: http://www.lsta.org/WorkArea/downloadasset.aspx?id=11904.

77 There are other "loan-level" requirements in Proposed Rules, all of which must be satisfied in order to benefit from the risk retention exemption. We await industry data regarding the amount of qualifying commercial loans with interest, but expect that this will be only a modest portion of the total leveraged loan market.

cash and cash equivalents) by one or more commercial loans, each of which meets all of the requirements of paragraph (b) of this section" and (ii) the transaction does not permit reinvestment periods. CLOs typically hold other credit or derivative products (which are used for a variety of purposes, including to hedge related interest rate or currency or to synthetically shorten the maturity of the referenced credit exposure), as well as bonds of other CLOs or other Exchange ABS. As such, the first condition imposes a severe limitation on CLOs. Making reinvestment periods impermissible is even more unworkable, since most CLOs are structured as arbitrage CLOs which require a reinvestment period to obtain excess spread for a sufficient period.

Bank balance sheet CLOs, however, may be viable under the Proposed Rules, subject to compliance with the other requirements for qualifying commercial loans.[78] Of course, historically, balance sheet CLOs have not been a significant portion of the overall CLO market.

RESECURITIZATIONS

As with qualifying commercial loans, the conditions for complying with resecuritizations make it impractical for CLOs. Under the Proposed Rules, for a resecuritization transaction to exempt the sponsor from the risk retention requirements, two conditions must be satisfied: (i) the transaction must be collateralized by existing ABS interests for which risk was retained or was exempted from such requirement, in each case in accordance with the Proposed Rules; and (ii) the transaction must be structured to issue only one class of ABS interests. The second condition is unworkable for CLOs since subordination may not be utilized to provide enhancement for the senior class(es). As a result, the resecuritization exemption is most likely not a viable alternative for CLOs.

FOREIGN TRANSACTIONS SAFE HARBOR

The only other exemption in the Proposed Rules pertinent to CLOs is the foreign transactions safe harbor. Under this proposed safe harbor, the risk retention requirements will not be applicable if, among other conditions: (i) no more than 10 percent of the ABS interests of the securitization transaction is sold to U.S. persons or for the account or benefit of U.S. persons; (ii) neither the sponsor (i.e., collateral manager) nor the issuing entity is (A) chartered, incorporated or organized under the laws of the U.S. or a U.S. State or Territory or (B) the unincorporated branch or office located in the U.S. of an entity not chartered, incorporated or organized under the laws of the U.S., or a U.S. State or Territory; and (iii) no more than 25 percent of the assets collateralizing the ABS interests sold in the securitization transaction were acquired by the sponsor, directly or indirectly, from a consolidated affiliate of the sponsor or issuing entity that is a U.S.-located entity.

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78 Balance sheet CLOs for banks may also be viable outside of the qualifying commercial loan exemption, if a bank can satisfy the representative sample requirements (although the minimum sample size – 1000 – will pose an issue for some as this is a far larger pool than is typical for balance sheet CLOs to date).

For CLOs, this safe harbor may be feasible if (x) the 10 percent limitation on U.S. investors can be managed and is measured at closing, (y) the Agencies provide more clarity on the 25 percent limitation on the direct or indirect acquisition of assets by the sponsor from its consolidated affiliates, and (z) the CLO collateral manager is organized offshore. Regarding the 10 percent limitation, the Proposed Rules do not state when these conditions are required to be met; however, since for most CLOs the related CLO securities are in global, book-entry form it would be difficult to test this condition at any time other than at closing. For the 25 percent limitation, no rationale was provided in the Proposed Rules for this restriction. Curiously (at least in light of the over 140 other questions posed by the Agencies in the Proposed Rules), no question is raised regarding the 25 percent limitation. However, the specific anti-evasion provision in the Proposed Rules would suggest that the limitation (and other conditions of the safe harbor) be unambiguous and provide clear guidance for when and how a CLO might meet the safe harbor conditions. Accordingly, we expect that commenters will seek such clarification (e.g., what does “indirectly” acquire mean in the 25 percent limitation) and hope that the Final Rules provide such guidance.

Evaluating Compliance with CRD Article 122a

On December 31, 2010, the Committee of European Banking Supervisors ("CEBS") of the European Union (the "EU") issued final guidelines (the "Guidelines") on the application of new Article 122a of the Capital Requirements Directive ("Article 122a"), [79] which became effective for "securitizations" completed on or after that date (and will apply to existing securitizations with new underlying exposures on or after January 1, 2015). [80]

Article 122a applies to credit institutions[81] regulated in the European Economic Area when they invest in or otherwise acquire credit exposure to "securitization positions"[82] or when they act as sponsors or originators in relation to "securitizations." Article 122a mandates, in addition to diligence and disclosure requirements, that credit institutions obtain confirmation from "the originator, sponsor or original lender" that that person has retained and will retain a material economic interest, not less than 5%, in the securitized exposures (the "Article 122a Rules").

Whether Exchange Act ABS is issued in connection with a particular structure or transaction, or whether a particular structure or transaction constitutes a CRD Securitization Position, is not always clear. Because of differences in scope, a particular transaction may be subject to one set of regulatory requirements but not the other. In general, however, a transaction that is subject to the Proposed Rules will also be subject to Article 122a if any of the investors or counterparties are EU credit institutions (or affiliates subject to consolidated supervision with them). Consequently, one important question for market participants is whether compliance with the Proposed Rules would automatically satisfy the Article 122a Rules and, in the alternative, whether compliance with the Article 122a Rules would satisfy the requirements of the Proposed Rules.

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79 The Capital Requirements Directive consists of two Directives, 2004/48/EC, commonly known as the Banking Consolidation Directive (the "**BCD**") and 2004/49/EC, known as the Capital Adequacy Directive. Article 122a is part of the BCD. Among other things, the CRD sets out bank regulatory capital requirements based on the Basel II Framework. The CEBS Guidelines to Article 122a of the Capital Requirements Directive (December 31, 2010), are available at: http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf.

80 For a summary of Article 122a, see our January 2011 Legal Update, "European bank regulators issue guidelines on securitization, risk retention, due diligence and disclosure requirements" available at http://www.mayerbrown.com/publications/article.asp?id=10230&nid=6.

81 Credit institutions are deposit-taking banks. BCD Article 4(1). Some provisions of Article 122a also apply to affiliates of a credit institution within the same scope of a group where consolidated supervision is applied. Guidelines clause 8.

82 We use the term "CRD Securitization Position" or "CRD Securitization" to refer to a securitization position or a securitization, respectively, within the meaning of Article 122a. BCD defines "securitization position" as "an exposure to a securitization" and "securitization" as "a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme." BCD Article 4 paragraphs (36), (40).

The chart below compares key provisions of the Proposed Rules and the Article 122a Rules:

SUBJECT	PROPOSED RULES	ARTICLE 122A RULES
Compliance Date	One year after Final Rules for RMBS; two years after the Final Rules for other ABS	On and after January 1, 2011 for new securitizations and January 1, 2015 for existing securitizations with new exposures.
Affected Transactions	Exchange Act ABS	CRD Securitization Positions regardless of location of originator, sponsor or securitized exposures.
Regulated Parties	Securitization "sponsors," subject to a limited safe harbor for certain foreign related transactions	Credit institutions acting as investors in or otherwise assuming exposure to securitization positions. Corresponding rules to be adopted for other kinds of regulated institutional investors.[83]
Basic Risk Retention Requirement	Subject to certain exemptions, the securitization sponsor must retain not less than 5% of the economic interest in the credit risk of securitized assets.[84]	Investor or counterparty to get disclosure from originator, sponsor or original lender that that party will retain material economic interest (not less than 5%)[85]
Party Retaining the Risk	The securitization sponsor or, in some circumstances, the originator. Under the Proposed Rules, the sponsor may retain the risk through a consolidated affiliate.	Sponsor, [86] originator[87] or original lender.[88]

83 This is the most significant difference between the Proposed Rules and the Article 122a Rules. The Proposed Rules affect "securitizers" of any kind; the Article 122a Rules affect credit institution investors and counterparties wherever securitizers or assets are located. Consequently, many transactions will be covered by both rules.

84 In some circumstances, the sponsor may allocate some portion of the retained risk to originators. See above discussion under "*Allocation of Risk Retention between Sponsor and Originator*."

85 Article 122a, paragraph 1.

86 The BCD defines "sponsor" as "a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitization scheme that purchases exposures from third party entities". BCD Article 4(42). The term thus clearly includes the "sponsor" of an ABCP program, while the Proposed Rules definition of "sponsor" does not.

87 The BCD defines "originator" as either "(a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor give rise to the exposure being securitized; or (b) an entity which purchases a third party's exposures onto its balance sheet and then securitizes them." BCD Article 4(41). This is broader than the Regulation AB definition of "originator" and closer to the Proposed Rule definition of "sponsor".

88 The term "original lender" is not defined. The understood meaning is close to the Regulation AB definition of "originator".

SUBJECT	PROPOSED RULES	ARTICLE 122A RULES
Calculating the Economic Interest	Retention requirement is based on 5% of ABS interests	Retention requirement is based on 5% of nominal amount of tranches sold to investors (in case of "vertical slice" retention) or nominal amount of securitized exposures (in case of other methods)
Permissible Forms of Risk Retention	(1) Vertical slice; (2) horizontal slice; (3) horizontal cash reserve fund option; (4) an "L" shaped option; (5) a representative sample option; (6) seller's interest; (7) originator-seller horizontal slice (eligible ABCP conduits); and (8) third-party purchaser horizontal slice option for CMBS.	(1) Vertical slice; (2) "first loss" slice; (3) randomly selected exposures; and (4) originator interest. Retention may be on a synthetic or contingent basis or through the use of derivatives.[89]
"Vertical Slice" Option	Retention of at least 5% of each class of ABS interests in the issuing entity.	Retention of no less than 5% of the nominal value of each of the tranches sold or transferred to investors.[90]
"Horizontal Slice"/"First Loss"	Retention of an "eligible horizontal residual interest" at least equal to 5% of the par value of all ABS interests in the issuing entity OR Establishment of a funded horizontal cash reserve account at least equal to 5% of the par value of all ABS interests in the issuing entity. The foregoing options may not be combined.	Retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors.[91] According to the Guidelines: "First Loss" position may be in various forms, including unfunded commitments, cash reserves or deferred purchase price.[92] The foregoing options may not be combined.
"L" Shaped Option	Retention of not less than 2.5% "vertical slice" and 2.564% "horizontal slice."	No equivalent option.

89 Guidelines clause 45. The option to hold risk retention synthetically, on a contingent basis or through a derivative is not included in the Proposed Rules.

90 Article 122a paragraph 1(a); Guidelines clauses 46-47.

91 Article 122a paragraph 1(d); Guidelines clause 54.

92 Guidelines clauses 56-60.

SUBJECT	PROPOSED RULES	ARTICLE 122A RULES
"On-Balance Sheet" Option	Retention of a "representative sample" selected as provided in the Proposed Rules from a minimum of 1,000 separate assets.	Retention of randomly selected exposures where no less than 100 securitized and un-securitized exposures. Equivalent risk based on "quantitative and qualitative factors."[93]
"Seller's Interest"/"Originator Interest"	Retention of the "seller's interest" of at least 5% of the unpaid principal balance of all the assets owned or held by the issuing entity. This option applies only to transactions involving revolving asset master trusts.	Retention of the "originator's interest" of no less than 5% of the nominal value of the securitized exposures. This option could apply to a revolving securitization of non-revolving loans (not just a master trust).[94]
Special Rules for ABCP Conduits	The sponsor of an eligible ABCP conduit may satisfy retention requirements if the originator-seller in its underlying customer transaction retains a 5% horizontal slice. To be an eligible ABCP conduit, the ABCP conduit must satisfy certain criteria, including having 100% committed liquidity coverage.[95]	For ABCP conduits, retention may be in form of program credit enhancement by program sponsor, 100% full-support liquidity by program sponsor, or, possibly, first loss or other risk retention by each originator.[96] The Proposed Rule appears stricter and less flexible than the Article 122a Rules for ABCP conduits.
Special Rules for CMBS	A sponsor may satisfy retention requirement in a CMBS transaction if a third party purchases a 5% eligible horizontal residual interest in the issuing entity.	No equivalent option.

93 Guidelines clause 50. The Proposed Rules mandate a very specific procedure in order to select the representative sample for the "on-balance sheet" retention option. The Article 122a Rules lack such specificity; arguably, compliance with the statistical sampling and other requirements of the Proposed Rules would satisfy the "quantitative and qualitative" analysis required by the Article 122a Rules (although compliance with the Article 122a Rules would not result in compliance with the Proposed Rules).

94 Article 122a paragraph 1(b); Guidelines clause 48.

95 Under the Proposed Rules, this liquidity coverage may be in the form of a lending facility, an asset purchase agreement, a repurchase agreement or other similar arrangement so long as the liquidity provider is committed to lend to, or purchase assets from, the issuing entity in the event that funds are required to repay maturing ABCP.

96 Guidelines clauses 47, 57, 60.

SUBJECT	PROPOSED RULES	ARTICLE 122A RULES
Exemptions to Risk Retention Requirements	There are four exemptions from risk retention requirements under the Proposed Rules, each as described above under *"Exemptions from the Risk Retention Requirement"*: (1) GSE Exemption; (2) Qualifying Asset Exemption; (3) Resecuritization Exemption; and (4) Other Statutory Exemptions.[97]	There is one basic exemption from risk retention requirements under Article 122a for securitizations in which the securitized exposures are obligations of or guaranteed by central governments or central banks, regional, local and public sector entities of EU Member States, certain supranational entities and multilateral development banks are exempt from the retention requirements[98].
GSE Exemption	Fannie Mae and Freddie Mac securitizations are exempt from retention requirements in certain circumstances, as described above.	Treatment of a Fannie Mae or Freddie Mac securitization under the Article 122a Rules depends on whether transaction is a CRD Securitization subject to the rule, and, if so, whether it falls into the exemption for government-guaranteed securitized exposures and, if not, whether Fannie Mae or Freddie Mac, as applicable, falls within the CRD definition of a sponsor or originator.
Qualifying Asset Exemption	Securitizations of residential mortgages, auto loans, commercial loans or commercial real estate loans backed by "qualifying assets" are exempt from retention requirements.	No equivalent exemption.
Resecuritizations	The Proposed Rules provide a narrow exemption for resecuritization transactions structured as pass-through deals if the underlying deal satisfied the applicable risk retention requirements, if any.	For a resecuritization, the investing credit institution is only required to ensure retention at the second layer (where the investment is being made), not at the underlying securitization.[99]

97 "Other Statutory Exemptions" includes exemptions for federally guaranteed mortgages, securitizations of farm loans, state issuances of Exchange Act ABS and qualified scholarship funding bonds, as described above under "*Exemptions from the Risk Retention Requirements – Other Statutory Exemptions*".

98 The EU rule does not exempt securitizations where the securitization positions, not the securitized exposures, are government-guaranteed. However, insofar as payments in such transactions are not "dependent upon the performance of the exposure or pool of exposures," such transactions may not be "securitizations" within the CRD definition, in which case the rule does not apply to them.

99 Guidelines clause 63.

SUBJECT	PROPOSED RULES	ARTICLE 122A RULES
Other Statutory Exemptions	There are no risk retention requirements for securitizations of federally guaranteed mortgages, securitizations of farm loans, state issuances of Exchange Act ABS and qualified scholarship funding bonds.	There are no risk retention requirements for securitizations in which the securitized exposures are obligations of or guaranteed by central governments or central banks, regional, local and public sector entities of EU Member States, certain supranational entities and multilateral development banks are exempt from the retention requirements.
Disclosure Requirement	Requirements tailored to each permissible form of risk retention, and designed to provide investors with material information on securitizer's retained interests and assumptions used in determining aggregate value of ABS interests.	Sponsor and originator credit institutions must disclose to investors, among other things, the level of their commitment to maintain net economic interest, the type of retention and any change.[100]
Treatment of Excess Spread	Sponsors may not receive advance compensation for future excess spread – "premium capture" cash reserve account requirement.	No equivalent prohibition – though excess spread may not be used as required risk retention.[101]
Hedging Retained Risk	A retaining sponsor and its consolidated affiliates may not hedge the retained interest, other than an interest rate or currency hedge or , subject to certain restrictions, an index that includes the Exchange Act ABS.	Retained risk may not be subject to any credit mitigation or any short position or any other hedge[102], although interest rate and currency hedges are acceptable. Hedging to "risk-manage" broader changes in the credit quality, collateral or macroeconomic variables is generally permitted.[103]
Transferring Retained Risk	A retaining sponsor may not sell or otherwise transfer the retained interest other than an entity that is and remains a consolidated affiliate.	The 5% net economic interest must be retained "on an ongoing basis"[104] and may not be sold.

100 Article 122a paragraph 7; Guidelines clauses 37, 123-24.

101 Guidelines clauses 35, 58.

102 Article 122a paragraph 1; Guidelines clauses 38-42.

103 Guidelines clause 39. See, however, clause 40(b), which limits broad hedges: "A hedge on the credit risk of exposures that specifically fulfill the retention requirement is not permissible."

104 Article 122a paragraph 1. A CRD Securitization may not be structured in a manner that would cause cash flows to reduce the retained interest faster than the interest held by investors. See Guidelines clause 43.

SUBJECT	PROPOSED RULES	ARTICLE 122A RULES
Financing Retained Risk	The retained interest may be financed under the Proposed Rules, so long as such financing is on a full recourse basis.	Retained exposures or positions may be financed , including in a secured funding transaction or "repo", so long as the party with the retained interest is not transferring the credit risk of such retained interest.[105]

As a general observation, a securitization transaction structured to comply with the risk retention requirements of the Proposed Rules likely also would satisfy the risk retention requirements of Article 122a. However, the exceptions to this general rule are significant—Article 122a does not permit "L" shaped retention, nor does it include the Qualifying Asset Exemption, GSE Exemption or other exemptions from the retention requirements included in the Proposed Rules. Additionally, resecuritizations face conflicting treatment under the Proposed Rules and the Article 122a Rules.

In contrast, a securitization transaction structured to comply with the Article 122a Rules, which are very wide but principles-based, would likely not satisfy the technical requirements of the Proposed Rules (even though the net economic effect may be the same under both regimes). Because of this lack of uniformity, it will be important for sponsors of Exchange Act ABS to analyze the transaction for compliance with the Proposed Rules and, to the extent that such Exchange Act ABS will be sold to EU credit institutions, the Article 122a Rules.[106]

105 Guidelines clauses 67-68.

106 As noted in the chart above, the Article 122a Rules do not directly apply to the sponsor; instead, Article 122a prescribes eligibility requirements for investments in CRD Securitization Positions by EU credit institutions.

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