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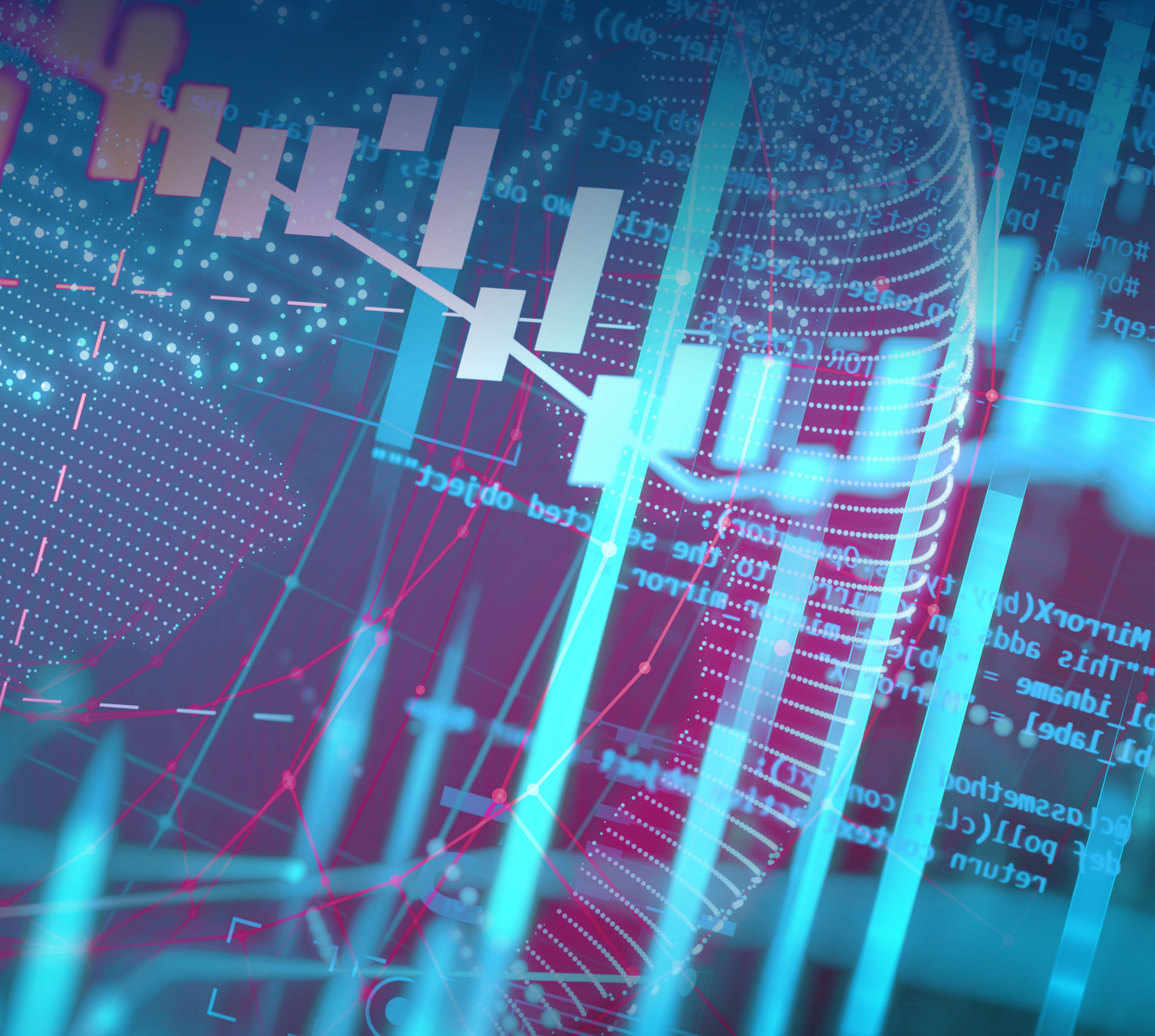
Structured Finance Bulletin

Legal Insights and Trends in the Structured Finance Markets



NOTES FROM THE EDITORS

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In this Spring 2020 edition of our *Structured Finance Bulletin*, we highlight key trends to watch in 2020 in the fintech, banking and regulatory spaces and in the mortgage and residential and consumer asset-backed securitization spaces.

We also take a deep dive into capital relief trades and structuring considerations in synthetic securitizations and discuss the latest in LIBOR replacement, transition preparedness, and the impact of LIBOR replacement on consumer loans.

We also look at recent Volcker Rule revisions, developments in the EU securitisation regulation, and initiatives to market and promote green finance. Finally, we describe a recent case that delivered a surprising ruling regarding collateral descriptions in UCC financing statements.

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What to Expect in 2020

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Experts estimate that worldwide securitization volume was up 4 percent in 2019 from the prior year. More specifically, in the personal loan space, volume was up 25 percent to $4 billion in 2019. Many are expecting a continuation of this trend in 2020 with this outlook being fueled by projections of ongoing economic growth, and many are predicting another bullish year.

This article summarizes some of the key trends to watch in 2020 in the fintech, banking and regulatory spaces and in the mortgage and residential and consumer asset-backed securitization spaces.

Fintech

While we expect to continue to see a wide array of transactions coming out of the personal and small business loan space from whole loan sales to pass-through certificates, levered certificates and traditional 144A transactions, what industry participants have been coining as “co-sponsored” transactions are beginning to become a market trend.

One of the main reasons co-sponsored transactions are attractive to companies is that they enable them to securitize their assets without holding risk retention. The transaction is usually structured such that the company will sell its assets in a whole loan sale flow arrangement between it and a special purpose vehicle (SPV) set up by a finance provider. Once enough loans are aggregated by the finance provider, it will typically securitize them in a capital markets transaction where it will act as the sponsor. The only significant role played by the company in the transaction is to act as servicer of the assets. The company will also provide the asset data as well as descriptions of its business, originations, underwriting and servicing. Since the company is not acting as the sponsor of the transaction, it is not required to hold risk retention. Rather, the finance provider acting as sponsor must retain the risk retention piece in compliance with the US (and possibly EU and Japanese, if applicable) risk retention regulations. This is obviously appealing to companies that want to securitize their assets but don't want to burden their balance sheet with risk retention.

Capital Relief Trades

Credit risk transfer transactions, or capital relief trades (often called CRTs), have become a hot topic in the US auto space as well as in other asset classes. CRTs, also often referred to as synthetic securitizations, are used by banks to transfer risk on a reference pool of assets to non-bank investors, reduce the risk weight of assets held by these banks and improve capital ratios.

A US bank may be interested in a synthetic securitization for a variety of reasons, including risk mitigation through the sharing of credit risk with investors or financing assets that cannot easily be sold or transferred in a traditional securitization. The primary reason for entering into this type of transaction, however, is typically the release of capital. Under the US capital rules, banks are able to reduce risk-based regulatory capital required for residential mortgage and other loan portfolios by converting exposures from wholesale to retail exposures to securitization exposures. Engaging in a synthetic securitization and recognizing the use of a credit risk mitigant to hedge underlying exposures provides a potential means of capital relief.

EU Securitisation Regulation

While the EU Securitisation Regulation has applied since January 1, 2019, much of the delegated legislation under this regime has still not been finalized. Notably, final templates for the provision of asset-level data have yet to be published in final form. On October 16, 2019, the European Commission adopted a delegated regulation comprising the regulatory technical standards (RTS) specifying the information and the details of a securitization to be made available. The RTS annexed the near-final disclosure templates required for compliance with the Securitisation Regulation (parallel draft "implementing technical standards" on disclosure have also been published by the EU).

The RTS are subject to a three-month "no objection" review period by the European Parliament and the Council, following which (assuming they are approved) they will be published in the *Official Journal of the EU.* They will enter force 20 days after publication. The RTS are therefore are expected to apply from February 2020 (at the earliest).

There is no additional transition period (as the EU regulators consider that everyone has had sufficient time to prepare), so everyone subject to these reporting requirements will need to be ready to report with the relevant data once they come into force in about February 2020.

The reporting templates annexed to the RTS closely follow the draft ESMA templates published early in 2019. There have been no material changes to those templates and it is not expected that there will be any further material changes in the final form reporting templates. The final form templates will be annexed to the delegated regulation which we expect will be published in the next couple of months. Accordingly, we expect the market to settle on ways in which to comply with this aspect of the EU securitization regulations over the coming year.

In this connection, a major unresolved issue, is the extent to which the EU due diligence requirements should apply when EU investors are investing in non-EU securitizations.

The EU Securitisation Regulation provides that an EU institutional investor is required to verify that the originator, sponsor or SPV of a securitization has "where applicable" made available the disclosure information—including that in the EU reporting templates. One interpretation is that this does not require EU institutional investors to verify compliance by non-EU originators, sponsors and SPVs with the disclosure requirements, as they would not be directly applicable to such entities.

However, there are different views on this point, and the Structured Finance Association (SFA) and the Financial Markets Law Committee (FMLC) have written to the EU Commission on this. This lack of legal clarity has led to significant compliance difficulties for EU institutional investors in US securitizations, who are forced to take a view on a very unclear provision without any form of official guidance. Mayer Brown was involved in drafting the SFA letter seeking clarification on this.

However, the views of the EU regulators are not yet known on this important point.

Mortgage and Residential Securitization Space

The 2013 Ability to Repay/Qualified Mortgage Rule

In 2013, the Ability to Repay/Qualified Mortgage (ATR/QM) Rule was issued, which requires lenders to verify a borrower's ability to repay a mortgage loan. If the lender (or its investors) want a safe harbor of compliance with that rule, they generally must confirm that such borrower's debt to income ratio does not exceed 43 percent. However, there has been a separate, temporary safe harbor for mortgage loans eligible for purchase by or guarantee from the Fannie Mae or Freddie Mac, widely known as the QM Patch. The QM Patch was included in order to temporarily support lending to borrowers that would not have otherwise been able to qualify for loans as the housing market was emerging from the depths of the Great Recession. In July 2019, the Consumer Financial Protection Bureau issued an Advanced Notice for Proposed Rulemaking and indicated its intention of terminating the QM Patch on January 10, 2021, or shortly thereafter, in order to effectuate a smooth and orderly transition.

Advocates of the QM Patch have cited the benefits that this exemption promotes lending to underserved minority and other communities that would not otherwise be able to obtain a loan. To let the QM Patch expire without any further revisions to the ATR/QM Rule would, they argue, result in a significant disruption to the housing market as approximately 16 percent of originations would no longer be available.

However, as opponents of the QM Patch point out, the patch gives an anti-competitive advantage to the GSEs and promotes riskier lending that is backed by the government and ultimately taxpayers. These same critics also support revisions to the rule that measure a borrower's ability to repay by looking at other factors like loan to value (LTV) ratios in addition to debt-to-income (DTI) to better assess a borrower's ability to repay a mortgage loan and have proposed revisions to the rule creating a safe harbor for loans that have demonstrated payment compliance for a period of time. While the government has indicated a desire to avoid minimal disruption, it seems inevitable that the QM Patch will be nearing the end of its life cycle.

Technology Innovations in Mortgage Lending Market

While the mortgage lending market has been a late adapter of technology, technology innovations have played an increased role in revolutionizing this space over the past year and we expect this trend to continue over the next several years. We see this in how collateral is accepted and how the entire loan process is handled, in particular as millennials slowly but surely enter the housing market and demand digitized consumer processes. In the first quarter of 2018, only 375 eNotes were registered on the MERS system. In Q1 of 2019, this number was approximately 19,000. Similarly, automated valuation models (AVMs) are expected to account for 70 percent or more of valuations performed throughout the year. And Fitch Ratings has expanded as part of its criteria the use of AVMs in secondary valuations and is now accepting AVMs as primary valuations for second liens and seasoned performing loans. As the components of origination and mortgage files become digitized, the securitization market will be forced to adapt and become increasingly reliant on technology. We expect custodians to shift from a paper dominated market into e-systems and storage. In addition, as these electronic processes begin to be more widely adapted, we expect to see shifts in asset-level reps that tie to the accuracy of a process rather than accuracy of human review and diligence. In addition, as consumers increasingly demand speed and convenience in all things in life and as millennials enter the housing market in larger numbers, there will be increased pressure in the real estate and mortgage space to digitize all aspects of the buying, selling and loan application process. We expect this trend to continue as the culture continues to shift to accept electronic collateral and the securitization market becomes more comfortable in this space. Many companies have already begun to seize these opportunities; many more will follow.

Growth of Non-Traditional Products

With interest rates remaining at relative lows, investors will continue to focus on non-traditional products as a way to increase rates of return. In addition, baby boomers with insufficient retirement savings will look to tap into equity from their existing homes and millennials lacking an interest or ability in home ownership will continue to look for alternative residential arrangements. These factors continue to indicate that non-traditional and non-QM products will continue to grow relative to the traditional products in the sector.

While the QM Patch is likely to disappear in 2021, it still exists for the next year. Over the next year, we expect to see strong demand for the Non-QM product, both on the borrower side (from borrowers with lower incomes, alternative incomes or less than perfect credit) and from investors (who are attracted to the higher yield). Non-Qualified Mortgage securitizations have grown exponentially since 2016. We expect this trend to continue in 2020.

In addition, with the aging baby boomer population looking to tap home equity, we expect the demand for reverse mortgage loans to continue to exist and likely grow in 2020, and we also expect to see an increase in private label originations in this space.

Furthermore, we have seen and expect to continue to see increased interests in "fix and flip" mortgage loans in 2020. These are business-purpose loans to individuals or small companies that are secured by residential properties intended to be fixed up and quickly sold for a profit. They typically feature maturities of less than a year and high interest rates. While these are not consumer loans and we don't expect them to be regulated as such, there are a few regulatory risks that lenders should be mindful of. First, under the terms of the loan documents, fix and flip borrowers are prohibited from living in the mortgaged properties. However, if a borrower is using a fix and flip mortgaged property as their primary residence and the originator knew at the time of origination, that could give rise to liability under consumer mortgage protection laws. In addition, in certain jurisdictions, if a fix and flip mortgage loan is backed by a personal guaranty from an individual, it could be subject to residential mortgage loan foreclosure requirements. For these and other reasons, large banks have typically been reluctant to originate fix and flip loans. However, the course of 2019 saw several securitizations backed by this asset class, and we expect this product to continue to gain considerable interest from both private investment funds who are aggregating the product and commercial banks providing warehouse financing.

We also expect to see a continued appetite for single-family rental products. Although rental prices continue to creep upwards, many individuals remain reticent to enter the home ownership market. Contributing factors to this trend include holdover unease from the last financial crises and the millennial generation that values the optionality of not being tied to a home and may not be able to afford a home given that this population has been saddled with student loan debt unlike any other generation. These social factors, combined with interest rate rises and tax reform, have made it more expensive to own a home. Single-family rentals are single-family properties owned by a company that are leased for a period of time to individuals. Single-family rental securitizations are somewhat of a hybrid of residential mortgage loan and commercial mortgage loan securitizations in that the actual properties and related valuations are more typical of the residential space but structuring tends to be similar to the Commercial Mortgage-Backed Securities (CMBS) space and the payment streams to investors rely primarily the rental income on the properties. We would expect demand in this space to remain relatively stable given the increased costs of home ownership.

It would also not surprise us if the origination of closed end second lien home equity loans picks up along with home price appreciation. Borrowers looking for debt consolidation loans may seek to unlock the equity in their homes, if they can, as an alternative to credit cards and higher-cost-peer-to-peer or so-called market place loans. Home equity lenders in the past found efficient funding in the securitization term markets. These markets could re-open in 2020 if origination volumes increase.

Finally, we expect non-bank depository institutions to continue tapping into Mortgage Servicing Rights (MSR) values to service financing activities and generate rates of return for lenders.

Consumer Securitization Space

FDIC Safe Harbor Developments

The Federal Deposit Insurance Corporation (FDIC) is generally the receiver or conservator for failed insured depository institutions and the terms of the receivership or conservatorship are governed by the Federal Deposit Insurance Act rather than the US Bankruptcy Code. The FDIC has the same rights and powers with respect to the bank's assets that the insolvent institution had at the time of commencement of the receivership or conservatorship. In addition, the FDIC has certain statutory "superpowers": first, the FDIC has the power to reject, disaffirm or repudiate any contract entered into by the depository institution if it determines that the performance of such contract is burdensome and repudiation will promote resolution of the institution's affairs; second, upon a bank insolvency, an automatic stay is created for the first 90 days of receivership and the first 45 days of conservatorship; and third, the FDIC can enforce contracts notwithstanding the existence of clauses providing for their termination if a receiver is appointed for the depository institution.

The FDIC has issued a rule providing a safe harbor for participations without recourse and for the transfer of assets as part of a securitization transaction. The Safe Harbor Rule was originally adopted in 2000 and was substantially revised by interim amendments in 2009 and a final amendment in 2010 as a result of changes in the accounting rules regarding off-balance sheet treatment of financial assets.

The 2010 rule contains several safe harbors, including for on-balance sheet securitizations. Under the on-balance sheet safe harbor, should the FDIC as receiver or conservator repudiate a contract to which the insolvent bank is a party, the secured parties are entitled to the benefits of their collateral, but only to cover their actual, compensatory damages arising from the repudiation.

Damages for transactions within this safe harbor would equal the par value of the obligations at the time of receivership, less any principal payments made in the interim, plus unpaid, accrued interest through the date of repudiation to the extent covered by collections on the securitized assets. The 2010 rule provides a safe harbor for off-balance sheet transactions. Transactions in this category that meet the new conditions would benefit from substantially the same protection from the repudiation power as is provided by the original 2000 rule and would also benefit from the relief from the automatic stay. This safe harbor does not include expedited consent for exercise of remedies because the FDIC views the automatic stay as generally not applying to assets that are not reflected on the sponsor's balance sheet.

Under the 2010 safe harbor rule, the FDIC adopted a number of conditions in order for the safe harbor to apply to securitizations, including risk retention requirements in accordance with Regulation RR and disclosure requirements that, at a minimum, comply with the US Securities and Exchange Commission's (SEC) Regulation AB, which is a disclosure regime applicable to publicly registered asset-backed security (ABS). This disclosure standard applies in all securitization transactions, whether the ABS are offered in public or private offerings.

One of the most difficult issues for banks that have wanted to rely on the 2010 Safe Harbor Rule for a Rule 144A or private securitization has been the requirement to provide the same disclosure to investors that would be required in a public offering under Regulation AB. For securitizations of mortgages and retail auto loans and leases, this has also meant, among other things, providing asset-level data to investors in accordance with Reg AB requirements. Many banks have not made the investments in their systems to be able to provide asset-level data under the Reg AB requirements. And so this requirement has discouraged some insured depository institutions from sponsoring securitizations that rely on compliance with the Safe Harbor Rule.

On July 16, 2019, the FDIC proposed changes to certain provisions of the 2010 Rule that would eliminate the requirement that securitization documents require compliance with Regulation AB in circumstances where Regulation AB would not apply to the issuance of the related ABS. If adopted as proposed, bank-sponsored ABS offerings under Rule 144A and other private securitizations relying on the 2010 Rule would no longer have to comply with Regulation AB requirements and sponsors would not be required to supply loan-level data to investors.

The proposal was issued in response to feedback from insured depository institutions indicating that it is difficult to comply with Regulation AB for certain types of securitization transactions, most notably Residential Mortgage-Backed Securities (RMBS). Requirements of Regulation AB, in particular asset-level data requirements, may have prevented some insured depository institutions from sponsoring securitizations that rely on compliance with the 2010 Safe Harbor Rule. If adopted, and we believe that the FDIC will finalize and adopt this proposal, we believe that the proposed change will likely result in an increase in the amount of bank-sponsored ABS and RMBS transactions.

Credit Union Securitizations

Despite the fact that the National Credit Union Administration's (NCUA) securitization "safe harbor" rule and other legal requirements to facilitate securitization by federal credit unions were finalized over 24 months ago, the first securitization by a federal credit union of a prime auto loan portfolio only recently has closed.

The NCUA has the authority under the National Credit Union Act to use its repudiation powers to reclaim financial assets transferred by a federally insured credit union in connection with a securitization or participation transaction or in certain circumstances to avoid an otherwise legally enforceable securitization agreement. These powers are similar to the FDIC's powers with respect to insured depository institutions described above.

The NCUA recognized the potential source of liquidity that securitization could provide for federally insured credit unions and, effective as of July 31, 2017, the NCUA board issued a final rule amending its regulations regarding the treatment by the board, as liquidating agent or conservator of a failed federally insured credit union, of financial assets transferred by such credit union in connection with a securitization or participation transaction. The New Rule creates two different safe harbors relating to the repudiation and avoidance powers applicable to securitizations, one for transactions meeting sale accounting requirements and another for securitizations that do not meet the sale accounting requirements. The New Rule also contemplates relief from the automatic stay in the form of advance consent to continued payments and contractual servicing activities during the automatic stay period in the event of a receivership or conservatorship of the sponsor. The New Rule defines the conditions for safe harbor protection for securitization and participation transactions for which transfers of financial assets would be made after the effective date. The safe harbors applicable to federal credit unions are substantially similar to the FDIC safe harbor applicable to bank, and so this article will not go into them in detail.

Although only one auto loan securitization has been completed to-date under the new safe harbor rules, we expect others to follow in 2020. However, the disclosure requirements under the NCUA safe harbor may continue to provide a chilling effect on new transactions. As previously discussed, in an attempt to spur bank-sponsored securitizations involving mortgage assets, the FDIC recently proposed eliminating the Regulation AB II and asset-level disclosure requirements for bank-sponsored securitizations that are not SEC-registered transactions. The NCUA has not undertaken to provide the same relief for credit union securitizations and so this disclosure requirement, which heavily relies on system and data tracking abilities, may continue to be an impediment to other credit unions engaging in term ABS activity.

LIBOR Alternatives

The selection of the Secured Overnight Financing Rate (SOFR) will pose challenges in its implementation as a benchmark replacement because of its differences as compared to LIBOR. First, SOFR is based on actual transactions (meaning, the interest rate on overnight loans that use US government obligations as collateral). On the other hand, LIBOR is based on quoted rates for interbank loans, but there are very few actual transactions on which to base a benchmark. Second, SOFR is a backward-looking historic rate, while LIBOR is a forward rate. Third, SOFR is a risk-free rate (because the collateral backing a SOFR loan would be US treasuries and other government obligations) and LIBOR is a cost of funds rate. And finally, SOFR rates have been relatively volatile (especially at quarter end), while LIBOR changes have been relatively gradual.

There are hurdles to implementing a LIBOR replacement in existing legacy transactions because most fallback provisions in legacy loan agreements and indentures were designed to deal with short-term disruptions in the LIBOR market (and not the permanent discontinuance of LIBOR). Existing fallback provisions often use a "waterfall" which first look at the screen or publisher for the LIBOR rate and, if the screen rate is "not available," then the calculation agent obtains a number of LIBOR quotes from reference banks. If no rate is quoted, then (depending on the specific terms of the deal) an alternative rate can be selected or, more likely, the benchmark rate is frozen at the last determined LIBOR rate.

There are a number of interpretive issues in legacy transaction. For example, how does one determine that LIBOR has become "unavailable"? What if LIBOR is still quoted, but not based on real transactions (the so-called "Zombie LIBOR" problem)? How difficult does it become to obtain quotes? Will sponsors and/or trustees have an incentive to continue obtaining quotes or, alternatively, to follow the "waterfall" fallback? What is the litigation risk for sponsors, trustees and other transaction parties? Those are questions that have yet to be answered. However, we do know that, in many cases, amendments to legacy deals may not be possible without unanimous investor consent which poses its own hurdles.

For new transactions, parties have focused on defining the "triggers" that would result in a transition to an alternate rate, with investors and lenders wanting either an objective standard or a standard which they control, and sponsors wanting the unilateral right, or at least a consent right, to make changes. Likewise, after a trigger occurs, is the transition automatic or permissive and what benchmark rate will be selected? Because of the differences between SOFR and LIBOR, what will be the applicable spread adjustment? Who makes any discretionary decisions and what liability could that party have in making those decisions? These are all negotiated items without a market consensus.

The Alternative Reference Rates Committee (ARRC) recommended fallback language for new securitizations in May 2019. Although an increasing number of new securitization transactions are incorporating LIBOR transition language based on ARRC, there are often variations, such as: (i) retaining the rigid ARRC "waterfall menu" for designating the replacement benchmark or giving the sponsor or lender some discretion in choosing an alternate benchmark based on the then market convention; (ii) alternatives exist for the sources and methods for determining any spread adjustment; (iii) recent transactions have added exculpatory clauses protecting decision-makers from any potential investor liability and allowing the transaction documents to be amended to reflect those decisions without investor consent; and (iv) there is variation regarding the timing for when the new benchmark will be adopted.

ARRC released a Practical Implementation Checklist for SOFR Adoption on September 19, 2019, to clarify practical considerations for market participants affected by LIBOR transition, and the New York Department of Financial Services sent a letter in late December 2019 to New York regulated institutions requiring the submission of a LIBOR cessation and transition risk plan—responses are due February 7, 2020. LIBOR transition will continue to be a developing issue for both legacy and new transactions during 2020 and provisions will be negotiated to determine whether sponsors have discretionary authority in selecting replacement benchmarks and related adjustments, or whether lenders and investors have such discretion or require a more objective standard.

LIBOR replacement will be a developing topic during the course of 2020.

Capital Relief Trades: Structuring Considerations for Synthetic Securitizations

Part One: Navigating US Insurance and Swap Regulations

(a three-part series providing a US and UK perspective)

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Why Are US Banks Interested in Synthetic Securitizations?

A US bank may be interested in a synthetic securitization for a variety of reasons, including risk mitigation through the sharing of credit risk with investors or financing assets that cannot easily be sold or transferred in a traditional securitization. However, the primary reason for engaging in a synthetic securitization is typically the release of capital.

Under the US capital rules,[1] banks are able to reduce risk-based regulatory capital required for residential mortgage and other loan portfolios by converting exposures from wholesale or retail exposures to securitization exposures. This is due to the fact that the risk-weight under the US capital rules for typical senior securitization exposures is 20 percent, while the risk-weight for most other exposures is 100 percent for banks using the standardized approach.[2] That means a senior securitization exposure can have required capital of 1/5 the amount required for holding a position in the unsecuritized loans. This result makes sense given that credit risk has actually been transferred in typical securitization transactions. However, in this regard, not all securitizations are treated equally, at least not under the US capital rules.

Operational Requirements under US Capital Rules

The operational criteria for traditional securitizations under US capital rules differ from those under the Basel framework in a way that can create a significant relative disadvantage to US banks. The operational criteria for traditional securitizations under the US capital rules require that the underlying exposures not be on the transferring bank's consolidated balance sheet under GAAP.[3] In contrast, the Basel framework requires, among other requirements, that a traditional securitization include a transfer to third parties of a "significant credit risk associated with the underlying exposures," but does not require that the underlying exposures be removed from the transferring bank's balance sheet.

Unlike the operational criteria for traditional securitizations under US capital rules, the operational criteria for synthetic securitizations under the US capital rules do not require off balance sheet treatment (but do require some transfer of credit risk in the underlying exposures). As a result, engaging in a synthetic securitization and recognizing the use of a credit risk mitigant to hedge underlying exposures provides a potential means of capital relief.

Because a synthetic securitization does not remove the underlying assets from the balance sheet of the transferring bank, the bank will look to the rules regarding credit risk mitigation to determine the resulting capital treatment of the exposure it holds in relation to the transferred tranche of credit risk. This normally will be a zero risk-weight if the exposure is secured by financial collateral (i.e., cash on deposit including cash held by a third-party custodian or trustee) or it will be a risk-weight corresponding to the risk weight for the counterparty providing the guarantee or credit derivative, if that counterparty is an "eligible guarantor"[4] under the US capital rules.

As an initial matter, in order to constitute a "synthetic securitization," as defined in the US capital rules, a transaction must meet the following requirements:

1. All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees;
2. The credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority;
3. Performance of the securitization exposures depends upon the performance of the underlying exposures; and
4. All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).[5]

In addition, the bank must also satisfy the operational requirements for synthetic securitizations,[6] including that the credit risk mitigant is one of the following three options: (1) financial collateral, (2) a guarantee that meets all criteria as set forth in the definition of "eligible guarantee"[7] (except for the criteria in paragraph (3) of the definition) or (3) a credit derivative that meets all of the criteria as set forth in the definition of "eligible credit derivative"[8] (except for the criteria in paragraph (3) of the definition of "eligible guarantee."

Because the operational criteria for synthetic securitizations recognize guarantees and credit derivatives as permissible forms of credit risk mitigants, those structuring a US capital relief trade (CRT)[9] structured as a synthetic securitization typically will find themselves debating between a guarantee or a credit derivative, and this decision will involve a number of regulatory considerations, including compliance with insurance regulations, swap regulations, the US risk retention rules and the Volcker Rule. Below, we discuss a number of the legal structuring considerations relevant to a typical CRT structured as a synthetic securitization. The discussion is intended to highlight the primary legal structuring considerations that may be encountered in doing a CRT in the United States, but such considerations may not apply to all structures, and a CRT may give rise to additional legal, regulatory and accounting considerations not discussed in this article.

Insurance Regulatory Issues

One of the more challenging issues in structuring a CRT is navigating between avoiding insurance regulation on the one hand, and swap regulation on the other.

In the case of insurance regulation, the analysis is complicated by the fact that in the United States the business of insurance is primarily regulated at the state level, so whether a guarantee is an "insurance contract" subject to state insurance regulation will be a question of the applicable state's law—and how that law is interpreted by the state's insurance regulatory authorities. A further complication is determining which states' laws may apply to a transaction. Generally, insurance regulatory jurisdiction in the United States is based upon where the insurance contract (or putative insurance contract) is solicited, negotiated, issued and/or delivered.

Taking New York state as a representative example, an "insurance contract" is defined in N.Y. Ins. Law § 1101(a)(1) as any agreement or other transaction whereby one party, the "insurer," is obligated to confer a benefit of pecuniary value upon another party, the "insured" or "beneficiary," dependent upon the happening of a fortuitous event[10] in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event. Under N.Y. Ins. Law §1101(a)(3), a CRT structured as a guarantee will face potential regulation as an insurance contract if made by a warrantor, guarantor or surety who is engaged in an "insurance business," which, as discussed below, is further defined in the New York insurance.

There is also a more specific definition of "financial guaranty insurance" in N.Y. Ins. Law § 6901(1)(a), which includes, among other things, a surety bond, insurance policy or, when issued by an insurer or any person doing an insurance business (as defined below), an indemnity contract, and any guaranty similar to the foregoing types, under which loss is payable, upon proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee as a result of various events, one of which is the failure of any obligor on or issuer of any debt instrument or other monetary obligation to pay principal or interest due or payable with respect to such instrument or obligation, when such failure is the result of a financial default or insolvency.

Under N.Y. Ins. Law § 1101(b)(1)(B), whether a guarantor is engaged in an insurance business depends on whether it is "making, or proposing to make, as warrantor, guarantor or surety, any contract of warranty, guaranty or suretyship as a vocation and not as merely incidental to any other legitimate business or activity of the warrantor, guarantor or surety …. " The most recent interpretive authority for when a guaranty is not conducted "as a vocation" but is "merely incidental" is a 2003 opinion issued by the Office of General Counsel of the New York State Insurance Department.[11] Under the reasoning articulated in that opinion, an "incidental" guaranty includes a guaranty by a parent company of a subsidiary's obligations, a personal guaranty by a shareholder of a closely-held corporation's obligations and a loan guaranty offered by a cooperative corporation to its owner-members for a nominal fee. By contrast, where a guaranty is provided to unrelated third parties, covers obligations of unrelated parties and is provided for a risk-based fee, that seems more like a "vocation"—and if a special purpose entity (SPE) provides the guaranty as its sole function, that would seem even more like a "vocation."

The consequence of a contract falling within the above definitions of "insurance" or "financial guaranty insurance," or of being a guaranty that is conducted as a vocation and not merely incidental to any other legitimate business or activity of the guarantor, is that the guarantor could be deemed to be engaged in an unauthorized insurance business and therefore subject to civil, and theoretically even criminal, penalties.

Notwithstanding the above, arguments could be made as to why a guaranty may not be insurance under applicable state law. For example, if a CRT does not require the beneficiary or protection buyer, as applicable, to own the underlying exposures, the instrument would generally not meet one of the defining characteristics of insurance, which is that the beneficiary have an insurable interest in the underlying exposures.[12]

In addition, in cash collateralized CRTs, the guarantor arguably does not have any future obligation to confer a benefit of pecuniary value, because it has satisfied all of its obligations upon the furnishing of cash collateral and has no future payment obligations. It should be noted, we are not aware of any insurance department having approved of such interpretation, and those structuring CRTs will need to consult with insurance counsel in applicable jurisdictions.

Swap Regulatory Issues

DODD FRANK AND COMMODITY POOL REGULATION

A CRT transaction documented as a swap will need to navigate potential regulation as a swap.[13] Moreover, the form in which the risk transfer instrument is documented is not dispositive. Therefore, even if a CRT transaction is documented as a financial guaranty rather than a credit default swap or other derivative, those structuring the transaction should still evaluate the possibility of swap characterization and whether compliance with the CEA is advisable. One also should consult the applicable rules promulgated thereunder by the Commodity Futures Trading Commission (CFTC).

If the CRT transaction is documented as a swap, a host of regulatory implications follow. For example, the parties will need to consider potential registration (or a potential exclusion or exemption therefrom) as a swap dealer, introducing broker, a commodity pool operator (CPO) or, for managed transactions, a commodity trading advisor (CTA). In addition, the parties will need to address the uncleared margin, trade reporting, and recordkeeping obligations under the Commodity Exchange Act, among other things.

In the context of securitizations, the most common registration trigger is that of a CPO, which functions as a sponsor or operator of a commodity pool (e.g., an SPE that enters into swaps). The CPO either itself makes trading decisions for the commodity pool or engages a CTA to do so.

Generally, a commodity pool is an enterprise in which funds contributed by a number of persons are combined, or pooled, for the purpose of trading commodity interests—which are defined to include swaps, OTC options, futures contracts, options on futures contracts, retail off-exchange forex transactions, and retail commodity transactions—or investments in another commodity pool. In many CRTs, the provider under the swap, guarantee or other loss sharing arrangement will be an SPE. Because the SPE will have received funds for the purpose of engaging in a swap transaction or a transaction potentially characterized as a swap transaction, the SPE may be characterized as a commodity pool.[14]

The CFTC has issued a number of no-action letters relating to securitization structures that use swaps. In particular, in CFTC No-Action Letter 14-111,[15] CFTC staff found that an SPE that holds an interest in a swap creating synthetic exposure to the risk of mortgage loans held or securitized by Fannie Mae and Freddie Mac would be considered a commodity pool. CFTC staff stated that, absent relief, the GSEs operating the SPEs would be required to register with the CFTC as CPOs.[16] The GSEs were seeking to avail themselves of the exemption under CFTC Rule 4.13(a)(3), but the transactions presented a significant question under the "marketing" prong of the exemption because the principal return-generating assets of the SPEs would be swaps. In the no-action letter, which is discussed further below, staff granted no-action relief from CPO registration provided that the GSEs and their SPEs complied with the requirements set forth in Rule 4.13(a)(3), as construed in the letter, and numerous other conditions discussed in the letter (not all of which are discussed in this article). In a subsequent letter, CFTC No-Action Letter 14-152, CFTC staff provided similar relief to operators of insurance-linked securities issuers.

Under Rule 4.13(a)(3), an operator can claim exemptive relief from the CPO registration requirements if a pool meets certain conditions relating to marketing, commodity interest exposure and investor qualification. More specifically, the following conditions must be satisfied on a pool-by-pool basis for those pools for which the operator claims the Rule 4.13(a)(3) exemption:

i. **Not marketed to the public –** interests in the pool must be exempt from registration under the Securities Act of 1933 and must be offered and sold without marketing to the public in the United States;[17]

ii. **Commodity interest exposure –** the pool must engage in a sufficiently limited amount of commodity interest trading (i.e., satisfy a *de minimis* test discussed below);

iii. **Sophisticated investors –** the pool operator must reasonably believe at the time of investment that each investor in the pool meets certain sophistication criteria; and

iv. **Marketing of the pool –** investments in the pool must not be marketed as a vehicle for trading in a commodity interest exposure.

In addition, certain requirements apply with regard to investor disclosure, notice filing with the National Futures Association (and updating and renewal of the notice), books and records, and submission to special calls from the CFTC to demonstrate eligibility and compliance with the exemption criteria.

As noted above, a condition for the exemptive relief from CPO registration under Rule 4.13(a)(3) is that the pool must engage in a sufficiently limited amount of commodity interest trading. For this purpose, a pool is considered to have a sufficiently limited commodity interest exposure if, at the relevant times, it meets one of the following *de minimis* tests: (a) the aggregate premiums are less than or equal to 5 percent of the liquidation value of the pool's portfolio; or (b) the aggregate net notional value of the pool's commodity interest positions is less than or equal to 100 percent of the liquidation value of the pool's portfolio (Notional Value Test). Here, liquidation value is to be determined after taking into account any unrealized profits and losses on commodity interest positions that the pool has entered into.[18] The notional value of an uncleared swap is the amount reported by the reporting counterparty as the notional amount of the swap under Part 45 of the CFTC's regulations.[19]

In No-Action Letter 14-111, CFTC staff addressed the application of the Notional Value Test to a credit default swap between a GSE and an SPE. Under the facts considered in the letter, note proceeds were used to collateralize the SPE's obligations to make payments of principal to noteholders and payments in respect of credit events to the GSE. In that letter, staff found that the Notional Value Test was satisfied because:

i. the GSEs (as operators of the SPEs) had represented that the notional amount[20] of the swap between the SPE and the GSE (as counterparty) would not exceed the amount of collateral raised from the SPE's sale of notes;

ii. collateral would be invested in certain short-term, highly liquid[21] assets with limited market risk; and

iii. the notional value of the swap would be reduced when defaulting mortgages exited the pool and the assets held by the SPE would be liquidated to pay credit coverage to the GSE, thereby reducing the collateral in the same amount as the notional value reduction.[22]

With respect to the marketing prong, CFTC staff noted that a facts and circumstances analysis must be applied and that factors enumerated in the context of revisions to another CPO-related rule were useful in interpreting the marketing prong of Rule 4.13(a)(3). For the GSE's proposed transactions, CFTC staff found it significant that the swap transaction would "serve as the conduit for exposure to the mortgage credit risk of assets actually held by a counterparty to said swap, and the terms of the swap will not be a source of investment returns or losses beyond those directly correlated to the underlying mortgage loans, as there is no leverage embedded in the terms of the swap."[23]

In summary, although a no-action letter cannot be relied upon by persons not addressed by the letter, those structuring CRT transactions may consider applying the reasoning articulated in the CFTC's no-action letters when determining whether the Rule 4.13(a)(3) exemption might be available to a CRT transaction involving swaps. In particular, parties may be able to structure their CRT transaction to comply with the Notional Value Test and, in placing securities to investors, observe the manner of offering and investor qualification conditions of Rule 4.13(a)(3). It should be noted that a more nuanced facts and circumstances analysis will apply to the marketing prong, including rigorous evaluation of the terms of the swap and other features of the CRT transaction that may affect investor returns and losses. But with the interpretive guideposts provided by the no-action letters and other CFTC guidance, counsel may be able to conclude with sufficient comfort that the CRT transaction, if marketed in accordance with the associated offering documentation, complies with the marketing prong of Rule 4.13(a)(3).

CHARACTERIZATION OF CREDIT LINKED NOTES AND SIMILAR CONTRACTS AS "SWAPS" OR OTHER COMMODITY INTERESTS

CRT transactions often use credit-linked notes (CLNs) or similar contracts that provide loss protection similar to credit default swaps and other derivative contracts, but are issued in the form of securities having debt-like characteristics. Such instruments may be able to meet the criteria of the "hybrid instruments" exclusion under the Commodity Exchange Act (CEA) for instruments that are predominantly securities. Under the CEA, a ''hybrid instrument'' is defined as "a security having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities," and

Section 2(f) excludes from CFTC jurisdiction "a hybrid instrument that is predominantly a security." Section 2(f) states that, a hybrid instrument shall be considered to be predominantly a security if the following characteristics are met:

A. "the issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument, substantially contemporaneously with delivery of the hybrid instrument;

B. the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price paid under subparagraph (A), whether as margin, settlement payment, or otherwise, during the life of the hybrid instrument or at maturity;

C. the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and

D. the hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to this Act."

In addition, the credit-linked notes or similar instruments may be able to meet the criteria of an exclusion from the definition of "swap" that is applicable to "any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933."

Endnotes

1 References to sections of the US capital rules are to Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Regulation Q), 12 CFR §217 (2013) [hereinafter "Regulation Q"].

2 As a result of the Collins Amendment under Dodd Frank, the standardized approach will be the binding constraint even for most banks subject to the advanced approaches.

3 §217.41(a)(1) of Regulation Q.

4 See definition of "Eligible guarantor" in §217.2 of Regulation Q.

"Eligible guarantor means:

(1) A sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank (MDB), a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty; or

(2) An entity (other than a special purpose entity):

(i) That at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade;

(ii) Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and

(iii) That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer)."

5 See definition of "Synthetic Securitization" in §217.2 of Regulation Q.

6 See §217.41(b) of Regulation Q for a full description of all operational criteria for synthetic securitizations.

7 See definition of "Eligible guarantee" in §217.2 of Regulation Q:

"means a guarantee that:

(1) Is written;
(2) Is either:

(i) Unconditional; or

(ii) A contingent obligation of the US government or its agencies, the enforceability of which is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, meeting servicing requirements);

(3) Covers all or a pro rata portion of all contractual payments of the obligated party on the reference exposure;

(4) Gives the beneficiary a direct claim against the protection provider;

(5) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(6) Except for a guarantee by a sovereign, is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(7) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligated party on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;

(8) Dœs not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure;

(9) Is not provided by an affiliate of the national bank or Federal savings association, unless the affiliate is an insured depository institution, foreign bank, securities broker or dealer, or insurance company that:

(i) Dœs not control the national bank or Federal savings association; and

(ii) Is subject to consolidated supervision and regulation comparable to that imposed on depository institutions, US securities broker-dealers, or US insurance companies (as the case may be); and

(10) For purposes of §§3.141 through 3.145 and subpart D of this part, is provided by an eligible guarantor."

8 See definition of "Eligible credit derivative" in §217.2 of Regulation Q:

"Eligible credit derivative means a credit derivative in the form of a credit default swap, n^{th}-to-default swap, total return swap, or any other form of credit derivative approved by the OCC, provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or n^{th}-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Receivership, insolvency, liquidation, conservatorship or inability of the reference exposure issuer to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or n^{th}-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the national bank or Federal savings association records net payments received on the swap as net income, the national bank or Federal savings association records offsetting deterioration in the value of the hedged exposure (either through reductions in fair value or by an addition to reserves)."

9 Capital relief trades are sometimes referred to as "capital release transactions" or "credit risk transfer" (also shortened to "CRT"). As noted by Richard Robb in "What's in a Name?", the term "CRT" can be particularly confusing for US market participants because such term is also used to refer to credit risk transfer deals involving housing collateral issued by the United States GSEs. Structured Credit Investor, 2018 Guide to Capital Relief Trades, p. 6.

10 "Fortuitous event" means any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party. N.Y. Ins. Law § 1101(a)(2).

11 Office of General Counsel Opinion No. 03-01-45 (January 23, 2003), available at http://www.dfs.ny.gov/insurance/ogco2003/rg030145.htm. The functions of the former New York State Insurance Department were assumed by the New York Department of Financial Services on October 3, 2011.

12 See, for example, the above quoted definition of "financial guaranty insurance" under the N.Y. Insurance Law which requires "proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee" as a result of any of the events enumerated in the statute. In addition, the "insurance safe harbor" regulations issued by the SEC and CFTC under Dodd-Frank, in order to delineate the boundary between insurance contracts and swaps, (i) require the beneficiary of an insurance contract to have an insurable interest and carry the risk of loss with respect to that interest continuously throughout the duration of the contract and (ii) limit the beneficiary's entitlement to payment to the amount of actual loss that occurs and is proved.

13 In certain cases, it may be possible to conclude that the risk transfer contract is a security-based swap or aggregation of security-based swaps. Security-based swaps are subject to a different regulatory regime than swaps. For example, the commodity pool issues discussed in this section would generally not be present for an SPE that enters into security-based swaps but not swaps. Further discussion of security-based swaps is beyond the scope of this article.

14 Certain commodity pool regulations remain applicable even if the CPO qualifies for exemption from registration. For example, under CFTC Regulation 4.20, a CPO must operate its pool as an entity cognizable as a legal entity separate from that of the CPO, the CPO must receive funds in the pool's name, and the CPO may not commingle property of the pool with that of any other person.

15 A no-action letter is a written statement by the staff of a Division of the CFTC or its Office of the General Counsel that such staff will not recommend that the CFTC commence enforcement action for failure to comply with a specific provision of the Commodity Exchange Act or CFTC regulations. It binds only the staff of the Division that issued it or the Office of the General Counsel with respect to the specific fact situation and persons addressed by the letter, and third parties may not rely upon it. CPOs wanting to rely upon the staff letter must first meet the conditions of relief, which include filing a notice with the CFTC Division of Swap Dealer and Intermediary Oversight.

16 CFTC No-Action Letter 14-111, at 7.

17 CFTC staff have addressed harmonizing this condition with the JOBS Act of 2012, which eliminated the prohibition against general solicitation in the SEC's Regulation D and Rule 144A. See CFTC Staff Letter 14-116 (Sept. 9, 2014). The CFTC subsequently proposed a codification of this relief.

18 CFTC Regulation 4.13(a)(3)(ii).

19 See "Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations," August 14, 2012.

20 The CFTC staff stated that, if the stated notional amount of a swap is leveraged in any way or otherwise enhanced by the structure of the swap or the arrangement in which it is issued, the threshold calculation would be required to be based on the effective notional amount of the swap rather than on the stated notional amount.

21 In CFTC No-Action Letter 14-152, the corresponding condition utilized the definition of "highly liquid" set out in CFTC Regulation 1.25(b)1), which states: "Investments must be 'highly liquid' such that they have the ability to be converted into cash within one business day without material discount in value."

22 In No-Action Letter 14-111, the CFTC noted that when conducting the Notional Value Test, it was not reducing the liquidation value of the assets held by the SPE by the amount owed to the SPE's note holders because where the SPE was required to pay coverage to a GSE due to a default event in the underlying pool of mortgages, the SPE's obligation to repay the note holders the principal and interest on the notes was equally reduced.

23 CFTC No-Action Letter 14-111, at 10.

Capital Relief Trades: Structuring Considerations for Synthetic Securitizations

Part Two: Volcker Rule and US Risk Retention Considerations

(a three-part series providing a US and UK perspective)

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In this series, we highlight a few of the regulatory considerations present in a typical CRT structured as a synthetic securitization. Parts one and two of this series discuss the primary legal considerations that may be encountered in doing a CRT in the United States, but such considerations may not apply to all structures, and a CRT may give rise to additional legal, regulatory and accounting considerations not discussed in this series. We continue our series with a look at issues that may arise under the Volcker Rule[1] and US risk retention rules in connection with structuring CRTs in the United States.

Volcker Rule Implications

If a CRT is structured to use a special purpose entity (SPE) that issues securities, the SPE will need an exemption or exclusion from registration under the Investment Company Act of 1940, as amended (ICA).

One potential avenue is reliance on the exclusion provided by Section 3(c)(7) of the ICA, which is available for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers (i.e., investors that meet certain thresholds for the holding of investment securities), and which is not making and does not at that time propose to make a public offering of such securities.

However, reliance on the exclusion provided by Section 3(c)(7) of the ICA can raise other structuring considerations under the Volcker Rule. The Volcker Rule defines a covered fund as including (i) an issuer that would be an investment company, as defined in the ICA, but for reliance on Section 3(c)(1) or 3(c)(7) of the ICA; and (ii) a commodity pool under Section 1a(10) of the Commodity Exchange Act (CEA) for which the commodity pool operator has claimed an exemption under 17 CFR 4.7 or is registered as a commodity pool operator in connection with the operation of a certain type of commodity pool.[2]

Why might those structuring a CRT need to consider whether the SPE is a covered fund? First, the Volcker Rule prohibits banking entities from engaging in certain transactions with covered funds, including acquiring or retaining any "ownership interest" in the covered fund as principal.[3] If investors in a CRT will include banking entities subject to the Volcker Rule and a transaction makes use of an SPE that is a covered fund, it will be necessary to consider whether the terms of the instrument are such that the investors might be considered to have an ownership interest in the SPE.

Banking entities are also generally prohibited from "sponsoring"[4] covered funds absent an exemption, and Section 13(f) of the Volcker Rule (often referred to as Super 23A), generally prohibits a banking entity, directly or indirectly, from entering into a "covered transaction,"[5] as defined under Section 23A of the Federal Reserve Act, with a covered fund for which the banking entity or any affiliate acts as sponsor, investment manager, or investment adviser. Therefore, a banking entity that enters into a CRT that makes use of an SPE that is a covered fund, needs to consider whether its relationship with such SPE could make it a "sponsor" of the covered fund or give rise to a "covered transaction" covered by Super 23A.

The Volcker Rule excludes from the definition of a covered fund an issuer that may rely on an exclusion or exemption from the definition of "investment company" under the ICA, other than the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the ICA.[6] Accordingly, the lender holding the reference assets may wish to avoid analyzing the Volcker Rule implications of utilizing an SPE that is a covered fund, by relying on an exception to the ICA for such SPE other than the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the ICA. Depending on the structure of a CRT, one potential exclusion from investment company status for an SPE used in a CRT may be Rule 3a-7 under the ICA, which provides an exclusion for certain issuers engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets (and in activities related or incidental thereto). Among other requirements, an issuer relying on Rule 3a-7 must issue fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets. For purposes of Rule 3a-7, eligible assets means "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 distribution of proceeds to security holders." As discussed below under *"Considerations Raised by US Risk Retention Rules—Could a CLN Be 'ABS' Subject to the US Risk Retention Rules,"* whether CRTs, particularly those involving the issuance of collateralized credit-linked notes (CLNs), satisfy the requirement that the issued securities entitle their holders to receive payments that depend primarily on the cash flows from eligible assets, is a question that raises certain interpretive issues.

Considerations Raised by US Risk Retention Rules

CRTs pose two potential issues under the US risk retention rules.[7] First, if the underlying exposures in a CRT include assets that have been previously securitized in a transaction subject to the US Risk Retention Rules, the sponsor of the previous securitization transaction must consider whether the entry into the CRT constitutes a prohibited transfer or pledge of the interest the sponsor was required to retain in connection with the securitization transaction. Second, the entity owning the underlying exposures must consider whether the CRT involves the issuance of an asset-backed security (ABS) in a transaction in which such entity could be considered a "sponsor" subject to the US Risk Retention Rules.

US RISK RETENTION RULES: PROHIBITION ON HEDGING

The US Risk Retention Rules, which were adopted by various US federal agencies in response to the Dodd-Frank Act, generally require the sponsor of a securitization transaction (or one or more majority-owned affiliates—as defined in the US Risk Retention Rules—of the sponsor) to retain a minimum economic interest in the credit risk of the securitized assets in accordance with one of the permissible forms of risk retention described in the US Risk Retention Rules and prohibit a sponsor or any affiliate from hedging or transferring the credit risk that the sponsor is required to retain.[8] Frequently, a bank that is interested in engaging in a CRT will already have securitized a portion of the potential reference pool in a traditional securitization that is subject to the US Risk Retention Rules, or may want the flexibility to include such assets in future securitization transactions. As a result, a bank indirectly holding reference assets subject to an on-balance sheet securitization must consider whether the CRT constitutes an impermissible hedge of its required risk retention interest in connection with the securitization transaction, which will be the case if:

1. Payments on the CRT are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and
2. The CRT in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.[9]

A sponsor grappling with the above analysis could consider whether the CRT may be designed to include securitized assets in a manner that still ensures that payments on the CRT do not reduce or limit the exposure of the sponsor to the credit risk it is required to retain. One potential method to do so may involve creating one or more synthetic securitization exposures that mirror the terms of the securitization exposures in the sponsor's traditional securitization that are not required to be retained for risk retention purposes and then including only such securitization exposures in the CRT reference pool (specifically excluding the retained risk retention interest).

For potential CRT sponsors that do not currently have traditional securitizations involving the potential reference pool, such sponsors may still wish to preserve flexibility under the terms of the CRT to remove assets from the reference pool for inclusion in future traditional securitizations that are subject to the US Risk Retention Rules. Doing so may raise additional issues—for example, potential prepayment risk for investors—that may need to be considered in structuring a transaction.

COULD A CLN BE "ABS" SUBJECT TO THE US RISK RETENTION RULES?

Only sponsors of asset-backed securities, as defined under the Securities Exchange Act of 1934, as amended (Exchange Act), are subject to the US Risk Retention Rules. CRTs will often involve the issuance of credit-linked notes or other securities, and therefore a bank engaging in a CRT must consider whether such securities are asset-backed securities. An asset-backed security is defined in the Exchange Act as follows:

"The term 'asset-backed security'" —

A. Means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including —
   i. A collateralized mortgage obligation;
   ii. A collateralized debt obligation;
   iii. A collateralized bond obligation;
   iv. A collateralized debt obligation of asset-backed securities;
   v. A collateralized debt obligation of collateralized debt obligations; and
   vi. A security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and …."[10]

CLNs issued in a CRT are often collateralized by the cash proceeds of the issuance of the CLNs, which may be held in a trust account for the benefit of both the CRT sponsor or protection buyer (to satisfy payments on the guaranty or credit derivative) and the investors in the CLNs. As a result, there are potentially two pools of "self-liquidating financial assets" that must be considered when analyzing whether CLNs are asset-backed securities—(1) the "cash" collateral for the CLNs, which may be invested in highly-rated securities and (2) the underlying reference assets for the CRT.

Whether CLNs are collateralized by self-liquidating assets that allow the holders of the CLNs to receive payments that depend primarily on cash flow from the assets (and are therefore potentially asset-backed securities) is a challenging question. On the one hand, the assets that can best be described as "collateralizing" the CLNs are the investment securities that provide security for the CLNs and are the sole source of cash flows for the CLNs. On the other hand, the assets which most directly affect the performance of the securities—that is, which determine the amount and timing of payments of principal in respect of such securities—are the reference assets. In other words, payments on the CLNs are highly dependent on the performance of the reference pool, but the CLNs are not entitled to the cash flow from the reference pool and CLN holders do not have the benefit of a security interest in the reference pool.

Second, one might question whether a bank holding a reference pool of assets in a CRT involving the issuance of CLNs is a "sponsor"— within the meaning of the US Risk Retention Rules—of an asset-backed securities transaction. Under the US Risk Retention Rules, a "sponsor" is defined as an entity that "organizes and initiates a securitization transaction by either selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[11] Whether a putative sponsor has sold or transferred assets has taken on heightened importance in the analysis after the recent United States Court of Appeals for the District of Columbia Circuit decision holding that the US Risk Retention Rules cannot be applied to managers of open market CLOs, in which the court found that a securitizer must "actually be a transferor, relinquishing ownership or control of assets to an issuer."[12] While a bank that enters into a CRT necessarily must transfer all or a portion of the credit risk of the underlying exposures to third parties,[13] the bank retains ownership of the reference assets, which would support the view that the US Risk Retention Rules are not applicable to synthetic securitizations.

Given the ambiguities discussed above, some bank sponsors may choose to comply with the US Risk Retention Rules rather than grapple with the potential interpretive issues.

Endnotes

1 Section 13 of the Bank Holding Company Act of 1956.

2 12 CFR 248.10(b)(1).

3 12 CFR 248.10(b)(1).

4 A "sponsor" would include an entity that:

   a. Acts as a general partner, managing member, trustee of a covered fund (or serves a CPO of a pool that is a covered fund due to its commodity pool status);

   b. In any manner selects or controls a majority of the directors, trustees, or management of a covered fund (including having employees, officers, directors or agents who constitute that majority); or

   c. Shares the same name, or a variation of the same name, with a covered fund for corporate, marketing, or other purposes.
   12 CFR 248.10(d)(9).

5 The definition of covered transaction includes (i) loans and other extensions of credit to the covered fund; (ii) purchases of assets from and investments in securities issued by the covered fund; (iii) issuance of financial guarantees on behalf of a covered fund; (iv) securities borrowing or lending that results in a credit exposure to the covered fund; and (v) a derivatives transaction that results in credit exposure to the covered fund.

6 12 CFR 248.10(c)(12)(ii).

7 79 FR 77601 [hereinafter the "US Risk Retention Rules"]

8 § __.12(a) of the US Risk Retention Rules. The US Risk Retention Rules contain certain "sunset" provisions for the hedging and transfer restrictions applicable to most ABS and RMBS, after which such restrictions will not apply.

9 *Id.*

10 Section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79)).

11 § __.2 of the US Risk Retention Rules.

12 *Loan Syndications & Trading Association v. SEC*, No. 17-5004 (D.C. Cir. Feb. 9, 2018).

13 §217.41 of Regulation Q.

Capital Relief Trades: Structuring Considerations for Synthetic Securitizations

Part Three: Navigating the European Rules and Regulations

(a three-part series providing a US and UK perspective)

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Introduction and Overview

Synthetic securitization has had a rocky ride in Europe. 2004-2005 was the high watermark, when issuance exceeded EUR 180 billion, the majority of which were arbitrage synthetic securitizations. The financial crisis almost killed off the market, before a gradual recovery began. In 2018, there were 49 European synthetic securitization deals, reaching a post-crisis record of EUR 105 billion. Although arbitrage synthetic securitization has not risen from the flames, there were 244 balance sheet synthetic securitizations between 2008 and the end of 2018.[1] Issuance levels are likely to rise further.

On September 24, 2019, the European Banking Authority published its draft report on an STS Framework for synthetic securitization under Article 45 of the Securitization Regulation (the "EBA Discussion Paper"). The EBA Discussion Paper is driven by the EBA's mandate under the Securitization Regulation[2] to develop a report on the feasibility of a framework for "*simple, transparent and standardized*" (STS) synthetic securitization, limited to balance sheet securitization.

Most of the EU banks that have originated balance sheet synthetic securitizations are domiciled in the United Kingdom, France, Germany, Italy and Spain. There has also been some healthy issuance levels in other EU jurisdictions. Although there is no official data, anecdotally it is clear that the European market for synthetic securitizations is for the most part documented under English law. This means that European synthetic securitization transactions have to navigate capital relief and legal issues arising from a mixture of English law and EU regulation.

This, the third and final part of our series, looks at:

- the criteria for effective credit risk mitigation and the operational requirements for synthetic securitizations under the EU bank capital rules and the Capital Requirements Regulation (the "CRR")[3];
- the insurance regulatory and guarantee issues under English law;
- the potential impact of EU regulation of derivatives contracts under the European Market Infrastructure Regulation (EMIR)[4]; and
- (a) the proposed criteria for a "*simple, transparent and standardized*" (STS) framework for synthetic securitization published by the European Banking Authority (EBA); and (b) the EBA Report on the Credit Risk Mitigation (CRM) Framework dated March 19, 2018 (the "EBA CRM Report").

What Is the Definition of *"synthetic securitization"* in the European Union?

The definition of "*synthetic securitization*" in the European Union is set out in the CRR, as amended in 2017 by Regulation 2017/2401,[5] (the "2017 Amending Regulation") via the EU Securitization Regulation.

The CRR (as amended by the 2017 Amending Regulation) defines "*securitization*" at Article 4(61), by cross-reference to Article 2(19) of the Securitization Regulation, as:

"a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having all of the following characteristics:

a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures;

b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme …"

The 2017 Amending Regulation then creates a definition of "*synthetic securitization*" by cross-referring to the corresponding Securitization Regulation definition. This defines a "*synthetic securitization*" as a "*securitization where the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitized remain exposures of the originator.*"

Operational Requirements under EU Rules

(I) THE CRR

In Part One of the Series, we discussed how the US Capital Rules are housed in the Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Regulation Q). In the European Union, credit institutions and investment firms subject to the CRR may reduce their credit risk capital requirements in respect of loan portfolios and other exposures by obtaining credit protection in transactions that comply with the rules for credit risk mitigation set out in the CRR.

(II) BANK CAPITAL RULES: FOUR POTENTIAL FRAMEWORKS

The EU bank capital rules on capital requirements for credit risk are set out in Part Three, Title II of the CRR. At least four different parts of this credit risk capital framework are potentially relevant for synthetic securitization transactions:

- **Standardized Approach**: This approach requires banks to assign risk weights to assets and off-balance sheet exposures using, among other things, rating agency ratings, and to calculate capital requirements based on the risk weighted exposure amounts.

  Under the "*Standardized Approach*" an affected financial institution must hold qualifying capital equal to at least 8 percent. (before buffers) of risk weighted exposure amounts ("RWEA") with respect to assets and off-balance sheet items.

  Although the Standardized Approach is simpler to apply than the "*Internal Rating Based Approach*" ("IRB") described below. the gap may soon reduce. Under CRR II, once the proposed package of reforms to complete the implementation of Basel III in the European Union comes into force in 2020, the determination of risk weight exposure amounts will become more complex.

- **Internal Ratings-Based Approach:** This is more complex than the Standardized Approach. It is used by the largest and most sophisticated banks which apply regulator-approved risk models to calculate their capital requirements.

  The Internal Ratings-Based Approach has two principal variations. The first, the "*foundation*" approach, known as "F-IRB," takes the permitted operating standards, credit risk mitigation and recognition techniques of the Standardized Approach and adapts these in the foundation IRB approach, by modifying the risk weight calculations.

  Instead of amending the risk weight of an exposure, as is done under the Standardized Approach, F-IRB permits a greater risk sensitivity by taking into account the effects of this mitigation on the different risk components and granting more beneficial capital relief than under the Standardized Approach.

  The second variation is the "*advanced*" approach, known as "A-IRB." A-IRB allows banks to include their own estimates of probability of default (PD) and loss given default (LGD) in its calculations of how much qualifying capital it must hold.

  An advanced financial institution's decision to adopt the Internal Ratings-Based Approach under either F-IRB or A-IRB, will affect which CRM rules it must apply.

- **Securitization:** The Securitization Framework is not an alternative to the Standardized Approach and Internal Ratings-Based Approach, but instead, interacts with these two approaches.

  Risk weights for securitization positions under these approaches, are determined using the "*Securitization Internal Ratings-Based Approach*" (SEC-IRBA). This approach takes into account the Internal Ratings-Based Approach or the "*Securitization Standardized*

Approach" (SEC-SA) based on the Internal Ratings-Based Approach or the Standardized Approach capital requirement for the relevant underlying asset (for example an SME loan).

- **Credit Risk Mitigation (CRM):** As further described above, for a pool of underlying assets, an affected financial institution would apply either the Standardized Approach or the Internal Ratings-Based Approach, with the latter approach being reserved for those financial institutions with the most complex risk management systems, and accompanying regulatory approval.

  The CRM framework sets out CRM rules for banks applying F-IRB and A-IRB frameworks. The A-IRB framework has its own CRM rules (which also refer to parts of the main CRM rules). If the referenced exposures are securitization exposures or the CRM creates securitization exposures, then the Securitization Framework will apply.

(III) CREDIT RISK MITIGATION/CRM AND SYNTHETIC SECURITIZATION

Synthetic Securitization is part of the Securitization Framework. It applies, as per the definitions we discussed above, when a bank transfers a tranche or tranches of credit risk of an exposure or pool of exposures to another party by means of a guarantee or credit derivatives – i.e., unfunded credit risk mitigation techniques. In essence it is a technique to reduce the credit risk associated with an exposure an institution holds, which is true of all CRM but only when the CRM creates credit risk tranching does it constitute synthetic securitization.

The CRR provides that CRM reduces RWEA by reducing the risk weight applied to covered exposures or by reducing other measures of credit risk based on probability of default (PD) or loss given default (LGD) used to calculate RWEA.

(IV) FUNDED OR UNFUNDED CRM

CRM can be either funded or unfunded. Unfunded credit protection takes the form of a guarantee or a credit derivative. The reduction of an institution's credit risk on its exposure derives from the obligation of a third party to pay a credit protection amount on a counterparty or borrower event default or credit event.

Funded credit protection, is where a financial institution seeking credit risk mitigation holds collateral, either directly or indirectly, against the third party's obligation to pay the credit protection amount.

Essentially, it is a credit risk mitigation technique where the reduction of the credit risk on the exposure derives from the institution's right on a counterparty event of default or credit event: (a) to liquidate, obtain transfer, appropriate, or retain assets or amounts; or (b) reduce exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the institution.

Funded credit protection can involve a credit derivative or guarantee, being supported by an SPV note structure, with credit protection payments supported by the liquidation of collateral.

(V) EFFECTIVE CRM REQUIREMENTS

CRM may only reduce bank capital requirements if specified conditions are met. These requirements include that the CRM arrangement is effective and enforceable in all relevant jurisdictions, and that the protection buyer has received a legal opinion to confirm the enforceability requirement under the CRR.

For unfunded CRM the credit protection provider must be an eligible provider, and the credit protection contract must be an eligible contract. Eligible providers include various types of public and private sector entities, such as corporate entities that have a qualified rating agency rating or, for a bank using the IRB approach, an internal rating by that bank.

For guarantees of securitization exposures, and some other purposes, although there is no minimum rating requirement for the protection provider, the protection provider must have a qualifying rating of A- or higher at the start of the transaction and investment grade ongoing from an external credit assessment institution ("ECAI") or, if the protection buyer is a bank using the IRB approach (and whether or not it has a rating from an ECAI), the protection provider needs to have an internal rating from the protected bank. SPEs may not be protection providers unless they fully cash collateralize their obligations.

The CRR, following the Basel framework, gives the types of eligible contracts for unfunded CRM as guarantees and credit derivatives.

It does not refer to insurance policies as such as eligible CRM. However, banking regulators have accepted credit insurance policies as CRM, provided the policies meet the other requirements that apply to guarantees used as CRM.[6]

The requirements that apply to guarantees and credit derivatives mainly relate to the certainty of the bank receiving payment from the credit protection provider if the primary obligor defaults.

First, the contract must provide a direct payment obligation from the protection provider to the bank.

The extent of protection, or scope of coverage, must be "*incontrovertible*" – clear and indisputable.

Any conditions on the obligation to pay, and any rights for the protection provider to cancel or terminate the protection, must be limited to events within the control of the protected bank.

The contract may not provide for increased cost of the protection based on deterioration of the covered credit. For a guarantee to be used as CRM, in addition, it needs to give the protected bank the right to pursue the guarantor for payment when the primary obligor fails to pay or another specified default event occurs. This is called "*pay now claim later,*" and is a level which few credit insurance policies include.

The bank must be able to exercise this right "*in a timely manner,*" which does not have to be the following day but may be up to 24 months. The UK PRA consulted on a fairly strict interpretation of this requirement, but did not include that in its final policy statement.

The guarantee must be a written obligation of the guarantor, and it must either cover all payments to which the financial institution is entitled, or, if it covers less than all payments, the capital benefit must be adjusted to reflect that.

For example, a guarantee might cover a pro rata share of a loan and the capital benefit would be applied to that pro rata share.

(VI) INTERSECTION OF CRM AND SECURITIZATION CAPITAL FRAMEWORK

The effect of CRM will be similar to that for other types of exposures, in that the risk weight or other credit risk measure of the protection provider will be substituted for that which would otherwise apply to the covered exposure or covered portion, and there will be an adjustment for any differences in maturity if the term of the protection is shorter than that of the exposure.

Securitizations can be "*traditional*," where the underlying assets are sold to an SPE or to investors, or "*synthetic*," where credit risk is transferred by means of a guarantee or credit derivative. So, where CRM covers a segment of credit risk of a pool of exposures, such as the mezzanine or second-loss piece of a pool of loans, very often that creates a synthetic securitization.

For the securitization to be effective for purposes of bank capital requirements under the Securitization Framework, a number of conditions must be met. The most important of these is a transfer of significant credit risk from the bank to third parties.

While this is a general requirement under the Basel framework, in the European Union, CRR (Article 245) provides a formula to give guidance on significant risk transfer.

Generally the bank must retain not more than half of the mezzanine tranche (by RWEA). However, if there is no mezzanine tranche, and the originator can demonstrate that the exposure value of the first loss tranche exceeds a reasoned estimate of the expected loss on the underlying exposures by a substantial margin, the originator is permitted to retain not more than 20 percent of exposure value of the first loss tranche.

Amendments implemented through the 2017 Amending Regulation made some changes to these rules. The "*mezzanine*" definition no longer refers to credit ratings, and the first loss option no longer refers to 1250 percent risk weighting.[7]

However, regulators can override this formula if they find the transfer of risk is not commensurate with the amount of capital relief claimed. This means that regulators have more discretion in deciding when capital reduction is appropriate, and so banks generally want to discuss transactions with regulators before they complete them.

Other operating conditions for synthetic securitization overlap somewhat with those for effective CRM: in addition to the general CRM requirements, there must be no terms such as price increases on deterioration in credit quality that effectively transfer the risk back onto the bank.

Early termination by the bank is generally allowed only in limited circumstances. Early termination in the case of a 10 percent clean-up call is allowed. Time calls, where at a point in time, the time period running from the transaction issue date is equal to or above the weighted average life of the initial reference portfolio at the issue date, are also permissible in restricted circumstances.

However, the only other permitted circumstance is following a narrow range of regulatory events. Other repurchases or early termination must be on arms-length terms.

Insurance Regulatory Issues under English law

As in the United States, for transactions governed by English law (as most deals are in the European Union), when structuring a synthetic securitization, which is documented using a guarantee or credit derivative, avoiding insurance regulation is a significant issue.

This is because, under English law, there is no definitive definition of "*insurance*" or "*contract of insurance.*" The leading case on the meaning of the term "*contract of insurance*" is *Prudential Insurance Company v Commissioners of Inland Revenue* [1904] 2KBD 658, which is well over 100 years old and generations before credit derivatives and synthetic securitization were ever dreamt of.

In that case, the judge, Channel J, set out three requirements for a contract of insurance:

i. "*it must be a contract whereby for some consideration, usually but not necessarily for periodical payments called premiums, you secure to yourself some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event*": a "***consideration to secure a benefit***" requirement;

ii. "*the event must be one which involves some amount of uncertainty*": an "***uncertainty requirement***"; and

iii. "*the insurance must be against something – that is to say, the uncertain event … must be an event which is prima facie adverse to the interest of the assured*": an "***insurable interest***" requirement.

While the definition does not have the force of statute, it has been cited with approval in other cases. Indeed, the FCA's "Perimeter Guidance Manual," in setting out its approach to this area of regulation, refers specifically to the *Prudential* case and the three requirements set out in it. The three *Prudential* requirements therefore carry some weight in deciding how to interpret the expression "*contract of insurance*" in the UK Regulated Activities Order.[8]

The potential characterization of derivatives arrangements as insurance has been most thoroughly considered in relation to credit derivatives.

In this area, and on the basis of market uncertainty, the trade body ISDA commissioned an opinion by Robin Potts QC dated June 24, 1997 (the "ISDA Opinion") on whether or not credit default options/swaps are contracts of insurance under the Insurance Companies Act 1982 and/or at common law.

Under a credit derivative transaction or guarantee in a synthetic securitization, the credit protection payer receives a premium from a credit protection buyer in return for assuming the risk that a credit event (i.e., a bankruptcy, failure to pay or a restructuring) may impact on a reference entity. If this occurs, the credit protection payer will, broadly speaking, pay the difference between the pre-default and post-default value of a reference asset.

In the ISDA Opinion, Potts opined, in summary, that:

i. a contract of insurance is a contract against the risk of loss of a potential payee; and that the requirement for "insurable interest" is simply another way of expressing the requirement that an insurance contract must be a contract against the risk of loss;

ii. in the case of a credit event under a credit derivative, a payment must be made to the payee irrespective of whether or not that payee has suffered loss or been exposed to the actual risk of loss;

iii. while the economic effect of certain credit derivatives transactions may be similar to the economic effect of a contract of insurance, the relevant authorities emphasise that economic effect is not the test to be applied to the characterisation of a transaction; and that the rights and obligations specified in the relevant contract must instead be addressed. Further the contract ought to be construed at the time it was entered into and not subsequently, so that, if a party subsequently receives payment that offsets a loss it has suffered it will not affect the characterisation of the transaction; and

iv. credit derivatives are not contracts of insurance because:

   A. the payment obligation is not conditional on the payee's sustaining a loss or having a risk of loss; and

   B. the contract is thus not one which seeks to protect an insurable interest on the part of the payee.

Credit derivatives and guarantees in synthetic securitization transactions are therefore structured so that the *Prudential Requirements,* on the basis analyzed by the ISDA Opinion, are not met. This is done through not requiring the entity holding the underlying reference assets to continue to hold them and deeming a credit protection payment to be payable whether or not the credit protection receiver, or beneficiary under the guarantee, has directly suffered a loss. This is intended to create no "*insurable interest.*"

The conclusions made in the ISDA Opinion have not been tested before the English courts. However, there is market reliance on the Potts' opinion and an absence of other relevant judicial authority, support for the view that if an English court reached the same conclusions as the Potts' opinion, it would also determine that if a synthetic securitization does not have an "*insurable interest*" and has not otherwise met the tests of being characterised as a contract of insurance within the meaning of that term as used in the Regulated Activities Order, then it will not be a contract of insurance.

Swap Regulatory Issues

The issues relating to derivatives regulation for synthetic securitizations are not as challenging under EU rules as they are under the US rules.

EMIR imposes legislative challenges for synthetic securitizations.

Where the relevant credit risk mitigation instrument is a credit derivative, then the key issues the parties to a transaction must analyze is whether (a) the transaction must be reported to a trade repository; and (b) whether any margining requirements apply.

The answer will depend on the jurisdiction and legal status of the parties, and there are many nuances. Where one of the parties is based in the European Union, then trade reporting requirements are likely to apply. Where one of the parties is not based in the European Union, but the other is, there may be additional reporting requirements in the jurisdiction of the Non-EU party.

EMIR also imposes obligations relating the exchange of margin. Variation margin must be exchanged against derivatives exposures between financial institutions and the largest non-financial institution derivatives market participants. So this captures banks, insurance companies, pension funds, asset managers and hedge funds: the core participant group in synthetic securitizations.

The largest market participants also need to exchange initial margin: a buffer amount of margin. Absent an avoidance motive SPVs do not need to exchange margin under EMIR with their derivatives counterparties.

Margin requirements can affect the economic attractiveness of a synthetic securitization, and institutions engaging in synthetic securitization must weigh up these costs.

Guarantees do not on a prima facie basis fall under EMIR. However, an institution using a guarantee for CRM purposes must consider whether the guarantee is a derivative in substance, if not form, and consider whether the provisions of EMIR discussed above, should be deemed to apply.

EBA Discussion Paper: Draft Report on STS Framework for Synthetic Securitization

The Securitization Regulation allows traditional securitizations to benefit from preferential regulatory capital treatment if they meet the applicable STS criteria together with some additional requirements under the CRR (pursuant to the 2017 Amending Regulation). However, it was decided not to include synthetic securitizations in the initial STS framework due to concerns about additional counterparty credit risk and complexity, and, instead, the question of STS for synthetic securitizations was postponed for future consideration. It was recognized in the Securitization Regulation that the EBA had already established a possible set of STS criteria for synthetic securitization in its Report on Synthetic Securitization published in 2015. Article 270 of the CRR, as amended by the 2017 Amending Regulation, already allows for preferential regulatory treatment of synthetic securitizations on a limited basis with respect to senior tranches of SME portfolios retained by originator credit institutions which meet certain requirements.

Article 45 of the Securitization Regulation required the EBA to publish a report on the feasibility of a specific framework for STS synthetic securitization by July 2, 2019, following which the European Commission (the "Commission") is required to submit a report and, if appropriate, a legislative proposal, to the Parliament and the Council by January 2, 2020. Given the delay in publishing the EBA Discussion Paper, the Commission report and legislative proposal is likely to be delayed as well. The creation of such STS framework is limited to balance sheet synthetic securitization and arbitrage securitizations will not be within its scope.

The EBA Discussion Paper sets out a set of proposed STS criteria for synthetic securitizations. These criteria broadly follow the existing STS criteria for non-ABCP securitizations in the Securitization Regulation, with some amendments and with some additional criteria covering matters which are specific to synthetic transactions. These additional criteria include certain credit events to be included in the credit protection agreement, provisions in relation to the calculation and timing of credit protection payments and requirements for eligible credit protection arrangements.

The EBA Discussion Paper identifies some points in favor of developing an STS framework for synthetic securitization which include increased transparency, further standardization and the potential positive impact on the financial and capital markets and the real economy. However, it also notes some points against creating such a framework, including the fact that there is no equivalent framework for synthetic securitization under the revised Basel securitization framework, where traditional securitizations that meet the criteria for "*simple, comparable and standardized*" securitizations can benefit from alternative capital treatment. The EBA concludes that an STS framework should be established for balance sheet synthetic securitizations, based on the proposed STS criteria.

The EBA Discussion Paper also separately considers the question of whether synthetic securitizations which meet the STS criteria should be able to benefit from preferential regulatory capital treatment. While it notes that this would have certain benefits, such as increased risk sensitivity, ensuring a level playing field with traditional securitization and the positive impact on the markets, and despite recognizing that synthetic securitizations perform as well as traditional securitizations, the EBA refrains from providing a recommendation as regards differentiated capital treatment for STS synthetic transactions.

The prospect of obtaining preferential regulatory capital treatment for STS synthetic securitizations is a very important issue for many market participants, and they will be hoping that this will be considered further and that this can be achieved.

The deadline for comments on the EBA Discussion Paper is November 25, 2019.

Endnotes

1 The EBA Draft Report on Synthetic Securitization, EBA/Op/2015/26

2 Regulation (EU) 2017/2402 of the European Parliament and of the Council of December 12, 2017 laying down a general framework for securitization and creating a specific framework for simple, transparent and standardized securitization, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012

3 Regulation (EU) (575/2013) of the European Parliament and of the Council of June 26, 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

4 Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories, as amended, and its related regulatory technical standards

5 Regulation (EU) 2017/2401 of the European Parliament and of the Council of December 12, 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms

6 Question ID 2014_768 of EBA Single Rulebook Q&A; EBA Report on CRM Framework, March 19, 2018, paragraph 36.

7 Article 242(17),(18)

8 Assisting in performing or administering a contract of insurance is a regulated activity under article 39A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (the "Regulated Activities Order").

Blended Benefits: LIBOR Replacement Provisions in CLOs

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Transactions in the collateralized loan obligation ("**CLO**") market have generally included some form of LIBOR replacement provisions for over a year, stemming from the announcement in July 2017 by Andrew Bailey, the head of the UK Financial Conduct Authority ("**FCA**"), that the FCA intended to phase out LIBOR in its present form by the end of 2021. Recently, a new iteration of LIBOR replacement mechanics has debuted. This latest iteration adapts language from the Alternative Reference Rates Committee's ("**ARRC**") May 31, 2019 recommended fallback language for new issuances of LIBOR securitizations,[1] resulting in these CLO provisions being viewed by some as "hardwiring" a replacement reference rate (based on a limited array of prioritized options) into CLO documents. However, while this approach does have an element of hardwiring, in that it specifies a fallback waterfall of particular replacement rates that can be implemented in the CLO without investor consent, the rate produced by the fallback waterfall—at least in the relevant CLO transactions in which Mayer Brown has been involved—is not automatically implemented as "pure" hardwiring would dictate.[2] Rather, the approach in these CLOs preserves discretion for the collateral manager, with the consent of specified classes of investors (typically a majority of the controlling class and frequently also a majority of the equity), to implement a replacement rate other than the rate produced by the fallback waterfall. Because the rate produced by the fallback waterfall (i.e. the "hardwired" rate) does not *automatically* replace LIBOR as the reference rate following a trigger event, this latest iteration blends a "hardwiring" approach with an "amendment" approach. We therefore refer to it as the "**Blended Approach**."

In our view, the Blended Approach achieves two positive outcomes for the CLO market: On the one hand, it signals an acceptance of SOFR as the preferred successor benchmark to LIBOR while, on the other hand, it preserves flexibility for the collateral manager to implement a different replacement reference rate with streamlined investor consent requirements following a disruption to LIBOR, a flexibility that can help avoid a basis mismatch with the reference rate prevailing in the CLO's portfolio at the time. We discuss these benefits in more detail below. Before doing so, we briefly look at how the Blended Approach updates the LIBOR replacement provisions otherwise prevailing in the CLO market and how the Blended Approach addresses value transfer and basis risk concerns.

The Amendment Approach to LIBOR Replacement in CLOs

The LIBOR replacement mechanics in CLOs that do not utilize the Blended Approach typically institute a reduced investor consent threshold for a supplemental indenture to change the reference rate applicable to the CLO's liabilities following a trigger event—including a complete elimination of investor consent if certain conditions are satisfied, as described below—with the collateral manager being the party responsible for selecting a replacement reference rate.[3] While there has been variation across the CLO market in some particulars of this approach, for simplicity we will refer to this approach as the "**Amendment Approach**."

Under many versions of the Amendment Approach, if the collateral manager selects a replacement reference rate that satisfies certain specified criteria (a "**Specified Rate**"), no investor consent is required to implement that replacement reference rate. The collateral manager may also select a replacement reference rate other than a Specified Rate, but the use of that other rate requires consent from a majority of the controlling class plus, frequently, consent from a majority of the equity.[4]

The primary evolution embodied in the Blended Approach is the replacement of the Specified Rate concept with a fallback waterfall of replacement reference rates based on the ARRC's fallback waterfall for new issuances of LIBOR securitizations (the "**ARRC-Based Waterfall**") that specifies a SOFR-based reference rate in the first and second instances as the replacement rate that can be implemented without investor consent,[5] while preserving the flexibility of the collateral manager (subject to a streamlined set of investor consents) to select a rate other than the one resulting from the ARRC-Based Waterfall.

Value Transfer and Basis Risk Considerations

Two of the central concerns that LIBOR succession mechanics aim to address are value transfer and basis risk. Based on current information about the loan market and the future of LIBOR, at this time we believe that the Blended Approach addresses these concerns in a way that, for CLO transactions, is superior to a "pure" hardwired approach that would automatically implement a predetermined successor reference rate following a trigger event.

Value transfer. First, automating the implementation of the replacement benchmark at the CLO level before the identity of the replacement benchmark is known at the underlying asset level may produce value transfer, because the replacement benchmark at the CLO level may favor either debt investors or equity investors relative to the rate being earned on the CLO's portfolio, and no class of investors will be able to prevent this value transfer because no class of investors will be entitled to consent rights in relation to the replacement benchmark (nor will the collateral manager have any ability to prevent implementation). The Blended Approach mitigates this problem because the collateral manager is not required to implement the rate produced by the ARRC-Based Waterfall but can implement another rate with investor consent. Nevertheless, the risk is not completely eliminated because value transfer could still result if the collateral manager elects to use the rate resulting from the ARRC-Based Waterfall, which the collateral manager is entitled to do without investor consent.[6]

The Blended Approach also mitigates value transfer as compared to the Amendment Approach in that the Blended Approach more precisely weds the selection of the spread modifier (often referred to as the "benchmark replacement adjustment") to the selection of the replacement base rate, thereby ensuring that the modifier and base rate are appropriately paired to create a rate that most closely approximates LIBOR.

Basis risk. Second, automating the implementation of the replacement benchmark at the CLO level before the identity of the replacement rate is known at the underlying asset level may produce basis risk because, if the fallback waterfall at the CLO level results in a replacement benchmark that is different from the one that is prevailing in the loan market at the time, there will be a mismatch between the interest rate that the CLO earns on its assets and the interest rate it must pay on its liabilities, which could reduce returns to the CLO's equity investors and potentially also adversely affect payments to one or more classes of the CLO's debt investors. Although current indications are that the consensus replacement benchmark in the loan market will be some form of SOFR (which would be consistent with the initial outputs of the ARRC-Based Waterfall), at this stage it remains unknown whether and, if so, when, SOFR will ultimately be the prevailing rate in the loan market.[7]

The Blended Approach mitigates basis risk by permitting the collateral manager (with specified investor consents) to implement a rate other than the rate produced by the ARRC-Based Waterfall, which the collateral manager could be expected to do if the loan market had adopted a different rate than the one produced by the ARRC-Based Waterfall. Since CLOs repackage loan exposures, there is a risk for CLOs in getting out in front of the loan market on benchmark replacement and committing to a specific replacement rate before the loan market does. And even if the replacement rates in the CLO market and the loan market ultimately end up being the same, a difference in the timing of the transitions in the respective markets could produce basis risk during the transition period. We believe that, in and of itself, favors the flexibility afforded by the Blended Approach.

To fully benefit from the mitigation of basis risk provided by the Blended Approach, we further recommend that market participants adopting the Blended Approach include a trigger event that occurs if a specified percentage (e.g., more than 50% by principal amount) of the loans in the CLO's portfolio use a benchmark other than LIBOR (an "**Asset Replacement Percentage**" concept), which is not uniformly included as a trigger by CLOs using the Amendment Approach. The Asset Replacement Percentage trigger can help to mitigate basis risk in the event that the loan market adopts a replacement benchmark before there has been a disruption to or cessation of LIBOR. In general, it would, of course, be a desirable outcome for the financial markets if the loan market adopts a successor benchmark before a LIBOR disruption occurs, but at the CLO level that would introduce basis risk if, due to the absence of a relevant pre-disruption trigger event, the CLO cannot respond through a streamlined amendment process to implement a benchmark replacement.

Conclusion: Benefits of the Blended Approach

While automatic implementation of a hardwired replacement rate following a disruption to LIBOR will undoubtedly be a desirable outcome in the CLO market in the future when there is certainty and complete information about the benchmark that will replace LIBOR in the loan market, the current environment is one of imperfect information. We believe that, in these circumstances and at this time, the Blended Approach for CLOs strikes a workable balance between signaling support for a SOFR-based replacement reference rate and preserving flexibility to mitigate basis risk and value transfer related to the replacement of LIBOR.

First, the Blended Approach signals to the CLO and loan markets an acceptance of SOFR as the preferred benchmark rate to replace LIBOR. It is desirable for the stability of the financial markets that they coalesce around a single replacement for LIBOR, and the Blended Approach indicates that the relevant CLO investors are comfortable enough with SOFR to accept it as a replacement rate at the CLO level without a requirement that investors give consent at the time of the transition. In fact, to be more specific, the Blended Approach signals that a SOFR-based benchmark will be acceptable to the relevant CLO investors as a replacement reference rate even if term SOFR is not available at the time of the transition. The fact that the Blended Approach is being adopted in some CLOs at a time when term SOFR is not currently available (other than as an indicative rate) demonstrates investor acceptance of the possibility that compounded SOFR, the second option in the ARRC-Based Waterfall after term SOFR, may be implemented in the CLO without investor consent.[8] This is a meaningful indication that SOFR is the preferred LIBOR replacement, even if term SOFR never materializes.

Second, it is a positive outcome for the CLO market, in our view, if the rate resulting from the "hardwired" ARRC-Based Waterfall is not automatically or necessarily implemented by the collateral manager. While the stability of the financial markets is a goal shared by CLO market participants, until there is greater certainty around the actual replacement benchmark that will be adopted by the loan market, we are concerned that committing CLOs to automatic benchmark replacement with a specified rate could produce an opposite, destabilizing result by causing a basis mismatch with the CLO's assets if the loan market has not yet transitioned to a successor rate or, worse, has implemented a different replacement rate. We believe that, to minimize basis risk, it is beneficial for CLO indentures to continue to include flexibility for the CLO to amend its reference rate to match the successor benchmark that ultimately prevails in the loan market.

Endnotes

1 The ARRC's recommended language is at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf.

2 It has come to our attention that there may have been CLO transactions issued after the original publication of this article in September 2019 that provided for a form of "pure" hardwiring such that if the replacement benchmark produced by the fallback waterfall is either term SOFR or compounded SOFR, that benchmark is automatically implemented. Mayer Brown has not been involved in transactions taking that approach and, for the reasons stated herein, we continue to believe that—at this time—"pure" hardwiring presents a greater risk of value transfer and basis mismatch than the Blended Approach and, therefore, the Blended Approach remains the preferable approach to LIBOR replacement in CLOs.

3 In the absence of such mechanics, a change to the reference rate would generally be expected to require the consent of 100% of the holders of every class of securities.

4 In many CLOs using the Amendment Approach, the Specified Rate is defined as the rate recognized or acknowledged by the Loan Syndications & Trading Association or ARRC, the rate used by 50% or more of the floating rate assets in the CLO portfolio or the rate used by 50% or more of new issue CLO liabilities issued over a specified lookback period.

5 The first replacement benchmark specified by the ARRC-Based Waterfall of replacement reference rates used in the Blended Approach is term SOFR (plus a spread modifier). If term SOFR is not available, the next replacement benchmark specified is compounded SOFR (plus a spread modifier). Since spot SOFR already exists, compounded SOFR already exists as well, making it unlikely that any of the other benchmarks included in the ARRC-Based Waterfall will come into play.

6 Market participants could consider modifications to the Blended Approach in order to further mitigate the risks of value transfer and basis mismatch. For example, the CLO indenture could grant an objection right to one or more classes of investors that applies if a specified percentage (e.g., more than 50% by principal amount) of loans in the CLO's portfolio are accruing interest based on a benchmark rate that is different from the rate resulting from the application of the ARRC-Based Waterfall. Alternatively, in lieu of investor objection rights, the ARRC-Based Waterfall could be modified to provide that if a specified percentage of loans in the CLO's portfolio are accruing interest based on a benchmark rate that is different from the rate that would otherwise result from the application of the ARRC-Based Waterfall, the rate prevailing among the loans in the CLO's portfolio would instead be the benchmark that could be implemented by the collateral manager without investor consent. Another possibility is that the collateral manager could be given discretion not only to implement a replacement rate other than the rate produced by the ARRC-Based Waterfall but also to defer implementation of a replacement rate until a specified percentage of loans in the CLO's portfolio were accruing interest based on a benchmark rate other than LIBOR.

7 Unlike some forms of traditional securitization that may be more suited to automated benchmark replacement provisions, CLOs have little control over the benchmark that will apply to the CLO assets, which, in the case of most CLOs of broadly syndicated loans, are purchased in the open market from third parties. Credit agreements in the broadly syndicated loan market have not yet implemented hardwired benchmark replacement mechanics that will prescribe SOFR as the successor rate to LIBOR but instead are generally adopting an amendment approach that requires lender consent to implement a replacement. To the extent that CLOs hold minority positions in loan facilities, CLOs will not necessarily be able to control the identity of the replacement rate selected by lenders if replacement dœs not require the unanimous vote of the lenders. Additionally, new information may arise or new developments may occur that could cause the loan market to implement a consensus replacement benchmark other than SOFR.

8 Presumably, a reputable collateral manager would not implement compounded SOFR if a SOFR-based benchmark were not prevailing in the loan market at the time, but the fact remains that under the Blended Approach, investors do cede control in relation to the implementation of the rate produced by the ARRC-Based Waterfall. If the collateral manager is unable to garner approval for a given alternative rate from investors at both the top and bottom of the CLO capital stack, investors could be stuck with SOFR even if a better alternative were available at the time.

More US Regulators Make LIBOR Transition Preparedness an Examination Priority

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Within the last week, both the US Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) and the Financial Industry Regulatory Authority (FINRA) have issued their 2020 annual report or letter[1] for their respective examination priorities and each included London Interbank Offered Rate (LIBOR) preparedness as a priority for examination.

The OCIE report includes the following (at p. 5):

> OCIE will . . . closely track and evaluate the impact of several major risk themes affecting its registrant population, including . . . the industry's transition away from LIBOR.

The OCIE report also includes the following (at pp.8-9; emphasis added):

> OCIE's analytic efforts and examinations remain firmly grounded in its four pillars: promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy. The risk-based approach, both in selecting registrants as examination candidates and in scoping risk areas to examine, provides OCIE with greater flexibility to cover emerging and exigent risks to investors and the marketplace as they arise. For example, as our registrants and other market participants transition away from LIBOR as a widely used reference rate in a number of financial instruments to an alternative reference rate, *OCIE will be reviewing firms' preparations and disclosures regarding their readiness, particularly in relation to the transition's effects on investors. Some registrants have already begun this effort and OCIE encourages each registrant to evaluate its organization's and clients' exposure to LIBOR, not just in the context of fallback language in contracts, but its use in benchmarks and indices; accounting systems; risk models; and client reporting, among other areas. Insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants.*

OCIE's commentary about the LIBOR transition echoes, in part, the guidance and concerns voiced by SEC staff in a June 2019 Public Statement: https://www.sec.gov/news/public-statement/libor-transition.

The FINRA letter states:

> FINRA will engage with firms—outside the examination program—to understand how the industry is preparing for LIBOR's retirement at the end of 2021, focusing on firms' exposure to LIBOR-linked financial products; steps firms are taking to plan for the transition away from LIBOR to alternative rates, such as the Secured Overnight Financing Rate (SOFR); and the impact of the LIBOR phase-out on customers.

Given the continued and increased focus by regulators on LIBOR transition preparation, SEC registrants and other market participants should carefully review the regulators' statements on this topic and take timely and appropriate actions in response.

Endnotes

1 The OCIE report is available at: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf and the FINRA letter is available at: https://www.finra.org/rules-guidance/communications-firms/2020-risk-monitoring-and-examination-priorities-letter.

Going Through Changes: Transitioning to a LIBOR-less World for Consumer Loans

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It is widely anticipated that the London Interbank Offered Rate ("LIBOR") will be discontinued in 2021. As LIBOR commonly is used as an index rate for both residential mortgage and consumer loans, its discontinuance has the potential to have a significant impact on lenders, servicers, and consumers. Since 2014, industry leaders have been working to settle on an alternative index and transition plan to minimize the disruption of the move away from LIBOR. Through its efforts, the Alternative Reference Rates Committee ("ARRC")[1] has identified a newly created rate, the Secured Overnight Financing Rate ("SOFR"), as a suitable LIBOR replacement and has established a SOFR implementation framework.

Significantly, however, ARRC has primarily focused on future originations. The question of how holders and servicers of the roughly $1.2 trillion of legacy consumer purpose adjustable-rate mortgages that use LIBOR as the index should proceed in a LIBOR-less world has largely gone unanswered.[2] Concerns over the coming transition have prompted the New York Department of Financial Services ("NYDFS") to request that regulated entities prepare and deliver a plan to address LIBOR cessation and transition risk, with a deadline of March 23, 2020.[3]

In this Legal Update, we discuss the legal and regulatory issues that industry participants, regulators, and courts will face in order to navigate the transition away from LIBOR, both with respect to new originations and legacy loans.

SOFR Implementation in New Originations

SOFR is a broad measure of the cost of borrowing cash overnight collateralized by US Treasury securities. The Federal Reserve Bank of New York publishes SOFR on its website each business day at approximately 8:00 a.m.[4] The ARRC described several of the benefits of SOFR in a published whitepaper, including that it is produced for the public good, is based on an active and well-defined market and is produced in a transparent manner based on observable transactions, rather than on estimates or models.[5] These traits make SOFR an attractive option, from a consumer protection standpoint, for consumer and residential mortgage loans, particularly in comparison to LIBOR, which has proven to be subject to manipulation.

The ARRC presented a number of recommendations with respect to the use of SOFR in newly originated, consumer purpose adjustable rate mortgages ("ARMs"), including:

- Using either a 30- or 90-day SOFR average to set rates, which will mitigate the risks of unusual single day fluctuations. While these averages are not currently being published, the Federal Reserve Bank of New York has indicated it will begin publishing SOFR averages in the first half of 2020.[6]
- Setting the adjusted interest rate by reference to an average of SOFR observed in advance of the period to which such adjusted interest rate pertains.[7]
- Adjusting the rate of SOFR-based ARMs twice a year, rather than the once per year common to current ARMs based on a LIBOR index.[8] Allowing rates to adjust on a more frequent basis should address potential investor concerns that setting the interest rate in advance may result in off-market interest rates.
- Restructuring interest rate caps to have a one percent periodic adjustment cap (rather than the two percent periodic adjustment cap most common today) to offset the potential increased payment shock risk to borrowers related to the increase in adjustment frequency.[9] As, under the ARRC model, interest rates will adjust twice per year, a one percent cap per adjustment under the new system will essentially equate to the current system's two percent cap annually.

In order to better accommodate future index substitutions, ARRC has suggested changes to standard agency (i.e., Fannie Mae and Freddie Mac) ARM agreements that can be implemented in new originations in order to clarify when and how index references can be amended.[10] ARRC has identified two "triggers" that would permit replacement of an index: (i) the administrator of the index called for by the note has permanently stopped providing the index to the public or (ii) the administrator (or the regulator with authority over such administrator) issues an official public statement that the index is no longer reliable or representative.[11] If either of these triggering events were to occur, the new index would be an index selected by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York (or a committee endorsed or convened by one of those entities). If one of those entities has not selected a new index, the note would provide for the holder to "make a reasonable, good faith effort to select" a replacement index and margin that, taken together, the holder of the note "reasonably expects will minimize any change in the cost of the loan, taking into account the historical performance of" both the original index and the replacement index.[12]

SOFR Substitution

One of the difficulties raised by the discontinuance of LIBOR is the sheer number of existing agreements that use LIBOR as an index, but do not clearly describe what should happen if the rate is no longer available. ARRC has noted that most contracts referencing LIBOR do not contemplate a permanent end to a published LIBOR.[13] Fortunately, residential mortgage loans – particularly "agency" mortgage loans that are eligible to be purchased by government-sponsored enterprises – typically give the noteholder the authority to name a successor index so long as it is based on "comparable information," although they provide little procedural guidance on how to identify and implement such a replacement.

There is no federal consumer financial law that expressly prohibits a servicer or noteholder from substituting one index for another. The CFPB's Regulation Z merely provides that a servicer must provide the borrower advance notice of a change in payment as a result of a rate adjustment, and disclose the index used and any adjustments to it.[14] Regulation Z does not bar a servicer or noteholder from changing the index nor does it impose any duty to use a replacement index and margin that provides for a similar rate of interest as the original index.[15] Nevertheless, servicers and noteholders should be mindful of legal and regulatory issues in the transition process. In a December 2019 letter to regulated financial institutions, the NYDFS noted that "changing the interest rate basis of any consumer loan presents various risks, such as legal, reputational and operational risks, that need to be carefully considered and managed."[16]

The road to a successful transition from LIBOR may be less bumpy for servicers of ARMs that are based on the FNMA/FHMLC uniform instruments. The uniform notes provide the holder a contractual right to substitute a new index based on "comparable information" should the original contracted-for index become unavailable.[17] However, the notes do not define "comparable information" or provide greater color as to when an index is based on "comparable information" to the original index. It is expected that Fannie Mae and Freddie Mac will resolve this uncertainty by issuing guidance that SOFR (or a spread-adjusted variant thereof) constitutes an index that is based on "comparable information," which would provide a contractual basis for servicers and noteholders of agency loans to transition existing ARMs from LIBOR to SOFR. This guidance also would be persuasive (although not binding) with respect to legacy ARMs that are not agency loans, but nonetheless use the uniform documents.

Even the presence of the contractual language in the uniform notes does not completely eliminate roadblocks to the transition away from LIBOR. The uniform notes grant noteholders the right to change the index, but do not expressly address the margin in the event the contracted-for index ceases to exist. SOFR is a secured rate, whereas LIBOR is unsecured; the consequence is that "because SOFR is secured and nearly risk-free, it is expected to be lower than LIBOR and may stay flat (or potentially even decline) in periods of severe credit market stress."[18] Thus, were a noteholder to substitute SOFR by itself, without amending the margin, it likely would receive interest at a lower rate than under LIBOR. Aggregated across the entire universe of adjustable-rate mortgage debt, the potential shortfall between expected returns on LIBOR-indexed loans and those under SOFR is an issue to consider.[19] The ARRC has addressed this issue through its anticipated issuance of a "spread-adjusted" SOFR index "that reflects and adjusts for the differences between LIBOR and SOFR; thus, minimizing the impact to the borrower's interest rate at resets."[20] In addition, the ARRC's proposed "fallback" language, which lenders may include in their promissory notes in future ARM originations, contemplate the noteholder adjusting the margin to mimic the economics of LIBOR.[21]

Noteholders and servicers whose adjustable-rate mortgage notes do not provide contractual authority to replace the index face a more difficult transition. In the absence of "fallback" language in the note that specifically authorizes the noteholder to substitute a comparable index, noteholders and servicers could amend the original loan agreement, with the borrower's consent, to provide for SOFR as the index. That said, drafting amendments to each adjustable-rate mortgage loan held by the noteholder (or serviced by the servicer), obtaining each borrower's consent, and tracking which borrowers have authorized the servicer or noteholder to substitute SOFR is likely to be a burdensome administrative and business process effort. And it is possible that a borrower will withhold his or her consent or refuse to accept an amendment designating SOFR as the replacement index.

Significantly, however, noteholders and servicers of contracts governed by New York law may have an additional "out" even if the ARM loan agreement is silent on whether the index may be substituted. The ARRC noted in November 2019 that it will explore a legislative fix under New York state law to address the LIBOR transition for loans that lack contractual provisions addressing cessation of LIBOR.[22] However, the scope of this proposed legislation is limited to contracts that provide for New York law as governing the loan agreement, and many legacy consumer loan promissory notes likely are not governed by New York law. Because the legislation has not yet been drafted, noteholders and servicers may wish to monitor the process and provide comments to the ARRC as necessary.

Finally, the Mortgage Bankers Association ("MBA") has adopted a model disclosure for consumers *applying* for an adjustable-rate mortgage in advance of the transition; the MBA is developing a separate template disclosure for use by lenders to provide borrowers with existing ARMs indexed to LIBOR.[23] It is unclear whether this model disclosure will be purely informational or tailored to borrowers on loans without "fallback" language.

Transition Planning

In December 2019, the NYDFS sent a letter to regulated financial institutions requesting that the institutions describe their transition plans in writing by February 7, 2020. In January 2020, the NYDFS extended that deadline by 45 days to March 23, 2020.

The NYDFS has requested that institutions address the following:

- Programs that would identify, measure, monitor and manage all financial and non-financial risks of transition;

- Processes for analyzing and assessing alternative rates, and the potential associated benefits and risks of such rates both for the institution and its customers and counterparties;
- Processes for communications with customers and counterparties;
- A process and plan for operational readiness, including related accounting, tax and reporting aspects of such transition; and
- The governance framework, including oversight by the board of directors, or the equivalent governing authority, of the regulated institution.[24]

Other state regulators may follow NYDFS's lead and demand that servicers and/or noteholders assess their LIBOR risk and create a transition plan. It does not appear that the NYDFS intends to prescribe how regulated institutions should transition from LIBOR; instead, the focus appears to be on the need to engage in robust transition planning with the development and implementation of well-considered policies and procedures.

Conclusion

LIBOR will continue to be a valid index up to its termination in 2021. Nonetheless, lenders, servicers, and noteholders should plan for an orderly transition well in advance. This may include assessing the types of loans held or serviced, surveying the contractual language related to the index and margin, and planning for communications with affected borrowers. In the meantime, servicers and noteholders with legacy adjustable-rate loans should carefully monitor issuances from the ARRC and guidance from regulators and government-sponsored entities.

Endnotes

1 ARRC is a group convened by the Federal Reserve Board of New York, comprising both public and private sector entities. ARRC has been tasked with ensuring a successful transition from US dollar LIBOR to a more robust reference rate.

2 See Second Report, Alternative Reference Rates Committee (Mar. 2018) at 33, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

3 Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, New York Department of Financial Services (Dec. 23, 2019), available at https://dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf and Re: Request for Assurance of Preparedness for LIBOR Transition (Update), New York Department of Financial Services (Jan. 23, 2020), available at https://www.dfs.ny.gov/system/files/documents/2020/01/il20200123_libor_update.pdf.

4 Available at https://apps.newyorkfed.org/markets/autorates/sofr.

5 Options for Using SOFR in Adjustable Rate Mortgages, Alternative References Rates Committee (Jul. 2019) at 5, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf.

6 Statement Requesting Public Comment on a Proposed Publication of SOFR Averages and a SOFR Index (Nov. 4, 2019), available at https://www.newyorkfed.org/markets/opolicy/operating_policy_191104.

7 Options for Using SOFR in Adjustable Rate Mortgages, Alternative References Rates Committee (Jul. 2019) at 8, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf.

8 Id. at 9.

9 Id. at 11.

10 See ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages, Federal Reserve Bank of New York (Nov. 15, 2019), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf.

11 Id. at 7.

12 Id. at 10.

13 Second Report, Alternative Reference Rates Committee (Mar. 2018) at 27, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

14 12 C.F.R. § 1026.20(c).

15 Of course, the lender must have accurately disclosed the index in the original TILA disclosures at consummation.

16 Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, New York Department of Financial Services (Dec. 23, 2019), available at https://dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf.

17 See https://www.fanniemæ.com/singlefamily/notes for relevant examples.

18 ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages, Federal Reserve Bank of New York (Jul. 12, 2019) at 4, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-ARM-consultation.pdf.

19 The ARRC's model projected SOFR ARMs to have a margin between 2.75% and 3%, versus 2.25% for LIBOR ARMs. See Options for Using SOFR in Adjustable Rate Mortgages, Alternative References Rates Committee (Jul. 2019) at 13 ("based on historical data, a margin in the range of 2.75 to 3 percent would have resulted in SOFR-based loans resetting to a rate approximately equivalent to that of current products.").

20 Id. at 8.

21 See ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages, Federal Reserve Bank of New York (Nov. 15, 2019) at 15, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf.

22 https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2019/ARRC-Minutes-Nov-2019.pdf.

23 MBA Releases Lender Disclosure Template for Adjustable-Rate Mortgage Borrowers in Preparation for LIBOR Sunset, Mortgage Bankers Ass'n (Jun. 6, 2019), available at https://www.mba.org/2019-press-releases/june/mba-releases-lender-disclosure-template-for-adjustable-rate-mortgage-borrowers-in-preparation-for-libor-sunset.

24 Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, New York Department of Financial Services (Dec. 23, 2019), available at https://dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf.

Volcker Rule Revisions Adopted by Agencies

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The US federal banking and functional regulators ("Agencies")[1] have finalized revisions to the proprietary trading and compliance program provisions of the Volcker Rule (the "2019 Revisions").[2] The 2019 Revisions implement some, though not all, of the changes that had been proposed by the Agencies in a May 2018 notice of proposed rulemaking ("2018 Proposal").[3]

Subject to the statutory constraints, the 2019 Revisions are intended to (i) establish a more risk-based approach to Volcker Rule compliance, (ii) make the implementation of the regulation more efficient and less burdensome by reducing its complexity and (iii) update the existing regulations to reflect the experiences of the industry and the regulators. While the 2019 Revisions address many of the implementation and compliance issues raised by the proprietary trading and compliance program sections of the current regulation and some issues related to covered funds, the Agencies have indicated that they intend to issue a notice of proposed rulemaking at a later date to address additional significant changes that they are considering for covered funds.[4]

The 2019 Revisions become effective on January 1, 2020, and compliance will be required on January 1, 2021, although there is an option for early adoption after the effective date.

I. Tailored Compliance Requirements

The 2019 Revisions tailor the application of the Volcker Rule by creating categories of banking entities based on their levels of trading activity. Specifically, banking entities are divided into the following categories:

- Entities with "significant trading assets and liabilities," meaning consolidated gross trading assets and liabilities of at least $20 billion (excluding obligations of or guaranteed by the United States, any agency of the United States or any US government-sponsored enterprise), which is an increase from the $10 billion thresh-old set forth in the 2018 Proposal;

- Entities with "moderate trading assets and liabilities," meaning consolidated gross trading assets and liabilities of less than $20 billion, but greater than or equal to $1 billion; and
- Entities with "limited trading assets and liabilities," meaning consolidated gross trading assets and liabilities of less than $1 billion.[5]

Non-US banking entities determine their level of trading assets and liabilities by reference to the aggregate assets of their combined US operations ("CUSO"). This is a change from the 2018 Proposal, which would have required non-US banking entities to use aggregate assets of their worldwide operations to determine if they had limited trading assets and liabilities.

Therefore, under the 2019 Revisions, non-US banking groups will be subject to the most onerous Volcker Rule compliance obligations only if CUSO trading assets and liabilities equal or exceed $20 billion. Non-US banking groups with CUSO trading assets and liabilities that equal or exceed $1 billion but are less than $20 billion will be in the moderate trading assets and liabilities category. Non-US banking groups with CUSO trading assets and liabilities of less than $1 billion will be in the limited trading assets and liabilities category.

Banking entities with significant trading assets and liabilities are required to have a comprehensive six-pillar Volcker Rule compliance program similar to that required by the current regulation. Banking entities with moderate trading assets and liabilities are subject to reduced compliance obligations tailored to their trading activities. Banking entities with limited trading assets and liabilities are presumed to be in compliance with the Volcker Rule unless an Agency determines that they were engaged in a prohibited activity and overcomes the presumption of compliance. The Agencies also have the authority under _.20(h) to apply additional requirements to a banking entity with moderate or limited trading assets and liabilities by making an individualized determination following notice and response procedures.

While the stratification of banking entities is based solely on the banking entity's trading assets and liabilities, the applicable level of compliance program obligations resulting from that trading measure apply equally to covered fund activities. Therefore, banking entities with "significant" trading operations will be subject to the most onerous compliance program requirements not only with respect to their trading activities, but also with respect to their covered fund activities. Likewise, banking entities with only "moderate" or "limited" trading activities are eligible for reduced compliance obligations with respect to both their trading and covered fund activities.

The implications of the stratification of banking entities into categories based on their trading assets and liabilities is discussed in more detail below in Part IV.

II. Proprietary Trading

A. CHANGES TO "TRADING ACCOUNT" DEFINITION

The 2019 Revisions significantly revise the definition of a "trading account" by modifying one of the three prongs in the current definition and inverting the related 60-day rebuttable presumption of proprietary trading.[6] The 2019 Revisions do **not** adopt the accounting prong from the 2018 Proposal, which was subject to considerable industry criticism, nor do they modify the market risk capital rule prong of the current definition.

1. Narrowing of the Application of the Short-Term Intent Prong

The 2019 Revisions retain the "short-term intent" prong (subparagraph _.3(b)(i) of the definition of trading account). Rather than replace the short-term intent prong with an "accounting prong" as had been proposed, the 2019 Revisions narrow the application of the short-term intent prong so that it applies only to banking entities that are not subject to the market risk capital rule prong and have not elected to comply with the market risk capital rule prong for purposes of the Volcker Rule. The Agencies indicate that the short-term intent prong was intended to cover a substantially similar scope of activities as the market risk capital rule prong, and therefore, there is no reason to apply both prongs to the same banking entity.

The market risk capital rule is a part of the regulatory capital requirements that applies to US bank and savings and loan holding companies and US insured depository institutions with aggregate trading assets and liabilities that exceed either 10 percent of their total assets or $1 billion. It requires covered institutions, which typically are larger banking entities, to measure and hold capital to cover their exposure to market risk. Such required market risk capital coverage is in addition to the capital those institutions are required to hold under the regulatory capital requirements to cover other types of risk.

Under the 2019 Revisions, a banking entity that is not subject to the US market risk capital rule, either (i) because its aggregate trading assets and liabilities do not exceed the relevant thresholds or (ii) because it is a non-US banking entity, may elect to evaluate its purchases and sales of financial instruments for purposes of the Volcker Rule as if the banking entity were subject to the market risk capital rule.

A banking entity that makes the election will need to determine if each purchase or sale of a financial instrument is both a covered position and a trading position under the market risk capital rule. If a purchase or sale of a financial instrument is a covered position and a trading position under the market risk capital rule, then it will be deemed for the banking entity's trading account under the market risk capital prong of the Volcker Rule and potentially subject to the prohibition against proprietary trading. A non-US banking entity that elects to apply the market risk capital rule prong for Volcker Rule purposes presumably will need to build out the infrastructure necessary to identify the purchases and sales of financial instruments that will be subject to the Volcker Rule under the US market risk capital rule.

A banking entity that elects to comply with the market risk capital prong will be required to apply the market risk capital rule prong to all of its wholly-owned subsidiaries to ensure consistent application of the trading account definition. This option will provide smaller and non-US banking entities with greater flexibility in structuring their Volcker Rule compliance programs.

2. Inverting the 60-Day Presumption

The 2019 Revisions effectively invert the existing rebuttable presumption that holding a financial instrument or related risk for fewer than 60 days is prohibited proprietary trading (subparagraph_.3(b)(2)) and replace it with a new presumption that financial instruments that are held (and have their risk held) for 60 days or more are not within the short-term intent prong. This new presumption would not be available to banking entities that are subject to or have elected to be subject to the market risk capital rule prong. This change appears to have been based on industry feedback on the existing presumption and proposed changes, and the Agencies' decision not to eliminate the short-term intent prong.

B. MARKET RISK PARITY EXCLUSION

The 2019 Revisions add a new exclusion for any purchase or sale of a financial instrument that does not meet the definition of a "trading asset" or "trading liability" under the reporting requirements of the market risk capital rule. Therefore, banking entities that are subject to the short-term intent prong or dealer prong will be permitted to exclude instruments that are excluded from the market risk capital rule, even though the market risk capital rule prong may not apply to the banking entity.

C. EXPANSION OF LIQUIDITY MANAGEMENT EXCLUSION

The 2019 Revisions expand the current liquidity management exclusion to the proprietary trading prohibition by allowing banking entities to use certain financial instruments that are not "securities" as part of liquidity management activities. Thus, banking entities clearly are authorized to use foreign exchange forwards, foreign exchange swaps and physically settled cross-currency swaps for liquidity management purposes if these are entered into in accordance with a documented liquidity management plan and comply with the other requirements of the current liquidity management exclusion for securities. In addition, the 2019 Revisions expand on the 2018 Proposal by authorizing banking entities to use non-deliverable cross-currency swaps for liquidity management purposes.

D. ERROR CORRECTION EXCLUSION

The 2019 Revisions adopt the proposed exclusion to the proprietary trading prohibition for purchases or sales of financial instruments that (i) were made in error while the banking entity was engaged in a permitted or excluded activity or (ii) are undertaken to correct such an error. The Agencies expect banking entities will make reasonable efforts to prevent errors from occurring, and the exclusion is available only if relevant facts and circumstances indicate that the trade was truly made in error. Citing duplicative and undue costs, however, the Agencies decided against adopting a provision in the 2018 Proposal that would have required the banking entity to transfer erroneously acquired financial instruments to a separately managed trade error account for disposition by personnel who are independent from the traders who made the initial error.

E. MATCHED DERIVATIVES EXCLUSION

The 2019 Revisions add a new exclusion to the proprietary trading prohibition for purchases or sales of financial instruments in matched swap or security-based swap transactions involving a customer-driven transaction if (i) the matching transactions are entered into contemporaneously; (ii) the banking entity retains no more than minimal price risk; and (iii) the banking entity is not registered as a dealer, swap dealer, or security-based swap dealer. This exclusion originated from the Agencies' review of industry feedback on the difficulty associated with engaging in loan-related swaps and related hedges when the market making exemption is not clearly available to a banking entity.

While the 2019 Revisions do not explicitly address loan-related swaps, the preamble discussion indicates that the Agencies expect (i) matched loan-related swaps will qualify for the new matched derivatives exclusion and (ii) unmatched loan-related swaps will not come within the revised definition of the trading account. Additionally, the new matched derivatives exclusion is not limited to loan-related swaps and is available in connection with any customer's end-user activity.

F. MORTGAGE SERVICING RIGHTS AND ASSETS EXCLUSION

The 2019 Revisions also add a new exclusion for purchases or sales of financial instruments that are used to hedge a banking entity's mortgage servicing rights or assets under the entity's hedging strategy. As with the market risk parity exclusion, this new exclusion permits banking entities that are subject to the short-term intent prong or dealer prong to exclude mortgage servicing rights and assets from the proprietary trading prohibition. The rationale behind this exclusion is to make the short-term intent prong consistent with the market risk capital prong, which already excludes such rights and assets.

G. RESERVATION OF AUTHORITY

The 2018 Proposal would have added a reservation of authority to the Volcker Rule that would have allowed an Agency to determine on a case-by-case basis and subject to notice-and-response that a particular purchase or sale of a financial instrument either was or was not for the trading account. As part of the 2019 Revisions, the Agencies determined that they would not add a reservation of authority because it was unnecessary in light of other changes made in the final rule. However, as noted above, the Agencies reserve the authority to apply additional requirements to the proprietary trading or covered fund activities of a banking entity that has moderate or limited trading assets and liabilities.

H. "TRADING DESK" DEFINITION

Certain aspects of the Volcker Rule apply at the "trading desk"-level of a banking entity. The 2019 Revisions modify the definition of a "trading desk," which currently is defined as the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate. The 2019 Revisions replace that definition with a multi-factor definition that aligns the definition of trading desk in the Volcker Rule with the definition in the Basel Committee on Banking Supervision's minimum capital requirements for market risk.

Under the 2019 Revisions, a trading desk is a unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof that is:

i. Structured by the banking entity to implement a well-defined business strategy;
ii. Organized to ensure appropriate setting, monitoring, and management review of the desk's trading and hedging limits, current and potential future loss exposures, and strategies; and
iii. Characterized by a clearly defined unit that:
    a. Engages in coordinated trading activity with a unified approach to its key elements;
    b. Operates subject to a common and calibrated set of risk metrics, risk levels, and joint trading limits;
    c. Submits compliance reports and other information as a unit for monitoring by management; and
    d. Books its trades together.

However, for a banking entity that calculates risk-based capital ratios under the market risk capital rule (or its consolidated affiliate), a trading desk is the unit of organization that is established by the banking entity or its affiliate for purposes of market risk capital calculations under the market risk capital rule.

I. CHANGES TO THE UNDERWRITING AND MARKET-MAKING EXEMPTIONS

The 2019 Revisions retain the current requirement that a trading desk's positions established in reliance on the underwriting and market-making exemptions in _.4 cannot exceed the reasonably expected near-term demands ("RENTD") of clients, customers and counterparties. Under the 2019 Revisions, however, compliance with the RENTD condition is presumed, under new section _.4(c), if a banking entity establishes, implements, maintains, and enforces internal limits for each trading desk.

As revised, the underwriting exemption continues to require that the banking entity establish, implement, maintain, and enforce internal limits for each trading desk based on the: (i) amount, types and risk of its underwriting position; (ii) level of exposures to relevant risk factors arising from its underwriting position; and (iii) period of time a security may be held. For the market-making exemption, the banking entity continues to be required to establish internal limits for each trading desk based on the: (i) amount, types and risk of its market maker positions; (ii) amount, types and risks of the products, instruments and exposures the trading desk may use for risk management purposes; (iii) level of exposures to relevant risk factors arising from its financial exposure; and (iv) period of time a financial instrument may be held. The processes for setting and reviewing trading desk-level limits should continue to be subject to internal policies and procedures. However, the 2019 Revisions, unlike the 2018

Proposal, do not require banking entities to report limit increases or breaches to the appropriate Agency. The Agencies retain authority to oversee and review internal risk limits and may refute the presumption of compliance if facts and circumstances indicate that the banking entity is engaging in an activity that is not based on the trading desk's RENTD. Additionally, banking entities are expected to take action as promptly as possible after a limit breach to bring the trading desk into compliance and to establish and follow written procedures for handling limit increases or breaches.

Banking entities with significant trading assets and liabilities are required to have a compliance program under subpart D for underwriting and market-making activities (i.e., reasonably designed written policies and procedures, internal controls, analyses and independent testing identifying and addressing products, instruments, exposures, limits, authorization and escalation related to the trading desk's exempted activities). Banking entities with moderate trading assets and liabilities are not required to have an exemption-specific compliance program, but must still comply with the terms of the exemption. Banking entities with limited trading assets and liabilities are presumed to comply with the Volcker Rule and are not required to have a Volcker Rule compliance program.

J. MARKET-MAKING HEDGING AND INTER-AFFILIATE TRADING ACTIVITY

The 2018 Proposal requested comment on whether affiliated trading desks should be permitted to treat each other as a client, customer or counterparty for purposes of establishing internal risk limits or RENTD levels under the market-making exemption. Alternatively, the Agencies sought comment on whether one desk should be allowed to treat a transaction as permissible market-making and the other, affiliated desk treat the same transaction as a risk-mitigating hedge.

The 2019 Revisions do not contain changes addressing market-making hedging. However, the Agencies indicated in the preamble to the 2019 Revisions that a trading desk (i) may undertake market-making risk management activities for one or more affiliated trading desks and (ii) may rely on the exemption for market making-related activities for its transactions with affiliated trading desks. The Agencies also clarify that banking entities may not treat affiliated trading desks as "clients, customers, or counterparties" for purposes of determining a trading desk's RENTD under the exemption for market making-related activities, but may engage in other permitted transactions with affiliated trading desks.

K. EASING THE CONDITIONS OF THE RISK-MITIGATING HEDGING EXEMPTION

The 2019 Revisions include four significant changes to the risk-mitigating hedging exemption, which together relax the eligibility restrictions and compliance obligations for banking entities relying on the exemption:

- The Agencies have eliminated the correlation analysis requirement.
- They also have eliminated the requirement to show that a hedge "demonstrably reduces or otherwise significantly mitigates" an identifiable risk, instead, a banking

entity need only show that the hedge "may reasonably be expected to reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged."

- As with the underwriting and market-making exemptions, only banking entities with significant trading assets and liabilities are required to have a compliance program under subpart D.[7]
- The Agencies have eliminated certain documentation requirements for banking entities with significant trading assets and liabilities that rely on the risk-mitigating hedging exemption.

Accordingly, as revised, banking entities with significant trading assets and liabilities are not required to comply with enhanced documentation requirements with respect to common types of hedging transactions that are listed on a pre-approved list of financial instruments and comply with pre-approved hedging limits.

L. LIBERALIZED TOTUS EXEMPTION

The 2019 Revisions also ease the conditions imposed on non-US banking entities seeking to rely on the exemption for "trading that occurs solely outside of the United States" or the "TOTUS" exemption. Specifically, the 2019 Revisions remove the requirements that (i) no financing for the banking entity's purchase or sale be provided by any US branch or affiliate of the banking entity and (ii) the purchase or sale generally not be conducted with or through any US entity.[8] Accordingly, non-US banking entities otherwise in compliance with the requirements of the TOTUS exemption may trade with and through unaffiliated US counterparties and US intermediaries (e.g., with US securities or derivatives counterparties and through US broker-dealers or US swap dealers).

The 2019 Revisions also amend the US-based personnel restriction so that it applies only to personnel engaged in the non-US banking entity's decision to purchase or sell the financial instrument and, therefore, no longer applies to (i) the non-US banking entity's personnel engaged solely in arranging, negotiating and executing trades or (ii) any personnel of the non-US banking entity's counterparty.

III. Compliance Program, Reporting and Recordkeeping

A. TAILORING OF GENERAL COMPLIANCE PROGRAM REQUIREMENTS

The 2019 Revisions revise the general compliance program requirements so that banking entities with:

i. significant trading assets and liabilities remain subject to the comprehensive compliance program requirements (including the CEO attestation requirement);

ii. moderate trading assets and liabilities are subject to a simplified compliance program requirement that does not include a CEO attestation requirement; and

iii. limited trading assets and liabilities have no compliance program requirements because they are presumed to be in compliance with the Volcker Rule.[9]

The Agencies retain the authority to require (i) a banking entity with limited trading assets and liabilities to implement a compliance program if an Agency determines, following notice and response, that the entity is engaged in prohibited proprietary trading or covered fund activity and (ii) a banking entity with limited or moderate trading assets and liabilities to comply with additional requirements if an Agency determines, following notice and response, that the size or complexity of the banking entity's trading or investment activities (or the risk of evasion) warrants doing so.

Among other impacts, this new structure has the effect of eliminating the covered fund documentation requirement for banking entities with moderate trading assets and liabilities, all of whom, under 2019 Revisions, are permitted to rely on the simplified compliance program requirement previously available to a more limited set of banking entities. This simplified compliance program generally consists of including appropriate references to Volcker Rule compliance in pre-existing policies and procedures.

B. RESTRUCTURING OF APPENDIX B ENHANCED MINIMUM STANDARDS FOR COMPLIANCE PROGRAMS

The 2019 Revisions eliminate the enhanced minimum standards for large banking entities and banking entities engaged in significant trading activities as being unnecessary in light of current compliance and risk management efforts and because banking entities may individually tailor their compliance programs to achieve the same level of compliance. The 2018 Proposal included a chart showing how the compliance program requirements would change from the current Volcker Rule, which is updated for the 2019 Revisions and reproduced as Appendix A to this update.

C. MODIFIED CEO ATTESTATION REQUIREMENT

Notwithstanding considerable criticism of the requirement that a banking entity's CEO must review and annually attest in writing that the banking entity has implemented an appropriate Volcker Rule compliance program, the 2019 Revisions retain a CEO attestation requirement for banking entities with significant trading assets and liabilities. This is a significant change from the 2018 Proposal, however, which would have required a CEO attestation for all banking entities other than those with limited trading assets and liabilities.

D. STREAMLINED METRICS REPORTING AND RECORDKEEPING REQUIREMENTS

Under the current rule, banking entities with substantial trading activity must report to the Agencies a wide range of metrics regarding proprietary trading activities. Under the 2019 Revisions (and consistent with the 2018 Proposal), only banking entities with significant trading assets and liabilities will be required to report metrics to the Agencies.

The 2018 Proposal included various revisions to the metrics, reporting and recordkeeping requirements for these largest trading banking entities. The 2019 Revisions broadly adopt the revisions from the 2018 Proposal and indicate that these changes should result in a 67 percent reduction in the number of data items and a 94 percent reduction in the total volume of data, relative to the current reporting requirements.

IV. Covered Funds

The 2018 Proposal included just a few proposed incremental adjustments to limited aspects of the covered fund regulations, coupled with extensive requests for industry comment on "all aspects" of certain elements of the covered fund rules, including most significantly the "covered fund" definition itself. Among other topics, the Agencies specifically requested comment on issues such as the Volcker Rule's treatment of securitization activities, which had already been subject to several years of extensive commentary throughout the rulemaking process as well as other forms of formal and informal dialogue between and among market participants and the Agencies.

The 2019 Revisions generally adopt the proposed incremental adjustments to limited aspects of the covered fund regulations, but defer further action on other covered fund issues to a later rulemaking. In particular, the 2019 Revisions contain no revisions to the definition of "covered fund" or the "Super 23A" prohibition but rather indicate that those items will be addressed in a future proposal.

A. RELAXATION OF RESTRICTIONS ON THE UNDERWRITING AND MARKET-MAKING EXEMPTIONS FOR CERTAIN COVERED FUND INTERESTS

The 2019 Revisions expand the ability of banking entities engaged in underwriting and market-making activities to engage in those activities with respect to ownership interests in third-party funds. Under the current regulation, a banking entity is permitted to act as an underwriter or market maker for covered fund ownership interests, provided that the banking entity includes the aggregate value of all ownership interests of a covered fund acquired or retained by the banking entity acting as underwriter or market maker in its aggregate covered fund ownership limit and subjects those interests to the capital deduction requirement. The 2019 Revisions provide that, for any covered fund that a banking entity does not organize and offer, ownership interests acquired in connection with permissible underwriting or market-making activity no longer count toward the aggregate fund limit and are not subject to the capital deduction. These limits, as well as the three-percent "per fund" limit, continue to apply to a covered fund that the banking entity organizes or offers.

B. EXPANSION OF THE RISK-MITIGATING HEDGING EXEMPTION FOR FUND-LINKED PRODUCTS

The 2019 Revisions address a longstanding issue raised under the current regulation that has precluded certain banking entities from serving in the intermediary capacity of providing clients and customers with indirect exposure to covered funds (i.e., offering fund-linked products). Specifically, the 2019 Revisions expand the risk-mitigating hedging exemption from the covered fund restrictions (which currently applies only in a very narrow context related to employee compensation arrangements) by permitting a banking entity to acquire or retain an ownership interest in a covered fund as a hedge, subject to certain compliance requirements, when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund. Unlike the proprietary trading risk-mitigating hedging exemption, the revised covered fund exemption is only applicable to transactions that accommodate specific customer requests. A banking entity may not rely on this exemption to solicit customer transactions.

C. ADJUSTMENTS TO THE SOTUS EXEMPTION

The 2019 Revisions make two minor adjustments to the "solely outside of the United States" or "SOTUS" exemption. Similar to the amendment to the TOTUS exemption, the 2019 Revisions eliminate from the SOTUS exemption the requirement that no financing for the banking entity's purchase or sale of a covered fund ownership interest is provided by any US branch or affiliate of the banking entity. In addition, the 2019 Revisions incorporate into the regulation the Agencies' February 2015 FAQ guidance regarding the scope and content of the US marketing restriction.

V. Banking Entity Status of Controlled Funds

The 2019 Revisions do not include any changes with respect to the Agencies' current approach to the banking entity status of controlled funds, which is based on a series of FAQs and no-action relief concerning registered investment companies ("RICs"), foreign public funds ("FPFs") and "foreign excluded funds."[10] Rather, the Agencies indicate that they will address this [longstanding] issue at a later date through a separate rulemaking and state that the 2019 Revisions do not "modify or revoke any previously issued staff FAQs or guidance related to RICs, FPFs, and foreign excluded funds."

VI. Conclusion

The 2019 Revisions become effective on January 1, 2020, and banking entities are required to comply with the 2019 Revisions by January 1, 2021. However, banking entities may voluntarily comply with some or all of the changes in the 2019 Revisions in 2020, prior to the compliance date.[11]

While not a wholesale revision of the Volcker Rule or a comprehensive treatment of areas previously raised by commenters, the changes in the 2019 Revisions represent a meaningful step forward in rationalizing the regulation. We expect continuing developments with respect to the Volcker Rule as the Agencies craft a covered funds proposal and implement their supervisory objectives with respect to the Volcker Rule.

Endnotes

1 The Agencies consist of the Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Federal Reserve"), Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC").

2 *FDIC Approves Interagency Final Rule to Simplify and Tailor the "Volcker Rule,"* (Aug. 20, 2019), *available at* https://www.fdic.gov/news/news/press/2019/pr19073.html. The Comptroller of the Currency indicated on August 20, 2019, that he had approved the 2019 Revisions on behalf of the OCC. The Federal Reserve, SEC and CFTC are expected to approve the 2019 Revisions in the coming weeks.

3 83 Fed. Reg. 33,432 (proposed July 17, 2018). See Mayer Brown's Legal Update on the 2018 Proposal: https://www.mayerbrown.com/en/perspectives-events/publications/2018/06/volcker-rule-revisions-proposed-by-agencies.

4 On May 24, 2018, certain amendments were adopted to the statutory Volcker Rule as part of the Crapo Act ("Economic Growth, Regulatory Relief, and Consumer Protection Act"). Please see our Legal Update on the Crapo Act at https://www.mayerbrown.com/Congress-Passes-Regulatory-Reform-for-Financial-Institutions-05-22-2018/. The Agencies issued amendments to the current regulation to implement these legislative amendments earlier in 2019. 84 Fed. Reg. 38,115 (Aug. 6, 2019).

5 While not set forth in the regulation, two other categories of financial institution exist in relation to the Volcker Rule: (i) financial institutions that would be banking entities but for the amendment to the definition of "banking entity" in the Economic Growth, Regulatory Relief, and Consumer Protection Act and (ii) banking entities that do not engage in proprietary trading or covered fund activities.

6 The 2018 Proposal noted that the term "trading account" is "a statutory concept and dœs not necessarily refer to an actual account." It "is simply nomenclature for the set of transactions that are subject to the prohibitions on proprietary trading."

7 As discussed below in section III.A. of this update, all banking entities with significant trading assets and liabilities are required to implement a comprehensive compliance program under subpart D.

8 While the 2019 Revisions remove the counterparty prong that restricts purchases or sales with or through any "US entity" in what appears to be an inadvertent drafting error, the revisions do not remove the otherwise unused definition of "US entity" at _.6(e)(4).

9 As discussed above, banking entities with limited trading assets and liabilities are not mandated to have a Volcker Rule compliance program because of the presumption of compliance. However, as a practical matter, we expect that most banking entities with limited trading assets and liabilities will implement some form of compliance program to protect against engaging in prohibited activities.

10 The preamble to the 2019 Revisions notes that the FAQs, like all staff guidance, has no legal force or effect. This position is consistent with the 2018 Interagency Statement Clarifying the Role of Supervisory Guidance and is generally reflected in the 2019 Revisions.

11 The Agencies indicate that early compliance is allowed subject to the Agencies' modification of the reporting system used to receive metrics reporting.

Appendix A

SUMMARY OF CHANGES TO COMPLIANCE PROGRAM REQUIREMENTS		
Requirement (Citation to 2013 Final Rule)	Banking Entities Subject to Requirement in 2013 Final Rule	Banking Entities Subject to Requirement in 2019 Revisions
6-Pillar Compliance Program **(Section __.20(b))**	Banking entities with more than $10 billion in total consolidated assets	Banking entities with significant trading assets and liabilities
Enhanced Compliance Program **(Section __.20(c), Appendix B)**	Banking entities with: • $50 billion or more in total consolidated assets or • Trading assets and liabilities of $10 billion or greater over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, if the banking entity engages in proprietary trading activity permitted under subpart B Additionally, any other banking entity notified in writing by the Agency	Not applicable. Enhanced compliance program eliminated (but see CEO Attestation Requirement below).
CEO Attestation Requirement **(Section __.20(c), Appendix B)**	Banking entities with: • $50 billion or more in total consolidated assets or • Trading assets and liabilities of $10 billion or greater over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters Additionally, any other banking entity notified in writing by the Agency	• Banking entities with significant trading assets and liabilities • Any other banking entity notified in writing by the Agency

Metrics Reporting Requirements **(Section __.20(d), Appendix A)**	• Banking entities with trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, is $10 billion or greater, if the banking entity engages in proprietary trading activity permitted under subpart B • Any other banking entity notified in writing by the Agency	• Banking entities with significant trading assets and liabilities • Any other banking entity notified in writing by the Agency
Additional Covered Fund Documentation Requirements **(Section __.20(e))**	Banking entities with more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years	Banking entities with significant trading assets and liabilities
Simplified Program for Banking Entities with No Covered Activities **(Section __.20(f)(1))**	Banking entities that do not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § __.6(a) of subpart B)	Banking entities that do not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § __.6(a) of subpart B)
Simplified Program for Banking Entities with Modest Activities **(Section __.20(f)(2))**	Banking entities with $10 billion or less in total consolidated assets as reported on December 31 of the previous two calendar years that engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § __.6(a) of subpart B)	Banking entities with moderate trading assets and liabilities
No Compliance Program Requirement Unless Agency Directs Otherwise **(N/A)**	Not applicable	Banking entities with limited trading assets and liabilities subject to the presumption of compliance

Regulatory Technical Standards on Homogeneity for STS Transactions Published in Official Journal

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Introduction

The EU has, on 6 November 2019, published in the Official Journal a delegated regulation[1] (the **"Delegated Regulation"**) supplementing the EU Securitisation Regulation[2] (the **"Securitisation Regulation"**) with regard to regulatory technical standards (**"RTS"**) on the homogeneity of the underlying exposures in securitisation. The Delegated Regulation will enter into force 20 days after publication.

The STS Framework

The Securitisation Regulation has applied across the European Union (the **"EU"**) since 1 January 2019 to all securitisations (as defined therein) where the securities have been issued since that date (or in respect of securitisations which do not involve the issuance of securities, where the securitisation positions have been created since that date).[3]

The Securitisation Resolution includes criteria for "simple, transparent and standardised", or "STS" securitisations. There is a separate set of criteria which need to be met for non-ABCP and ABCP securitisations, and in the latter case, there are separate requirements with respect to ABCP transactions, sponsors of ABCP programmes and ABCP programmes. In addition, the originator, sponsor and securitisation special purpose entity ("**SSPE**") need to be established in the EU in order for the securitisation to qualify as STS.[4]

If a securitisation is designated as STS[5] and provided that certain additional criteria under the Capital Requirements Regulation[6] (the **"CRR"**), as amended by Regulation 2017/2401,[7] are met, then an EU bank can obtain preferential regulatory capital treatment for its exposure to such a securitisation, as compared with the regulatory capital treatment for non-STS securitisations. A transaction qualifying as STS will also benefit from lower capital requirements for insurance and reinsurance undertakings subject to regulation under Solvency II[8] and will be eligible for inclusion in high quality liquid assets by banks for the purposes of the CRR liquidity coverage ratio[9] (subject, in each case, to additional criteria being met), as well as being eligible for investment by money market funds subject to the Money Market Funds Regulation.[10]

As at the date of this Legal Update, over 90 transactions have been notified to the European Securities and Markets Authority (**"ESMA"**) as being STS, in a range of asset classes (auto loans and leases, residential mortgages, trade receivables, credit cards, consumer loans, SME loans and leases) and both public and private.[11]

The current STS framework does not apply to synthetic securitisations[12] but a consultation is under way with respect to the creation of an STS framework for balance sheet synthetic securitisations pursuant to a discussion paper (the **"Synthetic STS Discussion Paper"**) published by the European Banking Authority (the **"EBA"**) in September 2019.[13]

The EBA has published a set of guidelines with respect to the ABCP and non-ABCP STS criteria (the **"EBA Guidelines"**).[14]

The Homogeneity Requirement

One of the STS criteria for both non-ABCP transactions[15] and ABCP transactions[16] is that the securitisation must be backed by "*a pool of underlying exposures that are homogeneous in terms of asset type, taking into account the specific characteristics relating to the cash flows of the asset type including their contractual, credit-risk and prepayment characteristics*". The Synthetic STS Discussion Paper also contains a proposed criterion in relation to homogeneity.

The Recitals to the Securitisation Regulation explain the overall purpose of the homogeneity requirement as follows: "*To ensure that investors perform robust due diligence and to facilitate the assessment of underlying risks, it is important that securitisation transactions are backed by pools of exposures that are homogenous in asset type, such as pools of residential loans, or pools of corporate loans, business property loans, leases and credit facilities to undertakings of the same category, or pools of auto loans and leases, or pools of credit facilities to individuals for personal, family or household consumption purposes.*"[17]

The EBA was required, in close cooperation with ESMA and EIOPA,[18] to develop draft RTS specifying which underlying exposures are deemed to be homogeneous. The EBA published its final draft RTS on homogeneity on 31 July 2018[19] and the European Commission published the Delegated Regulation based on the draft RTS on 28 May 2019.

The Delegated Regulation

The Delegated Regulation sets out four conditions for the underlying exposures in a securitisation to be considered homogeneous:

i. they fall within the same specified asset type[20];
ii. they have been underwritten according to similar underwriting standards for assessing the associated credit risk;

iii. they are serviced according to similar procedures for monitoring, collecting and administering cash receivables; and

iv. at least one of the applicable "homogeneity factors" for such asset type is applied.

The rationale for using these conditions is explained in the Recitals to the Delegated Regulation.

As regards asset types, it is stated that a pool of underlying exposures should only be considered homogenous where it contains exposures of a single asset type. As a result, distinct asset types have been identified, based on market practice. Furthermore, there is also a category for underlying exposures which do not correspond to one of those asset types, but that are considered by the originator or sponsor to constitute a distinct asset type.

The Recitals state that underwriting standards are designed to measure and assess the credit risk associated with the underlying exposures and are therefore useful indicators of their homogeneity. Consequently, the application of similar underwriting standards is an indicator of similar risk profiles.

The Recitals also recognise the fact that the servicing of underlying exposures has a substantial impact on the cash flows expected from those exposures. If similar procedures, systems and governance are used with respect to the servicing of the underlying exposures, this should allow an investor to confidently assess the impact of the servicing within similar parameters.

The specified "homogeneity factors" vary according to the asset type. One or more of the homogeneity factors should be applied on a case-by-case basis. They include factors relating to the type of immovable property and the ranking of security rights (with respect to residential or commercial mortgages) or the type of obligor (with respect to other asset types) and the jurisdiction of such properties or obligors.

In the case of credit facilities provided to individuals for personal, family or household consumption purposes, and trade receivables, it was determined that those asset types are sufficiently homogeneous provided that similar underwriting standards and servicing procedures are applied, and it is not necessary for a homogeneity factor to apply. This is on the basis that requiring homogeneity factors to apply to those asset types would lead to excessive concentrations in the relevant securitised portfolios.

In the event that there are changes in the characteristics of the underlying exposures for reasons outside of the control of the originator or the sponsor after origination, this will not prevent such exposures from being deemed to be homogeneous.

Mayer Brown has advised in relation to a number of STS transactions. Please contact us if you would like to discuss any of the matters referred to in this Legal Update.

Endnotes

1 Commission Delegated Regulation (EU) 2019/1851 of 28 May 2019 supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards on the homogeneity of the underlying exposures in securitisation, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R1851&from=EN.

2 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EC and Regulations (EC) No 1060/2009 and (EU) No 648/2012, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=EN (hereinafter cited as "**SR**").

3 Please see our previous Legal Update, "The EU Securitisation Regulation – Where are we now?", for a more detailed discussion of the Securitisation Regulation as at June 2019, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/06/eusecuritisationregulationwherearewenow_june19.pdf.

4 Following Brexit, a securitisation that meets all the other STS criteria but where any of the originator, sponsor or SSPE is established not in the EU but in the UK may not qualify as STS in the EU, although it may qualify as STS in the UK. Please see our Legal Update "Onshoring the EU Securitisation Regulation – How will it apply in the UK in the event of a no-deal Brexit?" for further information, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/onshoringtheeuropeansecuritisationregulatoryregime_aug19.pdf.

5 A securitisation may be designated as STS by notification to ESMA using the required template, after which it will appear on the ESMA website.

6 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, as amended.

7 Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation No 575/2013 on prudential requirements for credit institutions and investment firms, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2401&from=EN.

8 Commission Delegated Regulation (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertakings.

9 Commission Delegated Regulation (EU) 2018/1620 of 13 July 2018 amending Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for credit institutions, Article 1(8) (amending Article 13 of Delegated Regulation 2015/61).

10 Commission Delegated Regulation (EU) 2018/990 of 10 April 2018 amending and supplementing Regulation (EU) 2017/1131 of the European Parliament and of the Council with regard to simple, transparent and standardised (STS) securitisations and asset-backed commercial papers (ABCPs), requirements for assets received as part of reverse repurchase agreements and credit quality assessment methodologies, Article 1 (amending Article 13(1)(c) of Regulation (EU) 2017/1131 on money market funds).

11 For a list of securitisations notified as being STS, please see the ESMA register available at https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation.

12 "synthetic securitisation" is defined in Article 2(10) SR as "a securitisation where the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitised remain exposures of the originator". By contrast, "traditional securitisation" is defined in Article 2(9) SR as "a securitisation involving the transfer of the economic interest in the exposures being securitised through the transfer of ownership of those exposures from the originator to an SSPE or through sub-participation by an SSPE, where the securities issued do not represent payment obligations of the originator".

13 Discussion Paper – Draft Report on STS Framework for Synthetic Securitisation Under Art. 45 of Regulation (EU) 2017/2402, published on 24 September 2019 and available at https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/discussion-paper-on-sts-framework -for-synthetic-securitisation-under-art.-45-of-regulation-eu-2017/2402. For further information, please see our Legal Update "EBA consults on the creation of an STS framework for synthetic securitisations", available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/10/eba-consults-on-the-creation-of-an-sts-framework-for-synthetic-securitisations_oct19.pdf.

14 Final Guidelines on STS criteria for non-ABCP securitisation and Final Guidelines on STS criteria for ABCP securitisation, available at https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/guidelines-on-the -sts-criteria-for-abcp-and-non-abcp-securitisation.

15 Article 20(8) SR.

16 Article 24(15) SR.

17 Recital 27 SR.

18 The European Insurance and Occupational Pensions Authority.

19 EBA Final Draft Regulatory Technical Standards On the homogeneity of the underlying exposures in securitisation under Articles 20(14) and 24(21) of Regulation (EU) No 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, available at: https://eba.europa.eu/sites/default/documents/files/documents/10180/2298183/1ecb2150-fd3d-4æf-ac8f-393dc314deea/Draft%20RTS%20on%20homogeneity%20of%20underlying%20exposures%20in%20securitisation%20(EBA-RTS-2018-02%20).pdf.

20 The specified asset types are as follows:

(i) residential loans that are either secured by one or more mortgages on residential immovable property or that are fully guaranteed by an eligible protection provider;

(ii) commercial loans that are secured by one or more mortgages on commercial immovable property;

(iii) credit facilities provided to individuals for personal, family or household consumption purposes;

(iv) credit facilities, including loans and leases, provided to any type of enterprise or corporation;

(v) auto loans and leases;

(vi) credit card receivables;

(vii) trade receivables; and

(viii) other underlying exposures that are considered by the originator or sponsor to constitute a distinct asset type on the basis of internal methodologies and parameters.

Please note that commercial mortgage-backed securitisation transactions (CMBS) and other transactions where the repayment of the holders of the securitisation positions is predominantly dependent on the sale of the assets, together with managed CLOS (involving active portfolio management of the exposures on a discretionary basis), are not capable of being STS.

Technical Standards in Relation to Transparency Adopted by the European Commission

MERRYN CRASKE

ALICE HARRISON

The European Commission (the **"Commission"**) has now adopted and published the regulatory technical standards[1] (the **"RTS"**) and the implementing technical standards[2] (the **"ITS"**) in relation to the transparency requirements under the EU Securitisation Regulation[3] (the **"Securitisation Regulation"**).

The Securitisation Regulation has been applicable since 1 January 2019 to all securitisations (as defined therein) other than securitisations existing prior to that date to the extent that they are grandfathered.[4] Article 7 of the Securitisation Regulation sets out transparency requirements (the **"Article 7 Requirements"**) for originators, sponsors and securitisation special purpose vehicles (**"SSPEs"**). In addition, Article 5 of the Securitisation Regulation requires institutional investors, other than the originator, sponsor or original lender, to verify (among other things) that the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities set out therein.[5]

The Article 7 Requirements provide that the originator, sponsor and SSPE of a securitisation must report certain information to (i) holders of a securitisation position, (ii) competent authorities and (iii) (upon request) potential investors. The minimum information that must be reported is, in summary, as follows:

1. information on underlying exposures;
2. transaction documentation;
3. where the securitisation does not have a prospectus, a summary of the transaction;
4. for a securitisation that complies with the "simple, transparent and standardised", or "STS", criteria, the STS notification;
5. investor reports including information on the underlying exposures, trigger events, cash flows and risk retention;
6. any inside information required to be made public under the Market Abuse Regulation; and
7. any other significant event (such as a material breach, a change in structure, a change in risk characteristics, an STS securitisation ceasing to meet the STS requirements or any material amendment to the transaction documents).

Items 2, 3 and 4 must be made available before pricing. Items 1 and 5 must be reported either quarterly or, in the case of ABCP, monthly, for the duration of the securitisation. Any relevant information under items 6 or 7 must be reported "without delay". The originator, sponsor and SSPE are required to designate one entity between them to comply with the Article 7 Requirements for the securitisation.

Article 7 contains a requirement for the European Securities and Markets Authority (**"ESMA"**) to develop regulatory technical standards setting out the information to be provided in relation to items 1 and 5, and related implementing technical standards with standardised reporting templates. The RTS and ITS are based on the draft regulatory technical standards (the **"Draft RTS"**) and the draft implementing technical standards, respectively, published by ESMA on 31 January 2019.[6] While there are a number of changes between the Draft RTS and the RTS, they do not appear to be material. ESMA have also produced a set of Q&As which is useful in interpreting the disclosure requirements and which is expected to be updated and expanded from time to time.[7] ESMA have also published, on 20 December 2019, updated reporting instructions and XML schema for the templates.[8]

The RTS contain a set of Annexes, each of which applies to a particular type of underlying exposure. Each Annex specifies in detail the information that must be reported under items 1 and 5 above in relation to the particular type of underlying exposure, using the applicable reporting templates in the ITS.

If the information for a field in the applicable reporting template is not available or not relevant for the particular underlying exposures, it may be possible to use one of the "No Data" options (where permitted for that field). There are five specific circumstances in which a "No Data" option can be used — where the required information:

1. was not collected at origination because the lending/underwriting criteria did not require it (ND1);
2. has not been loaded onto the reporting entity's system (ND2);
3. has been loaded onto a system separate from that the reporting entity (ND3);
4. has been collected but can only be made available at a later date (that later date must be specified) (ND4); and
5. is not applicable to the relevant item (ND5).

The RTS emphasise that these circumstances should be narrowly construed, and that they should not be "used to circumvent" the Article 7 Requirements. Upon request of the relevant authorities, a reporting entity will have to provide details that justify the use of any "No Data" option.

The ESMA website states that the RTS are currently under a three-month extendable period of scrutiny by the European Parliament and the Council of the European Union and that, absent an objection, the RTS and ITS will be published in the *Official Journal of the European Union* at the end of such scrutiny period and will enter into force 20 days after the date of such publication. This means that the RTS and ITS are likely to become effective in Q1 2020 (likely to be February 2020 at the earliest).9 It is not expected that there will be any material changes made during this process. No transitional period is expected to apply. Consequently it would be advisable for market participants to ensure that they are ready and have the relevant data available to allow them comply with the new reporting requirements once the RTS and ITS come into effect.

Endnotes

1 Commission Delegated Regulation (EU)…/…of 16.10.2019, supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards specifying the information and the details of a securitisation to be made available by the originator, sponsor and SSPE, available at https://ec.europa.eu/finance/docs/level-2-measures/securitisation-rts-2019-7334_en.pdf with the associated annexes available at https://ec.europa.eu/finance/docs/level-2-measures/securitisation-rts-2019-7334-annex_en.pdf.

2 Commission Implementing Regulation (EU)…/…of, laying down implementing technical standards with regard to the format and standardised templates for making available the information and the details of a securitisation by the originator, sponsor and SSPE, available at https://ec.europa.eu/finance/docs/level-2-measures/securitisation-implementing-act-2019-7624_en.pdf with the associated annexes available at https://ec.europa.eu/finance/docs/level-2-measures/securitisation-implementing_-act-2019-7624-annex_en.pdf.

3 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017, laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EC and Regulations (EC) No 1060/2009 and (EU) No 648/2012, available at https://eur-lex.europa.eu/legal-content/EN/TXT/F/?uri=CELEX:32017R2402&from=EN (hereinafter cited as "SR").

4 See also our Legal Update "The EU Securitisation Regulation – Where are we now", available at https://www.mayerbrown.com/-/media/files/%20perspectives-events/publications/2019/06/%20eusecuritisationregulationwherearewenow_june19.pdf.

5 Article 5(1)(e)SR. See also our Legal Updates "The EU Securitisation Regulation – Where are we now?", referenced in the previous footnote and "The Impact of the EU Securitisation Regulation on US Entities", available at https://www.mayer-brown.com/en/perspectives-events/publications/2018/12/the-impact-of-the-eu-securitization-regulation-on, for further discussion of the jurisdictional scope of Article 5(1). The market is hoping for some guidance from the European supervisory authorities on this point.

6 Available at https://www.esma.europa.eu/press-news/esma-news/esma-publishes-opinion-and-qa-disclosure-technical-standards-under.

7 Questions and Answers on the Securitisation Regulation, Version 4. Last updated on 15/11/2019, available at https://www.esma.europa.eu/sites/default/files/library/esma33-128-563_questions_and_answers_on_securitisation.pdf.

8 See https://www.esma.europa.eu/press-news/esma-news/esma-provides-updated-xml-schema-and-reporting-instructions-securitisation.

9 In the United Kingdom, the extent to which the RTS and ITS will apply will depend on the outcome of Brexit. Please see our previous Legal Update "Onshoring the EU Securitisation Regulation – How will it apply in the UK in the event of a no-deal Brexit" for further information, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/onshoringtheeuropeansecuritisationregulatoryregime_aug19.pdf.

The Emergence of ESG Methodology and Green Financings in the Securitization Market

MICHAEL GAFFNEY

ROSS BUTLER

As concerns over climate change and other geopolitical concerns continue to grow, investors are becoming increasingly focused on measuring the environmental and societal effects of potential investments. This focus has resulted in the emergence, over the past several years, of Environmental, Social and Governance (ESG) ratings and evaluation criteria and "green" financings. In this article, we will address the current use of ESG methodology and green financings in the securitization space and look ahead to see how recent regulatory initiatives in Europe and, to a more limited extent, the United States may potentially lead to enhanced ESG-related disclosures and reporting requirements for all securitization facilities.

ESG Methodology

ESG methodology has developed over the past several years as a way to evaluate companies using key environmental, social and governance-related criteria. An ESG evaluation is typically performed by a third-party ratings company and would begin with the third-party ratings company identifying the key environmental, social and governance risks for the relevant company based on the industries and businesses in which the company operates. Once these key risks are identified, the third party would then assess and evaluate (1) how exposed the company is to these risks compared to other companies in these industries and (2) how the company is attempting to manage and overcome these exposures. While the use of third-party ratings providers has noticeably increased in the corporate and equity markets, there is currently a lack of uniformity among third-party ratings providers with respect to the ratings systems used and risks associated with certain environmental, social and governance factors. This means a company could expect to receive different ESG scores from different third-party ratings providers and that investors would need to understand such providers' particular rating system and ESG methodology in order to properly assess the ESG score.

Growing investor and regulatory interest in ESG analytics has led to several recent acquisitions of third-party ratings providers by ratings agencies looking to further cement their foothold in this space and satisfy the shifting needs of the market. Amidst a series of such acquisitions in late 2019, Moody's Investors Service Inc. released a statement that "[o]ur recent acquisitions demonstrate that we aim to be a leader in stand-alone ESG capabilities." Similarly, John Berisford, president at S&P Global Ratings, stated in late 2019 that "ESG is one of our top priorities on growth." On January 10, 2020, S&P announced that it had successfully completed its acquisition of the ESG ratings business from RobecoSAM, including the SAM Corporate Sustainability Assessment (CSA), a widely followed annual evaluation of over 4,700 global companies' sustainability practices operating since 1999. Fitch Ratings has now launched its ESG Relevance Scores, an integrated scoring system to highlight how ESG criteria impact a company's credit rating, which it plans to incorporate into all of its published credit reports by the middle of this year.

Currently, within the securitization space, the utilization of ESG methodology is primarily limited to collateralized loan obligations (CLOs). More and more collateral managers are developing their own ESG policies which can be used to calculate ESG scores for the collateral obligations managed by the collateral manager. So far, these ESG policies are typically focused on ensuring that (1) an underlying obligor of a collateral obligation does not participate in certain industries that are viewed as negative from an environmental or social perspective and (2) no events have occurred with respect to any underlying obligor that raise governance concerns. The recent European CLO, North Westerly VI, from this past month included more stringent ESG-related requirements than prior CLOs. The collateral manager in North Westerly VI, NIBC Bank N.V., (1) established ESG standards and methodology for the transaction, (2) agreed to perform initial and ongoing ESG-related due diligence and reporting requirements with respect to each collateral obligation and (3) agreed to calculate ESG scores for each collateral obligation and an aggregate weighted average ESG score for all collateral obligations. Also, in order for a collateral loan to satisfy the eligibility criteria in the transaction, the collateral obligation needs to constitute an eligible ESG collateral obligation. In the event a collateral obligation ceases to constitute an eligible ESG collateral obligation, the collateral manager will be required to attempt to fix the issue and the collateral manager will also have the option of selling the collateral obligation. It will be exciting to see if the approach taken in this recent CLO is replicated in other CLOs issued in early 2020.

Green Financings

There have been numerous "green" ABS issuances within the past several years. While there is currently no clearly identified set of criteria that needs to be satisfied in order for a securitization to be designated as a "green" transaction, thus far, issuers and investors have focused on the "green" nature of the asset portfolio being securitized in arriving at such a designation. As a result, sponsors of portfolios of multi-family CMBS, solar loans, property assessed clean energy (PACE) loans, or loans and leases for electric and hybrid vehicles have been the most likely to designate a facility as a "green" securitization.

Despite the lack of a standardized set of criteria for green securitizations, most green securitizations share certain similarities with the green loan standards that have developed over the past several years in the US and European corporate lending space. In 2018, the Loan Market Association (LMA), Asia Pacific Loan Market Association (APLMA) and Loan Syndications and Trading Association (LSTA) first jointly released their Green Loan Principles (GLP), which are minimum standards closely following the criteria set forth in the International Capital Market Association's Green Bond Principles. The GLP was extended in December of 2018 to make clearer considerations for revolving credit facilities and was followed by the Sustainability Linked Loan Principles (SLLP) released by the LMA, APLMA and LSTA in March 2019, which further expand green standards to general corporate revolvers.

The launch of the GLP was an attempt to clearly define what financings may be called "green" and contains minimum standards that a financing or the green tranche of a financing must satisfy in order to constitute a "green" financing. The four main criteria of the GLP are:

1. the proceeds of the financing or green tranche must be used to fund "green" projects, which may include conventional projects related to energy usage and conservation efforts, as well as modern and adapted examples, such as eco-efficient and sustainable products, clean transportation initiatives, management of land usage, green buildings and pollution prevention;
2. the borrower must clearly communicate to lenders (i) its environmental sustainability objectives, (ii) the process by which it determines how a project qualifies as a green project and (iii) the related eligibility criteria (and exclusion criteria, if applicable) and other processes applied to identify and manage environmental risks associated with the project;
3. the loan proceeds should be credited to a dedicated account or otherwise tracked appropriately by the borrower in a manner maintaining transparency and promoting the integrity of the product; and
4. borrowers should maintain current information on the use of proceeds (including the amounts allocated to each green project and their expected and achieved impacts), and such information should be made available to the lenders of the loan.

The SLLP, unlike the GLP, does not limit a borrower's use of proceeds to green projects. A borrower is permitted under the SLLP to use the proceeds of a financing for any corporate purpose so long as the borrower agrees to attempt to comply with certain predetermined sustainability benchmarks or social objectives (SPTs). The failure to achieve compliance with a

SPT could, depending on the terms of the underlying transaction, result in pricing step-ups, the inability of the borrower to request future borrowings and/or an event of default.

Given that a typical "green" securitization would already be able to satisfy several of the GLP prongs described above, it will be interesting to see if the securitization market develops a standardized set of criteria for "green" transactions that is similar to the GLP. It will also be interesting to see if any of the features of the SLLP (i.e., the use of SPTs and pricing step-ups) start to make their way into the securitization market.

Potential Regulatory Impacts on Securitizations

Regulatory efforts and other mandates with respect to ESG investing have increased in recent years notably regarding enhanced reporting and disclosure requirements. The European market, which is arguably the most advanced in terms of ESG investing and promotion of sustainable finance, is often leading the way with such initiatives. Last month, the European Commission published its European Green Deal Investment Plan outlining proposals to "unleash a green investment wave" of at least €1 trillion in part by "providing incentives to unlock and redirect public and private investment" and "putting sustainable finance at the heart of the financial system." The plan comes on the heels of the Commission's broader European Green Deal, published in December 2019, which aims "to make Europe the first climate neutral continent by 2050." Several of the Commission's previously outlined measures are already incorporated into EU laws, including requirements that certain investment managers provide disclosure on how sustainability considerations factor into their investment choices. Proposed amendments to MiFID II and other regulations would broaden these disclosure requirements to other institutional investors.

While not yet as prevalent in the United States, parallel regulatory initiatives are beginning to take shape and gain traction. The Illinois Sustainable Investing Act (ISIA), for example, took effect on January 1, 2020, requiring that (1) every public agency and governmental unit in the state develop, publish and implement sustainable investment policies applicable to the management of all public funds under its control; and (2) every public agency prudently integrate sustainability factors into its investment decision-making, investment analysis, portfolio construction, due diligence and investment ownership in order to maximize financial returns, minimize projected risks and more effectively execute its fiduciary duty. The ISIA also makes similar changes to the Public Funds Investment Act and the Illinois Pension Code.

Looking Ahead

Looking ahead, the market should continue to see an increase in the number of CLOs that utilize ESG scoring and securitizations that are designated as "green" transactions as the designation of what constitutes a "green" securitization becomes more standardized. What will be interesting to see is how quickly the combination of (1) growing investor interest in ESG factors, (2) regulations that require investors in certain jurisdictions to develop investment policies that take into account ESG factors and (3) the increasing ability of rating agencies to evaluate ESG factors will lead to a push within the securitization space for ABS sponsors and issuers to provide ESG-related disclosures and reporting for all securitizations, not just "green" ones. This would hopefully lead to the creation of standardized disclosures and reporting requirements that are specifically tailored to each asset class, similar to the way in which third-party ratings providers currently provide ESG evaluations based upon the ESG factors most relevant to the industries in which a company operates.

Seventh Circuit Issues Surprising Ruling on Sufficiency of UCC Collateral Description

BARBARA M. GOODSTEIN

In a surprising development, on September 11, 2019, the Seventh Circuit Court of Appeals issued a ruling on appeal reversing a lower bankruptcy court decision and found that a UCC financing statement that contained no collateral information whatsoever, but simply cross-referenced a security agreement, sufficiently "indicated" the collateral for purposes of UCC Article 9. In so doing, it put itself directly at odds with a January 2019 decision by the U.S. Court of Appeals for the First Circuit (*In re Financial Oversight & Management Board*) in connection with the insolvency proceeding for Puerto Rico.

The Seventh Circuit case, *In re I80 Equipment, LLC* (2019 WL 4296751), was a matter of first impression in Illinois. In that case, the debtor, I80 Equipment, LLC, had granted an "all assets" lien to First Midwest Bank to secure repayment of a loan. The security agreement covered 26 different categories of collateral. But the UCC financing statement simply said "[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party." Moreover, the security agreement was not attached to the filing. So there was no way a creditor, by looking at the UCC, had any information regarding the collateral.

Under UCC §9-502(a), a properly filed UCC financing statement must indicate the collateral covered by the financing statement. UCC §9-504 then provides two alternative safe harbors for a financing statement that "sufficiently indicates" the collateral, those being:

1. a description of the collateral pursuant to UCC §9-108; or
2. an indication that the financing statement covers all assets or all personal property.

UCC §9-108 lists six ways of describing the collateral, the last of which is *"any other method by which the identity of the collateral is objectively determinable."* This last option is what the court cited in deciding that no description within the four corners of the UCC was needed, but rather that a bare cross-reference to another unattached document (without any information as to how a copy could be obtained) would suffice.

The court's ruling could make one question whether a collateral description box in a financing statement serves any purpose at all if the court is willing to bless a filing such as the one in the I80 case. For secured parties, our recommendation would be to continue to follow the more common approach of including within the financing statement some modicum of information, whether it be asset type or category, regarding the collateral. If any incorporation by reference to another document is used, we also recommend including in the financing statement a statement on how the searcher can obtain a copy of that document.

Securitization & Structured Finance

INDUSTRY LEADERS

Mayer Brown's Structured Finance practice is one of the largest and most balanced in the industry, with genuine strengths across the entire range of asset classes—from mortgage-backed securities, asset-backed commercial paper, credit cards, and auto/equipment loans and leases to IP assets, marketplace loans, renewable energy, whole businesses and insurance-linked securities.

We are regularly called upon by both arrangers and issuers, and we are regularly at the top of the league tables in both categories.

We are leaders not only in ABS/MBS transactions but also in transactions privately funded by banks, hedge funds and asset-backed commercial conduits.

Many of the structured finance transactions that are commonplace today were first initiated by lawyers at Mayer Brown—for example, the first CLO transaction in 1988, the first partially enhanced multi-seller commercial paper conduit in 1989 and the first ABS shelf registration in 1992.

A key factor in our ability to structure cutting-edge transactions is our depth of knowledge resulting from decades of industry leadership on the entire range of regulatory, securities, bank capital, accounting and other issues that affect securitizations.

100+	Structured Finance lawyers in 10 offices
18	Partners with 20+ years of Structured Finance experience
13	*Chambers*-ranked Structured Finance lawyers
3	3 of the last 6 years named *IFLR Americas* "Structured Finance and Securitization Team of the Year"
4	Consecutive years as the most active ABS/MBS securitization firm (source: *Asset-Backed Alert*)
$207B	Represented issuer or underwriter on 320 public and 144A rated US ABS/MBS deals totaling > $207 billion in 2018-2019 (source: *Asset-Backed Alert*)

Accolades

Ranked First for ABS/MBS Issuer Counsel

Asset-Backed Alert 2019

Ranked Tier 1 for Structured Finance: Securitization

Legal 500 USA 2019

ABS Law Firm of the Year

GlobalCapital's 2019 US Securitization Awards

Ranked Tier 1 for Capital Markets: Structured Finance and Securitisation – United States

IFLR1000 2020

Ranked First for US Straight Debt Including ABS & MBS, Issuer Counsel

Refinitiv 2019

Ranked Fourth for ABS/MBS Underwriter Counsel

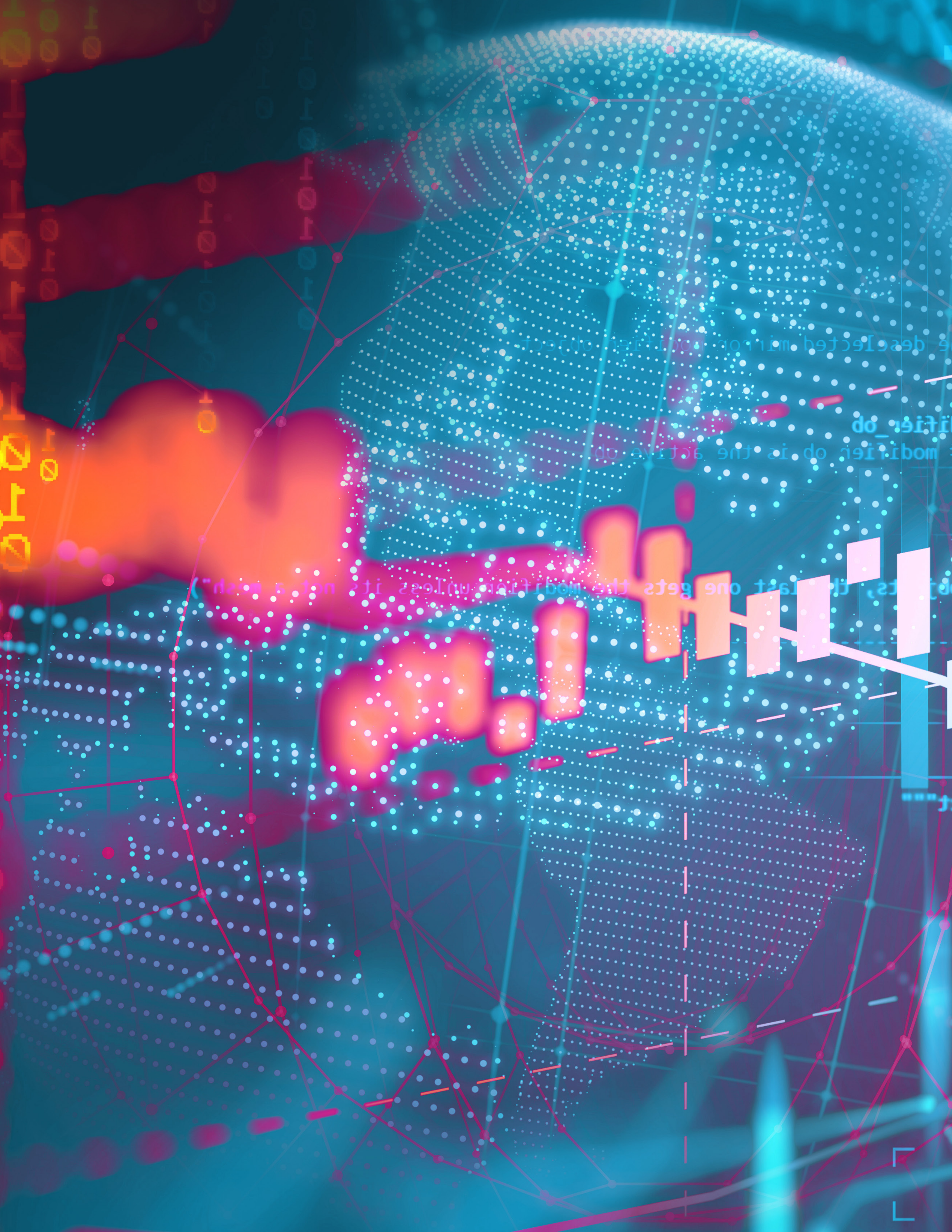
Asset-Backed Alert 2019

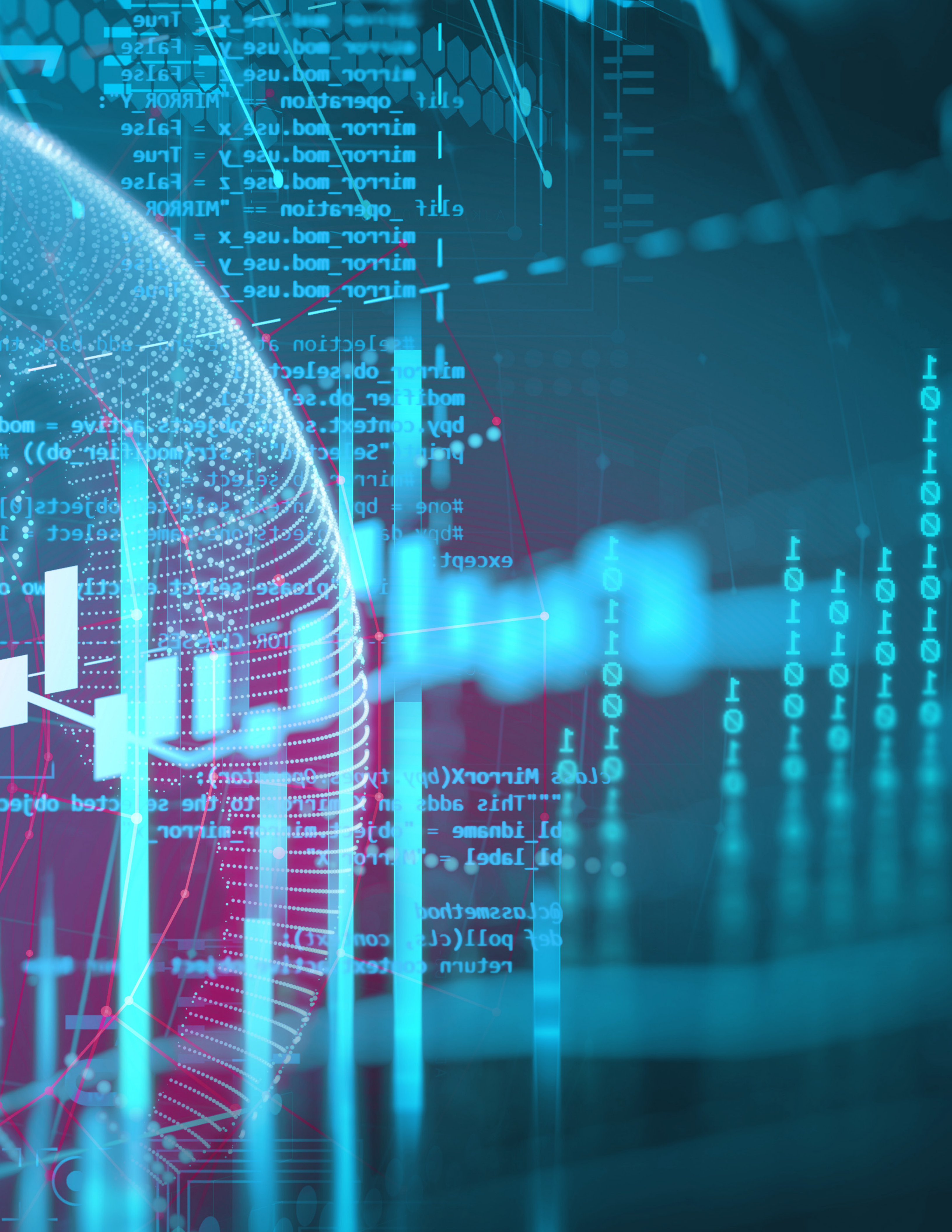
Ranked Band 1 for Capital Markets: Securitization

Chambers Global 2020

Practice Group of the Year in the Securitization Category

Law360 **Practice Group of the Year 2019 Series**





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