Morgan Lewis

GUIDE TO THE CREDIT RISK RETENTION RULES FOR SECURITIZATIONS

Updated February 20, 2018

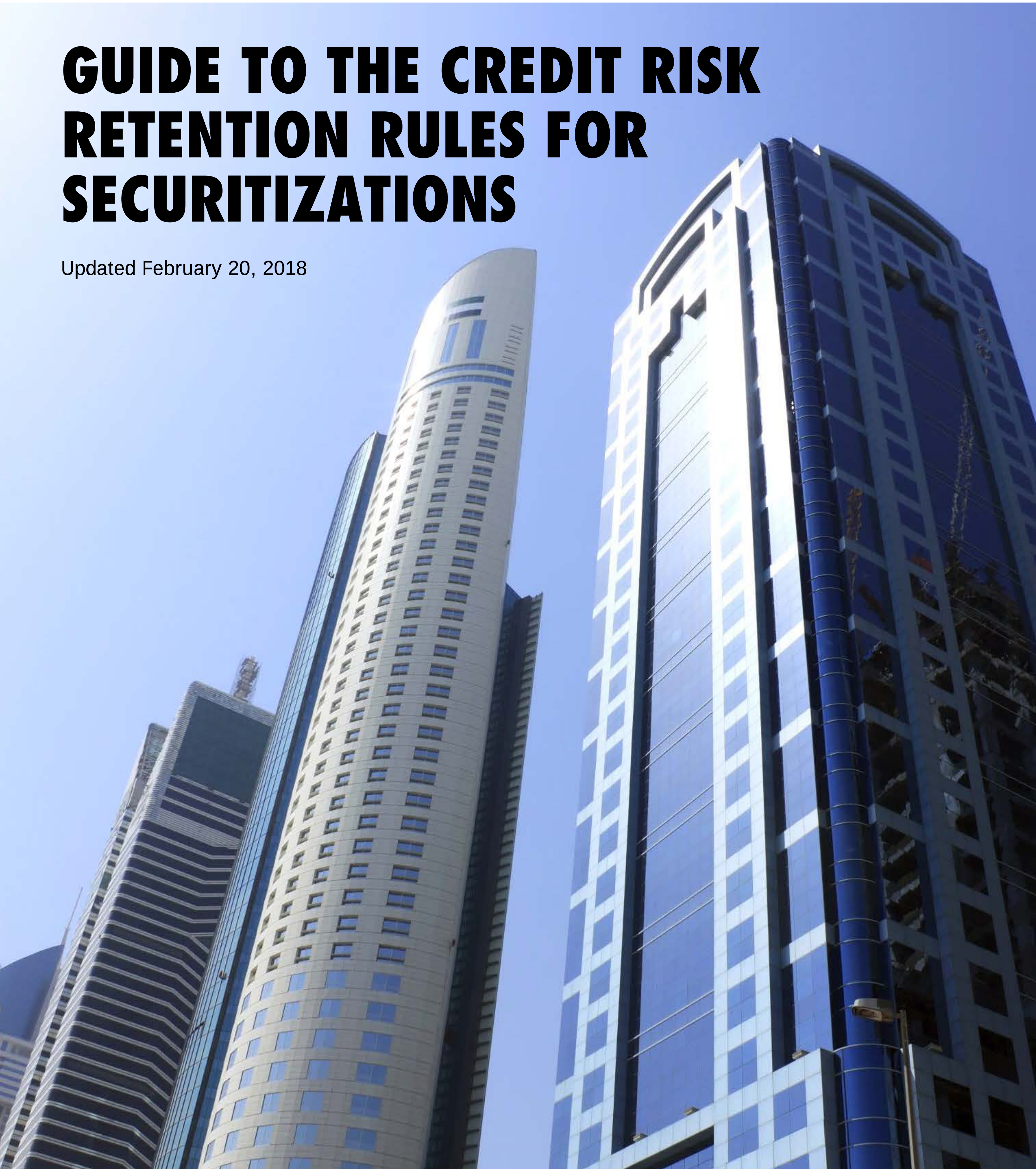

TABLE OF CONTENTS

A GUIDE TO THE CREDIT RISK RETENTION RULES FOR SECURITIZATIONS........................ 1

Background 2

Summary 3

Who Must Retain Credit Risk 5

Sponsors 5

Originators 5

Majority-Owned Affiliates.. 6

Permitted Forms of Risk Retention 6

Base Risk Retention Requirement and Standard Method 6

Vertical Retention by Sponsor 7

Horizontal Retention by Sponsor 7

Combined Retention by Sponsor 9

No Representative Sample Method... 9

Horizontal Retention by CMBS B-Piece Buyer 9

Retention of Seller's Interest in Revolving Pool Securitization..............................11

Retention of Credit Risk in ABCP Conduit Vehicles by Originator-Sellers..............13

No Additional Risk Retention for ABS Guaranteed by Fannie Mae or Freddie Mac 15

Open Market Collateralized Loan Obligations..16

Tender Option Bonds 17

Qualified Assets... 18

Qualified Residential Mortgages 18

Other Qualified Assets 19

Other Exemptions... 23

FFELP Student Loans...24

Resecuritizations 24

Seasoned Loans 25

Limitations on Hedging, Financing and Transfer of Retained Interests 26

Hedging of Retained Interests 26

Financing of Retained Interests...27

Sunset of Hedging and Transfer Restrictions....27
Disclosure Requirements 27
Safe Harbor for Foreign Transactions 30
Periodic Review of QRM Definition and Certain Other Provisions 31
CONTACTS 32

A GUIDE TO THE CREDIT RISK RETENTION RULES FOR SECURITIZATIONS

Updated February 20, 2018

On October 21 and 22, 2014, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), the Securities and Exchange Commission (the "SEC") and various federal banking and housing agencies adopted credit risk retention rules for securitizations. These rules, which were first proposed on March 29, 2011, and re-proposed on August 28, 2013, provide several methods of retaining the required 5 percent risk exposure, as well as limited exceptions for pools of assets that satisfy specified credit criteria.

The credit risk retention rules apply to sponsors of virtually all securitizations (other than synthetic structures), whether the asset-backed securities ("ABS," as more fully defined below) are publicly or privately offered, and permit only limited circumstances in which the required risk retention may be held by an originator or other party rather than the sponsor (or a majority-owned affiliate of the sponsor). The required risk may be retained in one of several forms, including vertical, horizontal, and a combined method; no representative sample method was adopted. The rules provide other methods of risk retention that apply only to specific types of assets or transactions, including revolving pool securitizations, such as asset-backed commercial paper conduits, commercial mortgage-backed securities, securitizations sponsored by government-sponsored enterprises like Fannie Mae and Freddie Mac, and tender option bond transactions.

The regulations set standards for a category of "qualified residential mortgages" ("QRMs") that are exempt from the risk retention requirements. The definition of QRM is consistent with the definition of "qualified mortgage" ("QM") as adopted from time to time by the Consumer Financial Protection Bureau (the "CFPB"), which does not include a loan-to-value ratio or down payment requirement. The rule also completely exempts any securitization with an asset pool containing a single class of qualified assets (*i.e.*, commercial loans, commercial real estate loans and consumer auto loans that meet stringent requirements), and imposes a zero percent risk retention requirement on qualified assets in blended pools with overall risk retention of at least 2.5 percent. Other exemptions include two narrow exemptions for resecuritizations, as well as exemptions for seasoned loans and for certain federally guaranteed student loans.

Generally, the required risk retention must be calculated under a "fair value" approach, with the notable exception of the vertical risk retention option. Retained credit risk exposure generally may not be transferred (other than to a sponsor's majority-owned affiliate), hedged, or financed by nonrecourse debt, though there are sunset timeframes after which most of these restrictions will expire.

The credit risk retention rules became effective December 24, 2015, for ABS backed by residential mortgage loans, and December 24, 2016, for all other securitizations.

Background

The credit risk retention rules were proposed[1], re-proposed[2] and adopted[3] jointly by the SEC, by the Department of the Treasury, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (the "Banking Agencies"), and by the Federal Housing Finance Agency and the Department of Housing and Urban Development (together with the SEC and the Banking Agencies, the "Agencies") to implement the mandate of Section 941(b) of the Dodd-Frank Act. Section 941(b) of the Dodd-Frank Act has been codified as Section 15G of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Under Section 15G of the Exchange Act, the SEC and the Banking Agencies were directed to jointly prescribe regulations that require securitizers to retain, generally, not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, subject to certain exceptions. Section 15G provides that securitizers will not be required to retain credit risk for securitized assets if all of the pooled assets are QRMs, as defined by the Agencies. The statute also provides that the regulations must permit securitizers to retain less than 5 percent of the credit risk of securitized commercial loans, commercial real estate loans and consumer automobile loans if the loans meet underwriting standards established by the Banking Agencies. Finally, Section 15G permits allocation of retained credit risk to originators under the regulations where appropriate.

The risk retention requirements of Section 15G and the rules are intended to address perceived problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. "[W]hen incentives are not properly aligned and there is a lack of discipline in the origination process," the Agencies reiterate in the Final Rule Release, "securitization can result in harmful consequences to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process." However, "[b]y requiring that a securitizer retain a portion of the credit risk of the securitized assets, the requirements of Section 15G provide securitizers an incentive to monitor and ensure the quality of the securitized assets underlying a securitization transaction, and, thus, help align the interests of the securitizer with the interests of investors."

The rules provide multiple options to satisfy the risk retention requirements. This flexibility "was designed to take into account the heterogeneity of securitization markets and practices and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses."

The credit risk retention rules became effective December 24, 2015, for ABS backed by residential mortgage loans, and December 24, 2016, for all other securitizations.

---

[1] The complete text of the original joint notice of proposed rulemaking, as adopted by the Agencies on May 29, 2011 (the "Original NPR"), is available **here**.

[2] The complete text of the joint notice of proposed rulemaking for the re-proposed rules, as adopted by the Agencies on August 28, 2013 (the "Re-Proposal NPR") is available **here**.

[3] The complete text of the final rules and the Agencies' explanatory text, as adopted by the Agencies on October 21-22, 2014 (the "Final Rule Release") is available **here**.

Summary

Securitization sponsors generally are responsible for satisfying the risk retention requirements, either by directly retaining the required interest or causing a majority-owned affiliate to retain that interest. Originators can agree to share risk retention in some cases, and some alternative risk retention methods permit retention of risk by other third parties.

For most securitizations, risk retention may take any of three forms provided by the so-called "standard" approach, subject to multiple rigorous and highly technical conditions:

Vertical: at least 5 percent of the fair value of each class of ABS interests issued by the issuing entity;

Horizontal: a residual interest equal to at least 5 percent of the fair value of all ABS interests issued by the issuing entity;[4] and

Combined: a combination, in any proportion, of the vertical and horizontal methods of risk retention.

Other risk retention options available for particular types of transactions, also subject to a variety of specified conditions, include:

Commercial mortgage-backed securities: the risk retention requirement may be satisfied through retention by up to two third-party B-piece buyers of a residual B-piece equal to at least 5 percent of the fair value of all ABS interests issued by the issuing entity;

Revolving pool securitizations: the risk retention requirement may be satisfied by retention by the sponsor of a seller's interest equal to at least 5 percent of the total principal balance of the pool assets that shares the same risks as investors on a proportionate basis, or by combining a seller's interest with certain other forms of retention;

Asset-backed commercial paper conduits: the risk retention requirement may be satisfied through retention by each originator-seller of a residual interest equal to at least 5 percent of the fair value of all ABS interests backed by receivables of that originator-seller and certain of its affiliates;

Securities guaranteed by Fannie Mae and Freddie Mac: the guarantee provided by Fannie Mae or Freddie Mac will satisfy the risk retention requirement;[5] and

Tender option bonds: the risk retention requirement may be satisfied by the retention by the sponsor of an eligible horizontal interest that meets the requirements of an eligible vertical interest upon a tender option termination event, or through the retention by the sponsor of at least 5 percent of the face value of the deposited municipal securities.

Generally, only one of these risk retention methods may be employed in any particular ABS transaction; different methods may not be combined, except as specifically permitted by the rules.

For the eligible horizontal interest option and most other risk retention options (excluding, most notably, the vertical interest option), the amount of the required risk retention must be calculated pursuant to a fair value approach under generally accepted accounting principles ("GAAP").

---

[4] As re-proposed, an eligible horizontal residual interest would have been subject to stringent cash flow limitations, but the Agencies eliminated that requirement from the final rules.

[5] This exception applies while these entities are in federal conservatorship or receivership, and to certain successors.

Securitizations consisting solely of performing QRMs are exempt from the risk retention requirement. The definition of QRM includes loans that meet the definition of QM as adopted by the CFPB from time to time. For a loan to be a QM, generally:

- it must fully amortize over its term, which cannot exceed 30 years;
- underwriting must take into account all mortgage-related obligations, must be based on the maximum rate permitted under the loan during the first five years and must be on a fully amortized basis;
- the lender must consider and verify the borrower’s current or reasonably expected income or assets and current debt obligations;
- the borrower must have a total (or “back-end”) debt-to-income (“DTI”) ratio that is less than or equal to 43 percent (based on the highest payment that could occur in the first five years of the loan); and
- it generally cannot require points or fees in excess of 3 percent of the loan amount (other than “bona fide discount points” on prime loans).

There is no loan-to-value (“LTV”) ratio or down payment requirement for QRMs. The Agencies did not adopt the stricter “QM-plus” approach that would have added several requirements to those imposed by the definition of QM, including a 70 percent LTV ratio.

Securitizations with an asset pool consisting entirely of qualified commercial loans, commercial real estate loans or consumer auto loans (but not auto leases) underwritten to high standards are exempt from the risk retention requirements. Qualified commercial loans, commercial real estate loans or consumer auto loans securitized in blended pools with non-qualified assets will have a zero percent risk retention requirement, so long as overall risk retention with respect to the securitized pool is a minimum of 2.5 percent. Blended pool treatment is not available for QRMs.

The rules also exempt certain securitizations in which the ABS or the pooled assets have the benefit of government guarantees. There are two narrow exemptions for resecuritizations. There is a partial exemption for securitization transactions collateralized by student loans originated under the Federal Family Education Loan Program (“FFELP”). A securitization transaction collateralized solely by FFELP loans will have a risk retention ranging from zero to 3 percent, depending on the lowest guaranteed amount for any FFELP loan in the pool. There also is an exemption for certain seasoned loans.

Sponsors and other parties that retain ABS interests to satisfy the credit risk retention requirement generally are prohibited from transferring the retained interests (other than to majority-owned affiliates), hedging the retained credit risk, or pledging the retained interests on other than a full recourse basis. Other than for seller’s interests retained in revolving pool securitizations, the final rules generally provide sunset timeframes for expiration of these restrictions.

Disclosure to investors (and to regulators, upon request) is required regarding, among other things, the form and amount of risk retention and the assumptions used in making the required fair value calculations.

Who Must Retain Credit Risk

Sponsors

Section 15G of the Exchange Act imposes risk retention requirements on any "securitizer" of ABS. As defined, a "securitizer" includes the "sponsor," defined as a "person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer,"[6] a phrase which is substantially identical to the definition of "sponsor" under Regulation AB[7] except that it is applicable to all securitizations, whether or not subject to the Regulation AB disclosure rules.

The rules generally require the sponsor (or a majority-owned affiliate, as described below) to retain the required economic interest in the credit risk of the securitized assets. If there is more than one sponsor, each sponsor is responsible for ensuring that at least one of them (or at least one of their majority-owned or wholly-owned affiliates, to the extent permitted as described below) retains the entire required credit risk.[8]

The definition of "securitizer" in Section 15G also includes an issuer of ABS. For purposes of the federal securities laws, an "issuer" of ABS generally means the depositor (*i.e.*, the entity that deposits the pool assets with the issuing entity).[9] However, the Agencies have chosen to apply the risk retention requirements to the sponsor rather than the depositor.

Originators

The rules do not require that any originator retain credit risk associated with securitized assets. However, the rules permit a sponsor (with the agreement of the affected originators) using the "standard" risk retention option (*i.e.*, the vertical, horizontal or combined method of risk retention) to allocate some or all of its risk retention obligations to one or more originators of the securitized assets. "Originator" is defined in Section 15G of the Exchange Act as any entity that "creates" a securitized financial asset and sells that asset directly or indirectly to a securitizer. Under the Agencies' interpretation, only the original creditor under the financial asset is an originator for this purpose, so the required risk retention may not be allocated to any subsequent purchaser or transferee.[10] The sponsor's risk retention requirements will be offset by any amount allocated to an originator in compliance with the rules.

The sponsor is permitted to allocate risk retention only to an originator that contributes at least 20 percent of the assets to the asset pool, and the originator will be required to hold a percentage of the retention interest of at least 20 percent, but no more than the percentage of the pool assets it originated. An originator is subject to the same restrictions as the sponsor on transferring, hedging, and financing its risk retention interest, as described below.

---

[6] The Agencies interpret "issuer" for this purpose as referring to the issuing entity.

[7] *See* Item 1101 of Regulation AB.

[8] According to the Final Rule Release, allowing multiple sponsors to allocate risk retention among themselves would dilute the economic risk being retained and, therefore, reduce the alignment of interest between the sponsor and the investors.

[9] *See*, *e.g.,* Rule 191 under the Securities Act of 1933, as amended (the "Securities Act") and Rule 3b-19 under the Exchange Act.

[10] Regulation AB uses the term "originator" but does not define it. In a correspondent lending arrangement in which a lender originates loans pursuant to a purchaser's underwriting guidelines and the purchaser has previously committed to purchase loans that satisfy its guidelines, ABS market participants generally have viewed the purchaser, not the correspondent lender, as the originator for purposes of Regulation AB. However, the risk retention rules view the original creditor as the originator. In the Final Rule Release, the Agencies state that "the definition of the term originator in Section 15G should not be interpreted to include persons that acquire loans and transfer them to a sponsor." Section 15G defines an originator as a person that "creates" a financial asset through the extension of credit or otherwise, and the Agencies believe that "[a] person that acquires an asset created by another person would not be the 'creator' of such asset."

The originator must acquire its risk retention interests in the same manner and proportion as they were originally established by the sponsor, either for cash or by reduction in the price paid by the sponsor or depositor for the related assets.

Sponsors that allocate risk retention to originators will remain responsible for compliance with the rules regarding retained credit risk, will be required to monitor the compliance by each originator, and will be required to notify securityholders upon discovery of any noncompliance by an originator.

Some of the asset-specific and transaction-specific alternatives and exemptions also permit other parties to retain the required risk, as further described below.

Majority-Owned Affiliates

Where the rules require or permit the sponsor, an originator or any other party to retain credit risk, then except as otherwise specifically provided, the risk may be retained by a majority-owned affiliate of that party. A "majority-owned affiliate" of a party is an entity other than the issuer that directly or indirectly majority controls, is majority controlled by, or is under common majority control with, that party. For these purposes, "majority control" means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

Permitted Forms of Risk Retention

Base Risk Retention Requirement and Standard Method

The rules apply to securitizers in issuances of "asset-backed securities" as defined in the Exchange Act pursuant to the Dodd-Frank Act.[11] This category of ABS encompasses a much broader range of instruments than asset-backed securities as defined in Regulation AB, including all securities that are collateralized[12] by self-liquidating financial assets that allow securityholders to receive payments based primarily on the cash flows from those assets, whether offered publicly or privately. Among other things, ABS for these purposes include collateralized debt obligations, securities issued or guaranteed by a government-sponsored enterprise (a "GSE") such as Fannie Mae or Freddie Mac, municipal ABS and any security that the SEC, by rule, determines to be an asset-backed security.

Synthetic securitizations, such as transactions effectuated through the use of credit default swaps, total return swaps or other derivatives, are not be covered by the rules.[13]

Section 15G generally requires that a securitizer retain not less than 5 percent of the credit risk for any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, unless an exemption is available. Therefore, the base risk retention provisions of the rules require the sponsor to retain an economic interest equal to at least 5 percent of the aggregate credit risk of the pool assets. The base risk retention requirement is a minimum, and sponsors, originators and other transaction parties may retain additional credit risk exposure.

---

[11] *See* Section 3(a)(79) of the Exchange Act.

[12] The rules clarify that the term "collateralize," as used in Section 15G and in the proposed rules, does not imply any specific legal structure for a securitization covered by the risk retention requirements. "Assets or other property collateralize an issuance of ABS interests if the assets or property serve as collateral for such issuance." Assets or other property serve as "collateral" for an ABS issuance if they "provide the cash flow and the servicing assets that support such cash flow for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in or rights to cash flow from such assets and related servicing assets."

[13] The Original NPR stated that because the term "asset-backed security" for purposes of Section 15G includes only those securities that are collateralized by self-liquidating financial assets, synthetic securitizations are not within the scope of the rules. This conclusion was affirmed by the Re-Proposal NPR.

The rules provide a “standard” risk retention option that allows for the use of a horizontal interest, a vertical interest or any combination, as well as several asset-specific and transaction-specific methods that attempt to recognize the diversity of asset classes and securitization structures. In general, no particular method is mandated. For each method, the rules prescribe disclosure requirements designed to make clear to investors, the SEC and other applicable regulators exactly how credit risk associated with the transaction is being retained.

Vertical Retention by Sponsor

A sponsor may satisfy its risk retention obligations by retaining (or causing a majority-owned affiliate to retain) at least 5 percent of each class of ABS interests issued as part of the securitization transaction. Alternatively, the sponsor (or a majority-owned affiliate) may hold a single vertical security representing the right to receive a specified percentage of the principal and interest paid on each class of ABS interests, effectively representing the same proportion of each class of ABS interests. In either case, the vertical risk retention option represents an interest in the entire structure of the securitization transaction.

For purposes of the rules, an “ABS interest” includes most types of interests issued by an issuing entity, whether or not certificated, including any security, obligation, beneficial interest or residual interest, the payments on which primarily depend on the cash flows from the collateral (*i.e.*, the pool assets),[14] other than a non-economic residual interest in a real estate mortgage investment conduit (or “REMIC”) or an uncertificated regular interest in a REMIC that is held by another REMIC where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors.[15]

The rules do not require fair value calculations for the vertical risk retention option, because the Agencies agreed with commenters that they are not necessary to ensure the retention of 5 percent of the credit risk of the ABS interests issued.

The rules clarify that “servicing assets,” meaning any rights or assets designed to assure the servicing or timely distribution of proceeds and other rights or assets that are related to or incidental to purchasing or otherwise acquiring and holding the securitized assets, may be included within the pool assets.[16]

Horizontal Retention by Sponsor

Eligible horizontal residual interest. A sponsor may satisfy its risk retention obligations by retaining (or causing a majority-owned affiliate to retain) an “eligible horizontal residual interest” in the issuing entity in an amount equal to at least 5 percent of the fair value of all ABS interests issued as part of a securitization transaction. The horizontal risk retention option represents a first loss position with respect to the entire asset pool.

In using fair value for purposes of calculating horizontal risk retention, the rules require the percentage calculations to be determined using a fair value measurement framework under GAAP, as of the closing date of the transaction. As detailed below, sponsors generally must describe, a reasonable period of time before closing, the expected fair values of the interest to be retained and of all ABS interests, including, if final information is not available, a range of fair values based on bona fide estimates, and the

---

[14] *See* note 12 above for the definition of “collateral.”

[15] The term “ABS interest” excludes common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity and the payments on which are not primarily dependent on the cash flows of the underlying assets. Fees for services, such as servicing fees, do not constitute ABS interests.

[16] Servicing assets include amounts received as proceeds of securitized assets, including proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

methodology used for calculating fair value, including the key inputs and assumptions used. Sponsors also must describe, a reasonable time after closing, final fair value calculations and any changes to the valuation methodology.

An eligible horizontal residual interest may consist of one or more ABS interests that collectively:

- require any shortfall in funds available to pay principal or interest on a payment or allocation date to reduce amounts payable to the horizontal interest before reducing amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other contractual provision, until the amount of all other ABS interests is reduced to zero; and

- have the most subordinated claim to payments of both principal and interest by the issuing entity (except for any non-economic REMIC residual interest).

A multiple-class residual interest generally must consist of the most subordinated classes, in consecutive order.

As re-proposed, the rules would have imposed limits on the cash flow to an eligible horizontal residual interest to better assure that it would not be repaid faster than expected. Many commenters opposed these limits. The Agencies eliminated them from the final rules, concluding that they "could not operate without significant risk or unintended consequences" and that the Agencies were unable to "identif[y] a cash flow restriction mechanism that would function effectively across asset classes without having an unduly restrictive impact on particular asset classes."

Horizontal cash reserve account. The rules allow a sponsor to establish and fund a cash reserve account, referred to as a "horizontal cash reserve account," in lieu of retaining all or any part of an eligible horizontal residual interest. The amount in the account must equal the same amount that would be required if the sponsor held an eligible horizontal residual interest. The account must be held by the trustee for the benefit of the issuing entity, and may be invested only in cash and cash equivalents. The term "cash equivalents" is not defined in the rules, but the Final Rule Release states that "[t]he [A]gencies view 'cash equivalents' to mean high-quality, highly liquid short-term investments the maturity of which corresponds to the securitization's expected maturity or potential need for funds and that are denominated in a currency that corresponds to either the securitized assets or the ABS interests."[17]

Until all ABS interests are paid in full or the issuing entity is dissolved, amounts in the account must be used:

- to satisfy payments on ABS interests when the issuing entity, if the issuing entity otherwise has insufficient funds; or

- to pay critical expenses of the trust unrelated to credit risk on any payment due, if the issuing entity otherwise has insufficient funds to make that payment, such expenses would otherwise be paid prior to any payments to holders of ABS interests, and the payments are made to parties unaffiliated with the sponsor.

The sponsor may receive interest income on the permitted investments in the account.

[17] According to the Final Rule Release, cash equivalents might include FDIC-insured deposits, certificates of deposit issued by a regulated US financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper. Where the pool assets or ABS interests are denominated in a foreign currency, cash equivalents would include cash equivalents denominated in that currency.

Combined Retention by Sponsor

The rules permit a sponsor to retain (or cause a majority-owned affiliate to retain) any combination of eligible vertical interests and eligible horizontal residual interests (including a horizontal cash reserve account), so long as the total percentages of the eligible vertical interest and of the fair value of the eligible horizontal interest equal no less than 5 percent.

No Representative Sample Method

As originally proposed, a sponsor could have satisfied its risk retention obligations by retaining a randomly selected representative sample of assets that was materially equivalent to the pool assets. Because many commenters criticized the proposal as impractical, unworkable, subject to manipulation and burdensome, the Agencies eliminated it altogether from the re-proposed rules. Many commenters on the re-proposal asked that the representative sample option be reinstated, with changes to make it workable, but the Agencies were not convinced to do so.

Horizontal Retention by CMBS B-Piece Buyer

Transfer to third-party buyers. Section 15G of the Dodd-Frank Act authorizes the Agencies to permit the retention of the "B-piece" of a commercial mortgage-backed security ("CMBS") transaction by up to two third party B-piece buyers, rather than the sponsor, to satisfy its risk retention requirements. The rules permit the sponsor of a CMBS transaction[18] to meet its risk retention requirements if one or two third-party B-piece buyers (or any majority-owned affiliate thereof) purchase and hold an eligible horizontal residual interest (alone or in combination with a vertical interest held by the sponsor), provided that several conditions are satisfied:

- each eligible horizontal residual interest must be acquired and retained by the B-piece buyer in the same form, amount, and manner that would be required of the sponsor under the horizontal risk retention option;
- each B-piece buyer must pay for the B-piece in cash at closing, without financing received directly or indirectly from any other transaction party other than an investor;
- each B-piece buyer must perform a due diligence review of the credit risk of each asset in the pool, including a review of the underwriting standards, collateral, and expected cash flows of each loan;
- no B-piece buyer may be affiliated with any transaction party other than investors or the special servicer, except as described below; and
- an operating advisor must be appointed for the transaction.

If there are two B-piece buyers, then each of their interests must be *pari passu*.

Affiliation and control rights. The Original NPR noted that while in CMBS transactions the B-piece buyer often is the holder of the "controlling class" and is, or is affiliated with, the special servicer, control of the special servicing function by the holder of a subordinate interest has the potential to create conflicts of interest with holders of senior securities.

[18] The collateral must consist entirely of commercial real estate loans, together with servicing assets.

As adopted, the credit risk retention rules strictly prohibit affiliation of any B-piece buyer with any transaction party other than an investor[19] or the special servicer, regardless of the appointment of an operating advisor. Appointment of an operating advisor, subject to the requirements described above, is required for all CMBS transactions relying on a B-piece buyer for satisfaction of any of their risk retention requirements.

The transaction documents must specify standards with respect to the operating advisor's experience, expertise and financial strength to fulfill its duties for the life of the transaction, and the terms of its compensation. When the principal balance of the B-piece is reduced by principal payments, realized losses and appraisal reduction amounts (as determined by the transaction documents) to 25 percent or less of its original principal balance, the special servicer will be required to consult with the operating advisor before any major servicing decision (such as any material modification or waiver of any provision of a loan agreement, and any foreclosure on or acquisition of property). The transaction documents must give the operating advisor access to sufficient information and reports to perform its duties under the transaction documents (including all reports made available to holders of ABS interests and B-piece buyers), and must make the operating advisor responsible for reviewing the actions of the special servicer and issuing a periodic report to investors (including any B-piece buyers) concerning its belief (in its sole discretion, exercised in good faith) as to whether the special servicer is in compliance with its applicable servicing standards.

In addition, the transaction documents must provide that the operating advisor has the authority to recommend that the special servicer be replaced as special servicer if the operating advisor determines (in its sole discretion, exercised in good faith) that the special servicer failed to comply with any applicable servicing standard and that its replacement would be in the best interest of all investors. The special servicer will be required to be replaced if the operating advisor makes such a recommendation and upon the vote of a majority of the outstanding principal balance voting of ABS interests voting on the matter, with a minimum quorum set forth in the transaction documents (but not to exceed 20 percent of the outstanding principal balance of all ABS interests, and including at least three holders of ABS interests that are not affiliated with each other).

Transfer and hedging prohibitions. In general, a B-piece buyer is subject to the same restrictions on transferring, hedging, and financing its retained interest as any sponsor with respect to a horizontal risk retention option, as discussed below. However, transfer of a B-piece by an initial purchaser will be permitted to another third-party purchaser that meets all of the applicable requirements after five years from the closing date. Any such subsequent third-party purchaser may transfer a B-piece at any time to another qualified third-party purchaser. A sponsor that retains a B-piece also may transfer it to a qualified third-party purchaser after five years from the closing date. Any transferor must provide the sponsor with complete identifying information regarding its transferee.

The transfer and hedging prohibitions will no longer apply to a CMBS transaction after each commercial real estate loan in the asset pool has been defeased, meaning that:

- cash or cash equivalents whose maturity corresponds to the remaining debt service obligations have been pledged to the issuer as collateral for the loan in such amounts and payable at such times as are necessary to timely generate enough cash to make all remaining debt service payments on the loan; and

---

[19] This requirement is subject to a *de minimis* exception permitting affiliation with one or more originators of the securitized assets collectively comprising less than 10 percent of the securitized pool's unpaid principal balance.

- the issuer has an obligation to release its lien on the loan.

Duty to comply. If a B-piece buyer holds any credit risk, the sponsor remains responsible for compliance with all of the relevant risk retention requirements, and must implement and adhere to policies and procedures to monitor the B-piece buyer's compliance. If the sponsor discovers any noncompliance, it must promptly notify investors.

Retention of Seller's Interest in Revolving Pool Securitization

A revolving pool securitization, commonly referred to as a "master trust,"[20] often is used to securitize revolving receivables such as credit card accounts or dealer floorplan loans. In this structure, which allows a trust to issue more than one series of ABS backed by the same revolving asset pool, the sponsor typically holds a "seller's interest" in the asset pool that generally is *pari passu* with or subordinated to the ABS interests sold to investors until the occurrence of an early amortization event. The seller's interest adjusts for fluctuations in the outstanding principal balances of the securitized assets.

The revolving pool method of risk retention was substantially revised in the final rule in order to make it available to more types of vehicles and to more closely align it with current market structures.

The rules define a "revolving pool securitization" as an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass or tranche of ABS that are collateralized by a common pool of assets that will change in composition over time, and that does not monetize excess interest and fees. The prohibition on monetizing excess interest and fees was new in the final rules. The Agencies had considered prohibiting the issuance of senior interest-only bonds or premium bonds, but commenters expressed concerns about the feasibility of such a requirement with respect to legacy structures. Therefore, the Agencies took the approach of prohibiting the monetization of excess interest and fees, which is dependent on facts and circumstances, including "whether the revolving pool securitization issues ABS interests that price materially above par in light of all the features of the ABS interests and market conditions, or the revolving pool securitization issues ABS interests that pay investors interest on notional principal absent issuance of a corresponding issuance of principal-only bonds to support the revolving pool securitization."

The sponsor of a revolving pool securitization may satisfy its risk retention obligations by maintaining (or causing one or more wholly-owned affiliates to maintain) a seller's interest in an amount not less than 5 percent of the aggregate unpaid principal balance of all outstanding investor ABS interests in the issuing entity.[21] A qualifying "seller's interest" is an ABS interest or interests that:

- is collateralized by the issuing entity's securitized assets and servicing assets, other than servicing assets allocated as collateral only for a specific series (*e.g.*, a principal accumulation or interest reserve account), and other than assets that the transaction terms do not include in determining whether the revolving pool securitization holds securitized assets in specific proportions to aggregate outstanding investor ABS interests (collectively, "Excluded Assets");

- is *pari passu* with (or partially or fully subordinated to) each series of investor ABS interests with respect to the allocation of distributions and losses before an early amortization event; and

- adjusts for fluctuations in the outstanding principal balance of the pool assets.

---

[20] The final rules use the term "revolving pool securitization" rather than "master trust" because the legal form of such transactions is not always a trust.

[21] ABS interests held for life by the sponsor or its wholly-owned affiliate may be excluded.

There are several special rules for calculating the amount of the seller's interest. The unpaid principal balance of the pool assets (which is used as the numerator of the 5 percent ratio) must not include any Excluded Assets. The aggregate unpaid principal balance of outstanding investor ABS interests (the denominator of the 5 percent ratio) may be reduced by the amount of any funds held in a segregated principal accumulation account, if the transaction documents prevent them from being applied for any purpose other than principal payments on those investor ABS interests, and funds in the account are invested only in cash and cash equivalents. If the transaction documents set the minimum required seller's interest as a proportion of the unpaid principal balance of outstanding investor ABS interests of one or more series, rather than of all such series combined, the percentage of the seller's interest for each such series must (when combined with the percentage of any minimum seller's interest measured as a proportion of the aggregate outstanding investor ABS interests) equal at least 5 percent. Finally, the 5 percent test must be determined and satisfied at the closing or each issuance of ABS interest to investors, and at least monthly at a specified measurement date (the "Regular Measurement Date") until no ABS interest is held by anyone other than a wholly-owned affiliate of the sponsor. If the 5 percent test is failed at any Regular Measurement Date, and the transaction documents include a cure period, then the 5 percent test must be determined and satisfied within the earlier of the cure period and one month after that Regular Measurement Date.

When calculating closing date fair value percentages for purposes of these rules, the sponsor may use data about pool assets or about previously-issued ABS interests as of dates that it specifies, so long as no such date is more than 60 days before the first use of the related investor disclosures described below (or for transactions that make investor distributions on a quarterly basis or less frequently, no such date is more than 135 days before first use of the related investor disclosures).

The rules contemplate the possibility of "legacy trusts," i.e., multi-level revolving pool securitization structures. If one revolving pool securitization issues collateral certificates representing a beneficial interest in its pool assets to another revolving pool securitization, which then issues ABS interests based on those collateral certificates, the sponsor (or its wholly-owned affiliate) may retain a seller's interest in the lower-level structure, so long as the proportion held at that level equals its proportional share of the combined securitized assets of the two trusts.

The amount of the required seller's interest may be reduced dollar-for-dollar by the amount of cash and cash equivalents retained in an excess funding account. The account must be funded by seller's interest distributions, and be available to meet the minimum seller's interest requirement or a minimum balance requirement, and its funds must be payable to investors in the same manner as amounts received on the securitized assets.

The rules permit the sponsor to reduce its seller's interest to a percentage lower than 5 percent if, for all series of investor ABS interests, the sponsor retained a minimum corresponding fair value percentage of subordinated risk retention. This subordinated interest in a series may be held in the form of either a residual interest in excess interest and fees, or as a horizontal interest in that series.

A residual interest in excess interest and fees is available only when each series distinguishes between cash flows from interest, fees and principal on the pool assets—a typical structure for securitizations of credit card and floorplan receivables with an initial revolving period, followed by a controlled amortization period. For such an interest to qualify, the sponsor's claim in the cash flows from a series' share of interest and fee cash flows would have to be subordinated to all accrued and payable interest on any payment date for more senior ABS interests in that series, and reduced by the series' share of losses (including principal defaults) to the extent that those payments would have been included in amounts payable to more senior interests. Further, the revolving pool securitization must continue to revolve. For purposes of the offset, the fair values of the residual interest and of the investor ABS interests are measured as of the closing date of the issuance of the investor ABS interests, and at each Regular Measurement Date (though the sponsor has the option to continue to use the closing fair value of the investor ABS interests rather than re-valuing them at the Regular Measurement Date if it wishes to do so).

A horizontal interest in a series may be used for an offset if it would meet the requirements of an eligible horizontal residual interest, but for the sponsor's simultaneous holding of subordinated seller's interests and/or residual interests in excess interest and fees. For purposes of the offset, the fair values of the horizontal interest and the investor ABS interests are measured as of the closing date of the issuance of the investor ABS interests. The sponsor may not include in the fair value percentage numerator:

- any fair value based on the subordinated seller's interest or residual interest in excess interest and fees;
- the interest payable to the sponsor on the horizontal interest (if the value of a residual interest in excess interest and fees is being used as an offset); or
- the principal payable on the horizontal interest if the sponsor is including the value of a seller's interest and distributions on the seller's interest are available to reduce charge-offs that otherwise would be allocated to reduce principal payable on the horizontal interest.

A sponsor of a revolving pool securitization that suffers a decline in its seller's interest as a result of an early amortization event (resulting in the seller's interest falling below its minimum maintenance level) will still be considered to be in compliance with its risk retention requirements if:

- the sponsor was in full compliance before the early amortization trigger occurred;
- the terms of the seller's interest continue to make it *pari passu* or subordinate to each series of investor ABS with respect to the allocation of distributions and losses on the pool assets;
- the master trust issues no additional ABS interests except to a wholly-owned affiliate of the sponsor; and
- to the extent the seller's interest is combined with any offsetting horizontal interest, those interests are required to continue to absorb losses.

Retention of Credit Risk in ABCP Conduit Vehicles by Originator-Sellers

The rules permit the sponsor of an asset-backed commercial paper ("ABCP") conduit vehicle to meet its risk retention requirements if each originator-seller that transfers assets to collateralize the ABS interests issued by the conduit retains certain credit risks. This option is available only for ABCP having a maturity of 397 days[22] or less that is collateralized by certain ABS interests that themselves are collateralized by assets originated by an originator-seller and are acquired from one or more intermediate SPVs (and by

[22] Exclusive of grace periods and renewals the maturity of which is likewise limited. The limit that had been proposed was nine months, but in the final rules the Agencies extended the maximum maturity in response to commenters' concerns that conduits will need to issue ABCP with a longer maturity to accommodate the needs of regulated institutions under the Basel liquidity standards.

servicing assets and certain other related assets), and supported by a liquidity facility that provides fully-supported, 100 percent liquidity coverage from a regulated institution.

Many commenters urged the Agencies to expand the liquidity facility requirement to include partially-supported facilities, in which there typically is a borrowing base that is reduced by any excess of non-performing collateral over the customer's credit enhancement, but as to which the bank sponsor typically also provides an additional unconditional credit enhancement of at least 5 percent of the conduit's ABCP. The Agencies did not accommodate this request. Many commenters also urged the Agencies to expand the types of assets that may be acquired by an eligible ABCP conduit to include, for example, direct loans to a customer, the direct purchase of financial assets, and ABS purchased on the open market, but these requests were not granted either.

Eligible ABCP conduits. This risk retention option is available only with respect to ABCP issued by an "eligible ABCP conduit," which must meet several requirements:

- the issuing entity must be bankruptcy remote from the sponsor and any intermediate SPV;
- the ABS interests acquired by the ABCP conduit must be:
  - ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets;
  - special units of beneficial interest (*i.e.*, SUBIs) or similar ABS interests in a lease trust or SPV where the leases were originated by an originator-seller and transferred to an intermediate SPV in a securitization collateralized solely by such leases and by servicing assets;
  - ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller and by servicing assets;
  - ABS interests of the foregoing types that are wholly or partially collateralized by assets acquired by an originator-seller in a business combination that qualifies for business combination accounting under GAAP;[23] and
  - acquired by the ABCP conduit by or on behalf of an intermediate SPV, directly or indirectly from an underwriter or other person who acquired them directly from the intermediate SPV;
- the ABCP conduit must be collateralized solely by ABS interests acquired from intermediate SPVs as described above and by servicing assets; and
- a regulated liquidity provider must have committed to provide fully-supported, 100 percent liquidity coverage on the ABCP.

An "originator-seller" is an entity that originates assets and sells or transfers those assets, directly or through a majority-owned affiliate, to an intermediate SPV, and generally includes any affiliate of the originator-seller that majority controls, is majority controlled by or is under common majority control with the originator-seller.

An "intermediate SPV" is a special purpose vehicle that:

---

[23] And if collateralized in part, the remainder of such assets are the foregoing types of assets.

- is a direct or indirect wholly-owned affiliate of the originator-seller;[24]
- is bankruptcy-remote or otherwise isolated for insolvency purposes from the ABCP conduit and from each originator-seller and each majority-owned affiliate that directly or indirectly transfers assets to it;
- acquires assets from the originator-seller that were originated by that originator-seller, or acquired by the originator-seller in the acquisition of a business that qualifies for business combination accounting under GAAP, or acquires ABS interests issued by another intermediate SPV of the originator-seller that are collateralized solely by such assets; and
- issues ABS interests collateralized solely by such assets.

Originator-seller risk retention for eligible ABCP conduits. The sponsor of an eligible ABCP conduit may satisfy its risk retention obligations if, for each ABS interest it acquires from an intermediate SPV, each originator-seller of the intermediate SPV retains the same amount and type of credit risk as would be required under the standard risk retention option (or the option for revolving pool securitizations, as described below), subject to all of the same requirements, and the sponsor:

- approves each originator-seller and intermediate SPV from which assets or ABS interests may be acquired;
- establishes criteria governing such assets and ABS interests;
- administers the ABCP conduit by, among other things, monitoring the acquired such assets and ABS interests and ensuring compliance with the ABCP conduit's documents and credit and investment policies; and
- maintains procedures for compliance with all of the foregoing requirements.

The sponsor is responsible for the originator-sellers' compliance and must maintain policies and procedures to monitor that compliance. If the sponsor determines that an originator-seller is noncompliant, the sponsor must promptly notify investors and, upon request, the SEC and the sponsor's appropriate Banking Agency. Any such notice must include a variety of additional information, such as the name and form of organization of any originator-seller that fails to retain the required risk, and any remedial actions taken by the sponsor.

Transfers between certain eligible ABCP conduits. An eligible ABCP conduit that acquired an ABS interests as described above may transfer those ABS interests to another eligible ABCP conduit if the sponsors of both conduits are in compliance with all of the foregoing requirements, and the two conduits share the same regulated liquidity provider.

No Additional Risk Retention for ABS Guaranteed by Fannie Mae or Freddie Mac

The rules contain special provisions regarding credit risk retention requirements for Fannie Mae and Freddie Mac, while operating under the conservatorship or receivership of the Federal Housing Finance Agency (the "FHFA"), and certain successors to Fannie and Freddie.

[24] Or has nominal equity owned by an unaffiliated, independent trust or corporate service provider.

Fannie and Freddie fully guarantee the timely payment of principal and interest on their mortgage-backed securities, so they are exposed to the entire credit risk of the underlying mortgage loans. The credit risk retention rules provide that the guarantee of Fannie or Freddie while operating under the conservatorship or receivership of FHFA with capital support from the United States (and an equivalent guarantee by a successor also operating under the direction and control of FHFA with capital support from the United States) will satisfy the risk retention requirements of Section 15G. Neither do the hedging and financing prohibitions described below apply to Fannie, Freddie or any successor.[25]

Both the administration and Congress have considered a variety of proposals to reform the housing finance system and to reform (or even wind down) Fannie and Freddie. In the Final Rule Release, the Agencies confirm that they expect to revisit these provisions after the futures of Fannie and Freddie become clearer.

Open Market Collateralized Loan Obligations

As adopted, the rules contain an alternative risk retention option for open market CLOs. As defined, a "CLO" is a special purpose entity that issues debt and equity interests, and whose assets consist primarily of loans that are securitized assets and servicing assets, and an "open market CLO" is a CLO whose assets consist of certain senior, secured syndicated loans acquired directly in open market transactions (together with servicing assets), that is managed by a CLO manager, and that holds less than 50 percent of its assets by aggregate outstanding principal amount in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO manager or originated by originators that are affiliates of the CLO or the CLO manager.The open market CLO risk retention option is not available to a balance sheet CLO, in which the CLO obtains a majority of its assets from entities that control or influence its portfolio selection.

An open market CLO satisfies its risk retention requirements if:

- its assets consist solely of senior, secured syndicated loans that are CLO-eligible loan tranches and servicing assets, and its governing documents so require;
- it does not invest in ABS interests or credit derivatives other than hedges that are servicing assets to hedge the CLO's risks;
- all purchases of assets prior to issuance of the CLO's ABS interests are made in open market transactions on an arms' length basis; and
- the CLO manager is not entitled to receive any management fee or gain on sale when the CLO issues its ABS interests.

To qualify as a "CLO-eligible loan tranche," the firm serving as lead arranger of the loan must retain at origination at least 5 percent of the face amount of the loan tranche, until the earliest of repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan, subject to the general restrictions on hedging, transferring and pledging described below. In addition, the loan documents must give holders of a CLO-eligible tranche consent rights with respect to, at a minimum, material waivers and amendments of the loan documents, and the provisions of the loan documents must not be materially less advantageous to the obligor than the provisions that apply to non-CLO-eligible loan tranches. The lead arranger must have an initial allocation of the funded portion of the facility that includes the loan tranche of at least 20 percent of the aggregate principal balance at origination, with no

[25] So long as Fannie, Freddie or its respective successor is operating under the conservatorship or receivership of FHFA with capital support from the United States.

other syndicate member that funded at origination having a larger allocation or commitment. The lead arranger must be identified at the time of syndication, and the loan documents would have to include covenants to satisfy its requirements.

Unless a CLO satisfies all of the requirements for the open market CLO option, including an asset pool consisting entirely of CLO-eligible loan tranches and servicing assets, the rules as adopted would require a CLO manager to satisfy the credit risk retention requirements under the standard approach or in some other way.

During the comment process for the rules, many commenters had expressed the view that a CLO manager is not a "sponsor" because it does not sell or transfer assets to the issuing entity. The Agencies rejected this interpretation, stating that a "CLO manager indirectly transfers the assets to the CLO issuing entity because the CLO manager has sole authority to select the commercial loans to be purchased by the CLO issuing entity for inclusion in the CLO collateral pool, directs the issuing entity to purchase such assets in accordance with investment guidelines, and manages the securitized assets once deposited in the CLO structure." On February 9, 2018, the US Court of Appeals for the DC Circuit issued a ruling adopting the commenters' view, holding that managers of open market CLOs are not subject to the risk retention rules because they do not sell or transfer possession or control of the assets to the issuing entity, either directly or indirectly.[26]

Tender Option Bonds

The rules permit a method of credit risk retention for a type of municipal bond repackaging known as "tender option bonds" that closely tracks several of the requirements for these repackagings as outlined in the rules of the Internal Revenue Service (the "IRS"). This method applies to "qualified tender option bond entities" in which:

- the collateral consists solely of servicing assets and municipal securities as defined in Section 3(a)(29) of the Exchange Act, and all of those securities have the same municipal issuer and the same underlying obligor or source of payment (without regard to credit enhancement) and are not subject to substitution;
- the only two classes of securities issued are a preferred variable return tender option bond and a residual interest;
- interest on each the underlying municipal security is exempt from taxation;
- the terms of the tender option bond and the residual are structured so that interest to all holders is exempt from taxation;
- a regulated liquidity provider has committed to provide 100 percent guarantee or liquidity coverage;
- the issuing entity qualifies for monthly closing elections pursuant to IRS rules; and
- the holder of a tender option bond has the right to tender to the issuing entity for purchase at any time upon no more than 397 days' notice for purchase at approximately the amortized cost of the security plus accrued interest.

---

[26] *The Loan Syndications & Trading Ass'n v. SEC and Board of Governors of the Federal Reserve System*, No. 17-5004 (D.C. Cir. Feb 9, 2018). For more details, see our LawFlash titled **The LSTA Case: DC Circuit Court Delivers Victory for CLO Industry, with Some Broader Ramifications**.

The sponsor of a qualified tender option bond entity will satisfy its risk retention requirements if it retains an eligible horizontal residual interest, an eligible vertical interest or any combination, as described above. Alternatively, a sponsor of a qualified tender option bond entity may retain either:

- an interest that meets the requirements of an eligible horizontal residual interest, but on the occurrence of a "tender option termination event" as defined by the IRS will meet the requirements of an eligible vertical interest; or

- municipal securities from the same issuance deposited into the qualified tender option bond entity in a face value equal to 5 percent of the face value of the deposited securities.

- Regardless of the risk retention method chosen, the retained interests or municipal securities are subject to all of the general restrictions on hedging, transferring and pledging described below.

Qualified Assets

Section 15G of the Exchange Act exempts from the risk retention requirements any ABS collateralized solely by QRMs. Section 15G also directs the Agencies to define jointly what constitutes a QRM, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default," but does not permit the definition of QRM to be broader than the definition of QM as adopted by the CFPB. In addition, Section 15G directs the SEC and the Banking Agencies to adopt separate risk retention rules for ABS backed by commercial real estate loans ("CRE loans"), other commercial loans, auto loans, and any other asset class that they deem appropriate, providing for retention of less than 5 percent credit risk if the loans satisfy underwriting standards developed by the Banking Agencies that indicate low credit risk. The Agencies refer to QRMs and CRE loans, other commercial loans and auto loans that satisfy the criteria for exemption from the credit risk retention requirement as "qualified assets."

Qualified Residential Mortgages

ABS are exempt from the risk retention requirement if:

- the securitized asset pool consists solely of QRMs — and not a class of ABS backed by QRMs (or other assets) — and servicing assets;

- as of the cut-off date, every loan in the pool currently is less than 30 days or more past due, in whole or in part; and

- the depositor certifies that "it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages and has concluded that its internal supervisory controls are effective."

These "internal supervisory controls" must be evaluated for each issuance of ABS relying on the QRM exemption within 60 days prior to the related cut-off date, and a copy of the depositor's certification must be delivered to prospective investors and, upon request, to the SEC and any applicable Banking Agency.

QM as QRM. According to the Final Rule Release, "a QRM definition aligned with the definition of QM meets the statutory goals and directive…to limit credit risk and promote sound underwriting," and "also will meet the important goals of preserving access to affordable credit for various types of borrowers and facilitating the return of private capital to the mortgage market." Therefore, under the final rules, a QRM is a QM, as defined by the CFPB from time to time.[27] For a loan to be a QM, generally:

- the loan must fully amortize over its term, so it cannot feature negative amortization, interest-only or graduated payments or balloon payments;
- the term cannot exceed 30 years;
- underwriting must take into account all mortgage-related obligations, must be based on the maximum rate permitted under the loan during the first five years and must be on a fully amortized basis;
- the lender must consider and verify the borrower's current or reasonably expected income or assets, and current debt obligations, alimony and child support (*i.e.*, it cannot be a "no-doc" loan), in accordance with specific guidelines and standards based on FHA guidelines;
- the borrower must have a total (or "back-end") DTI ratio that is less than or equal to 43 percent (based on the highest payment that could occur in the first five years of the loan); and
- the loan cannot require points or fees in excess of 3 percent of the loan amount (other than "bona fide discount points" on prime loans), with higher thresholds for smaller loans.[28]

QRM includes not only the general definition of QM summarized briefly above, but also:

- the temporary rule defining as QMs loans that meet certain prohibitions on certain risky features and are eligible for purchase or guarantee by the GSEs such as Fannie Mae and Freddie Mac, or eligible to be insured or guaranteed by the FHA, the Veteran's Administration (the "VA"), the Department of Agriculture (the "USDA") or the Rural Housing Service (the "RHS");
- any QM definitions later adopted by the FHA, the VA, the USDA and the RHS; and
- the small creditor and other special QM definitions adopted from time to time by the CFPB.

Preservation of exemption. If after the closing of a securitization it is discovered that one or more securitized loans does not satisfy all of the QRM criteria, the sponsor will not lose its exemption from the risk retention requirement if:

- the depositor complied with the certification requirement described above;
- within 90 days of discovery of the noncompliance, the sponsor repurchases all affected loans from the trust for a price equal to not less than the unpaid principal balance plus accrued interest; and
- the sponsor promptly notifies securityholders of the noncompliance and the repurchase.

Other Qualified Assets

The rules on other qualified assets include underwriting standards for CRE loans, commercial loans, and consumer automobile loans. ABS backed by solely qualifying assets are completely exempt from the risk retention requirements.

---

[27] The final rule release adopting the original ability-to-repay rules and the associated definition of QM is available **here**.. The final rule release adopting certain amendments to these rules is available **here**.

[28] For more details, please see our LawFlashes on the ability-to-repay rules and the associated definition of QM, available **here** and **here**..

There is a zero percent risk retention requirement for qualified CRE loans, commercial loans, and consumer automobile loans (but not QRMs), where both qualified assets and non-qualified assets back ABS interests. Therefore, the sponsor's 5 percent risk retention requirement will be reduced by the ratio of the combined unpaid principal balance of qualified pool assets to the unpaid principal balance of all pool assets, measured as of the cut-off date. This treatment is available only for securitizations backed by loans of the same asset class. There is a 2.5 percent risk retention minimum for blended pool transactions, even if the proportion of qualified assets to non-qualified assets in the securitized pool is more than 50 percent. The Agencies were concerned that "reducing the minimum risk retention for blended pools to less than 2.5 percent…would significantly weaken the economic incentive for the sponsor to ensure that the non-qualifying loans in the pool are appropriately underwritten." Sponsors of blended pool ABS must disclose to investors, their primary federal regulator and the SEC the manner in which the sponsor determined the blended risk retention requirement, in addition to describing both the qualified and non-qualified assets in the pool and their material differences.

Although Section 15G authorized the Agencies to develop underwriting standards for non-QRM qualified assets that would be subject to a credit risk retention requirement of "less than 5 percent," the Agencies chose only to adopt standards consistent with a complete exemption from the risk retention requirement. Section 15G also authorized the identification of additional asset classes that could be subject to a lower credit risk retention requirement, but the Agencies did not exercise this authority.

Qualifying commercial loans. The rules define "commercial loan" to mean any secured or unsecured loan to a company or an individual for business purposes, other than a loan to purchase or refinance a one- to-four family residential property, or a commercial real estate loan. A qualifying commercial loan must meet the following requirements, among others:

- the creditor must verify the borrower's ability to repay its obligations by taking specified steps, including verifying and documenting the borrower's financial condition as of the two most recent fiscal years, and analyzing the borrower's ability to service its debts during the next two years, based on compliance with a total liabilities ratio of 50 percent or less, a leverage ratio of 3.0 or less, and a debt service coverage ("DSC") ratio of 1.5 or greater;
- the loan payments must be based on level monthly payments of principal and interest (at the fully indexed rate) that fully amortize the debt over a term that does not exceed five years from the closing date;
- payments must be required at least quarterly for a term not exceeding five years, and the primary source for repayment must be revenue from the borrower's business operations;
- the loan must have been funded within six months before the cut-off date, and at the cut-off date all payments must be current;
- if the loan is collateralized, the collateral must be subject to a perfected security interest (which must be a first lien if the purpose of the loan is to finance or refinance the purchase of tangible or intangible property) and the documentation must include a variety of covenants designed to ensure that the collateral is maintained, insured and available to satisfy the borrower's obligations; and
- the loan documentation must include several specified covenants that require the provision of financial information and restrict the borrower's ability to incur additional debt or transfer or pledge its assets.

A securitization of qualifying assets (including qualifying commercial loans) may not include a reinvestment period, which would foreclose use of this exemption by most CLOs. Also, commercial loans typically included in CLO pools generally do not satisfy one or more of the required criteria.

Qualifying CRE loans. The rules define a "CRE loan" to mean a loan secured by a property with five or more single-family units, or by nonfarm non-residential real property, the primary source (50 percent or more) of repayment for which is expected to be derived from the proceeds of the sale or financing of the property, or rental income associated with the property, as well as loans secured by improved land if the obligor owns the fee interest and the land is leased to a third party who owns all improvements (which are nonresidential or residential with five or more single-family units). For these purposes, rental income may include income derived from a lease with an unaffiliated lessor, and income derived from hotel, nursing home, mini-storage warehouse or similar properties used primarily by non-affiliates of the borrower. A land development and construction loan (including a one- to four-family residential or commercial construction loan), a loan on raw or unimproved land, or an unsecured loan to a developer will not qualify as a CRE loan.

A qualifying CRE loan must meet the following requirements, among others:

- the creditor must verify the borrower's ability to repay its obligations by taking specified steps, including analyzing the borrower's ability to service all outstanding debt obligations during the next two years, based on reasonable projections (including operating income projections);
- the borrower's DSC ratio must be a required minimum (1.5 for certain qualifying leased CRE loans, 1.25 for qualifying multi-family property loans, and 1.7 for any other type of CRE loan), based on two years' actual performance immediately preceding the origination of the loan if the borrower owned the property and based on two years of projections following the origination of the loan;
- the CRE loan must have a fixed interest rate, though an adjustable rate may be allowed if the borrower obtains a derivative that effectively results in the payment of a fixed rate, or if the borrower obtained an interest rate cap and the loan was underwritten using the maximum interest rate under the cap;
- the loan payments must be based on level monthly payments of principal and interest (at the fully indexed rate) that fully amortize the debt over a term not exceeding 25 years from the closing date (or 30 years for a qualifying multifamily loan), with payments required at least monthly over a term of at least 10 years;
- at origination, the LTV ratio must be 65 percent or less and the combined LTV ("CLTV") ratio must be 70 percent or less, though in certain cases where very low direct capitalization rates are used, the maximum LTV ratio is limited to 60 percent and the maximum CLTV ratio is limited to 65 percent;
- the creditor must obtain an appraisal with an effective date no more than six months before the loan origination date and must conduct an environmental risk assessment of the property;
- the borrower must be current on the loan at the closing date of the securitization;
- the property must be subject to a first lien security interest;
- the documentation must include a variety of covenants designed to ensure that the collateral is maintained and available to satisfy the borrower's obligations, including a covenant to comply with all legal obligations with respect to the property; and

- the documentation must include covenants that require the provision of financial information (including leasing and rent-roll activity) and restrict the borrower's ability to incur additional debt secured by the mortgaged property (even on a subordinated basis) or transfer or pledge the property, other than loans secured by a junior lien which when aggregated with the CRE loan do not exceed the applicable CLTV ratio, or loans to finance the purchase of machinery and equipment that is pledged as additional collateral for the CRE loan.

Qualifying automobile loans. The rules define an "automobile loan" as a loan to an individual to finance the purchase of, and secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck (but not a motorcycle or recreational vehicle), for personal, family, or household use. An automobile loan does not include any loan to finance fleet sales, a cash loan secured by a previously purchased automobile, a loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family or household purposes, any lease financing, or a loan to finance the purchase of a vehicle with a salvage title. A qualifying auto loan may be for a new or used vehicle. Despite requests by commenters, the Agencies declined to include vehicle leases within this exemption.

A qualifying auto loan is required to have the following characteristics, among others:

- the creditor must verify the borrower's ability to repay its obligations by taking specified steps, including verifying and documenting that the borrower is not currently 30 days or more past due on any debt obligation and has not been 60 days or more past due on any debt obligation within the past 24 months, as well as other specified credit standards;

- at origination, the borrower's DTI ratio may not exceed 36 percent;

- in an effort to encourage the use of consistent underwriting standards, the creditor must verify and document the borrower's income and debt obligations using a variety of specified methods, though the creditor may satisfy these requirements regarding the borrower's credit history by obtaining a credit report on the borrower within 30 days of the loan closing, so long as there is no subsequent credit report obtained before closing that indicates that the borrower did not meet any applicable requirements;

- the loan must have a fixed interest rate;

- the loan must require level monthly payments that fully amortize the loan over its term;

- the borrower may not be permitted to defer repayment of principal or interest and must make the first payment within 45 days of the loan's contract date;

- the loan term may not exceed the lesser of six years from the closing date, or 10 years less the vehicle's age (current model year less the vehicle's model year);

- the borrower must be current on the loan as of the cut-off date; and

- the borrower must make a minimum down payment (including any trade-in allowance[29]) that is sufficient to pay all title, tax, and registration fees, all dealer-imposed fees, and 10 percent of the purchase price of the automobile.[30]

The Agencies declined to accommodate the many commenters who requested the ability to use a credit score (such as FICO) in determining whether automobile loans qualify for an exemption from the risk retention requirements.

Depositor certification; preservation of exemption. The rules for each class of qualifying assets require the depositor to certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security meet the applicable underwriting standards.

If after the closing of a securitization it is discovered that one or more securitized loans does not satisfy all of the applicable criteria in any material fashion, the sponsor will not lose its exemption from the risk retention requirements if:

- the depositor complied with its certification requirement;

- within 90 days of discovery of the noncompliance, the sponsor repurchases all affected loans from the trust for a price equal to not less than the unpaid principal balance plus accrued interest or (as and when permitted) effectuates a cure; and

- the sponsor promptly notifies securityholders of the noncompliance and the repurchase or cure.

Other Exemptions

Various portions of Section 15G require or permit the Agencies to adopt other exemptions from the risk retention requirements for certain types of ABS transactions. The Agencies adopted the following exemptions in the final rules:

- any securitization transaction collateralized solely by residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States, and by servicing assets;[31]

- any securitization transaction in which the ABS are insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States and collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets, or interests in such assets;[32]

- any securitization transaction in which the ABS are collateralized solely by obligations issued by the United States or an agency of the United States and servicing assets, collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States and servicing assets, or fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States;

---

[29] The trade-in allowance may not exceed the highest trade-in value of the existing vehicle, as determined by a nationally recognized automobile pricing agency such as N.A.D.A. or Kelley Blue Book.

[30] The purchase price of an automobile is the net amount the consumer paid after any incentive payments or cash rebates.

[31] Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are specifically deemed not to be agencies of the United States.

[32] *E.g.*, Ginnie Mae securitizations.

- any securitization sponsored by the Federal Deposit Insurance Corporation acting as a conservator or receiver;
- any securitization transaction that is collateralized solely by loans or other assets made, insured, guaranteed, or purchased by any institution that is supervised by the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, and by servicing assets;
- ABS that are issued or guaranteed by any state of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act under Section 3(a)(2), or that are defined as "qualified scholarship funding bonds" in Section 150(d)(2) of the Internal Revenue Code of 1986, as amended;
- any securitization transaction secured by the intangible property right to collect charges for the recovery of certain statutorily-specified costs and other assets of an issuing entity owned, directly or indirectly, by a regulated utility company, and by servicing assets;
- any securitization transaction that is collateralized solely by certain community-focused residential mortgages that are exempt from the CFPB's ability-to-repay rules and by servicing assets, with such community-focused residential mortgages qualifying for blended pool treatment with a 2.5 percent risk retention minimum, even if the proportion of other assets to such community-focused residential mortgages is more than 50 percent; and
- any securitization that is collateralized solely by three-to-four-unit mortgage loans that otherwise would qualify as QMs and by servicing assets, subject to compliance with the QM depositor certification and repurchase requirements.

FFELP Student Loans

The rules include a partial exemption for securitization transactions collateralized by FFELP student loans. A securitization transaction collateralized solely (other than servicing assets) by FFELP loans that are guaranteed as to 100 percent of defaulted principal and accrued interest (generally, loans originated before October 1, 1993) are exempt from the risk retention requirements. A securitization transaction collateralized solely (other than servicing assets) by FFELP loans that are guaranteed as to at least 98 percent of defaulted principal and accrued interest (generally, loans originated from October 1, 1993, to July 1, 2006) have a reduced risk retention requirement of 2 percent. A securitization transaction collateralized solely (other than servicing assets) by FFELP loans that are guaranteed as to at least 97 percent of defaulted principal and accrued interest (generally, loans originated from July 1, 2006, to July 1, 2010) have a reduced risk retention requirement of 3 percent. Therefore, for example, if the lowest guaranteed amount for any FFELP loan in a pool is 97 percent, the required risk retention for the transaction is 3 percent — even if the pool also contains loans that are 98 percent or 100 percent guaranteed.

The Agencies declined commenters' requests to fully exempt FFELP loans from the risk retention requirements and to create an exemption for state agency and nonprofit student lenders.

Resecuritizations

According to the Agencies, most repackagings of corporate debt and resecuritizations are subject to the risk retention requirements, even for a resecuritization in which the sponsors of the underlying securities complied with the risk retention rules in the securitization of the underlying assets.

The rules provide two narrow exemptions from the risk retention requirements for resecuritizations.

Certain single class pass-through resecuritizations are exempt, under two conditions:

- the transaction must be collateralized solely by existing ABS issued in a securitization for which credit risk was retained as required under the rule or which was exempted from the credit risk retention requirements of the rule ("15G-compliant"), and servicing assets; and

- the transaction must involve the issuance of only a single class of ABS interests and provide for the pass-through of all principal and interest payments received on the underlying ABS (net of the issuing entity's expenses).

Certain multiple class securitizations of first-pay classes of RMBS also are exempt. A "first-pay class" is defined as a class of ABS interests which are all entitled to the same priority of payment and are entitled to payments of principal and interest prior to or *pro rata* with all other classes (except for principal-only or interest-only tranches that are prior in payment). There are several conditions to this exemption:

- the transaction must be collateralized solely by servicing assets and by first-pay classes of ABS that themselves are collateralized solely by first lien residential mortgages and servicing assets, and that are 15G-complaint;

- the transaction may not provide for any ABS interests to share in realized principal losses other than *pro rata* with all other ABS interests based on current unpaid principal balance when the loss is realized;

- the transaction may be structured to reallocate prepayment risk, but may not reallocate credit risk (other than as a consequence of the reallocation of prepayment risk); and

- the transaction may not include any inverse floater or similar ABS interest.

Traditional resecuritizations that re-tranche the credit risk or (unless they qualify for the first-pay class exemption) the prepayment risk of the underlying ABS, or that are structured to achieve a sequential paydown of tranches—which historically represent the vast majority of resecuritizations— do not qualify for either of these exemptions. Also, private-label ABS issued before the effective date of the final rules typically were not 5G-compliant, so traditional resecuritizations of these securities are not eligible for these limited exemptions.

Seasoned Loans

The rules include a limited exemption for securitization transactions collateralized solely by servicing assets and by certain seasoned loans. To qualify as "seasoned" under this exemption:

- a residential mortgage loan must have been outstanding and performing for the longer of five years, or until its outstanding principal balance has been reduced to 25 percent of the original principal balance, but no longer than seven years; and

- a loan of any other type must have been outstanding and performing for the longer of two years, or until its outstanding principal balance has been reduced to 33 percent of the original principal balance.

In addition, each loan must not have been modified since origination, and may not ever have been delinquent for 30 days or more.

Limitations on Hedging, Financing and Transfer of Retained Interests

In general, a sponsor is prohibited from transferring or hedging an interest that it is required to retain under the rules, or financing the retained interest on other than a full recourse basis. Third parties that retain any required risk as described above generally are subject to similar requirements.

As noted above, a sponsor generally may satisfy its risk retention requirements if the required interest is retained by a majority-owned affiliate. A sponsor also may transfer a retained interest to a majority-owned affiliate. In either case, the majority-owned affiliate is then subject to the same restrictions on hedging, transfer and financing as if the interest were held by the sponsor.

Hedging of Retained Interests

Neither a sponsor nor any affiliate may enter into any transaction or agreement if payments on a related financial instrument, derivative or other position are materially related to the credit risk of any ABS interests that the sponsor (or a majority-owned affiliate) is required to retain, if the position would in any way limit the financial exposure of the sponsor (or majority-owned affiliate) to the credit risk of interests it was required to retain.

Permitted hedging includes:

- hedges related to interest rates, currency exchange rates or home prices, or tied to other sponsors' securities; and
- credit hedges involving instruments tied to an index that includes the ABS, provided that:
  - any class of ABS interests in an issuing entity as to which the sponsor was required to retain risk represents no more than 10 percent of the dollar-weighted average (or corresponding average for ABS interests issued in a foreign currency) of all instruments in the index; and
  - all classes of ABS interests in all issuing entities as to which the sponsor (or a majority-owned affiliate) was required to retain risk represent no more than 20 percent of the dollar-weighted average (or corresponding average for ABS interests issued in a foreign currency) of all instruments in the index.

Issuing entities' hedging activities are similarly limited. Any credit protection or hedge obtained by an issuing entity may not limit the financial exposure of the sponsor (or any majority-owned affiliate) on any interest required to be retained. For example, a credit insurance policy to cover losses on ABS interests or on a pool of securitized assets may not benefit the retained interest.

According to the Final Rule Release, "a sponsor would not be in compliance with the rule if it were to engage in, direct of control a series of transactions designed to add credit enhancement to assets ultimately securitized by it in a manner that indirectly achieve[s] what the sponsor is prohibited from doing directly." Therefore, a sponsor may not benefit from asset-level or pool-level insurance that covers 100 percent of the credit risk of the pool assets, unless the sponsor's right to receive insurance proceeds is subordinated to the payment in full of all other investors.

When risk reducing transactions or instruments cover either the retained ABS interests (*e.g.*, bond insurance) or 100 percent of the credit risk of the securitized assets (*e.g.*, municipal bond insurance), the sponsor may not receive distributions that otherwise would not be available for distribution unless all other amounts due to all other holders of ABS interests have been paid in full. Thus, for example, if a sponsor holds an eligible vertical interest and its portion of the senior tranche would benefit from bond insurance proceeds, it would have to subordinate its interest in these proceeds to tie payment of all amounts due to all other ABS interests, including subordinated interests.

Financing of Retained Interests

Neither a sponsor nor any affiliate may pledge an interest it is required to retain as collateral for any financing (including a transaction structured as a repurchase agreement)[33] unless the financing is full recourse to the borrower. The Agencies noted in the Original NPR that if a sponsor or consolidated affiliate were to default under such a financing or otherwise permitted a pledged retained interest to be taken by the lender, the borrower will have violated the prohibitions on transfer of retained interests.

Sunset of Hedging and Transfer Restrictions

For all ABS other than RMBS, the transfer and hedging restrictions generally will expire on the latest of:

- the date that the total unpaid principal balance (if applicable) of the securitized assets has been reduced to 33 percent of the cut-off date unpaid principal balance;
- the date that the total unpaid principal balance of the ABS interests issued has been reduced to 33 percent of the closing date unpaid principal balance; and
- two years after the closing date.

For RMBS, the transfer and hedging restrictions will expire on the later of:

- five years after the closing date; and
- the date that the total unpaid principal balance of the underlying mortgages has been reduced to 25 percent of the unpaid principal balance as of closing date, but no later than seven years after the closing date.

For CMBS, a retained B-piece may be transferred by the sponsor or initial third-party purchaser five years after closing, provided that the transferee satisfies all requirements applicable to the initial third-party purchaser, as described above.

The transfer and hedging restriction sunset provisions do not apply to any sponsor of a revolving pool securitization that satisfies its risk retention requirements by retaining a seller's interest, as described above.

Disclosure Requirements

The credit risk retention rules generally require that a variety of disclosures be provided to prospective investors a reasonable period of time prior to the sale of the ABS (and, in some instances, there also are disclosures to be provided a reasonable time after the closing).

A sponsor retaining risk in the form of an eligible horizontal residual interest must provide, a reasonable time before sale of the ABS, the fair value of all ABS interests and of the eligible horizontal residual interest and the dollar amount of the eligible horizontal residual interest that the sponsor expects to

[33] Although the rules generally prohibit the sale of an interest required to be retained, the rules contemplate financings in the form of repurchase agreements.

retain at closing. If specific prices, sizes or interest rates of the deal's tranches are not available, the sponsor must provide a range of fair values that it expects to retain, based on bona fide estimates or specified prices, sizes or interest rates of each tranche, and the method by which the range of bona fide estimates or specified prices, sizes or interest rates was determined. The sponsor must describe the material terms of the retained interest, the methodology used to calculate fair value (or range of fair values), and the key inputs and assumptions used (or a comprehensive description thereof) in measuring fair value (or range of fair values).[34] At a minimum, the disclosure must include all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to an investor's evaluation of fair value, with specific items required if the disclosure includes a curve. If information about the pool assets is used, it generally must be as of a date no more than 60 days before first use with investors. Finally, the sponsor must summarily describe the reference data set or other historical information used to develop its key inputs and assumptions.

A sponsor retaining risk in the form of an eligible horizontal residual interest also must provide, a reasonable time after closing, the fair value of the eligible horizontal residual interest retained at closing, based on finalized sale prices and tranche sizes, and the fair value thereof that it was required to retain. To the extent the valuation methodology or any key input or assumption materially differs from what was previously disclosed, those differences must be described.

A sponsor retaining risk through funding of a horizontal cash reserve account must provide substantially similar disclosures relating to that account.

A sponsor retaining risk in the form of an eligible vertical interest must, a reasonable period of time before sale of the ABS, describe the form of the eligible vertical interest, the percentage that the sponsor is required to retain, the material terms of the vertical interest and the amount that the sponsor expects to retain at closing. A reasonable time after closing, the sponsor must disclose the amount of the vertical interest retained if it is materially different from the amount previously disclosed.

Records of all of these items must be retained, and disclosed upon request to the SEC and the appropriate Banking Agency, until three years after all ABS interests are no longer outstanding.

If vertical or horizontal risk is allocated to an originator, the sponsor must, in addition to providing the other applicable information described above, identify the originator and the amount and form of risk it retains, as well as its method of payment.

For a revolving asset master trust with respect to which the risk retention requirement is satisfied through retention of a seller's interest, the sponsor must, a reasonable period of time before sale of the ABS, describe the material terms of the seller's interest and the percentage that the sponsor expects to retain at closing, measured as a percentage of the aggregate unpaid principal balance of all outstanding investor ABS interests or as a percentage of the aggregate principal balance of outstanding ABS interests for one or more series, as required by the transaction documents. These disclosures may include adjustments to the amount of pool assets that the sponsor expects to make before closing, and adjustments to the amount of outstanding investor ABS interests to account for expected increases and decreases under the sponsor's control. Also, a reasonable time after closing, the sponsor must disclose the amount of the seller's interest actually retained, the material terms of any offsetting horizontal interest, and the fair value of those retained horizontal interests (in the same manner as is required for

[34] Including, to the extent applicable, discount rates, loss given default (recovery), prepayment rates, default rates, lag time between default and recovery, and the basis of forward interest rates used.

eligible horizontal residual interests, as described above). As under the standard option, records of all of these items must be retained, and disclosed upon request to the SEC and the appropriate Banking Agency, until three years after all ABS interests are no longer outstanding.

For CMBS with respect to which the risk retention requirement is satisfied through retention of an eligible horizontal residual interest by a third party, the sponsor must, a reasonable period of time before sale of the ABS (and on request, to the SEC and the appropriate Banking Agency), identify the B-piece buyer and describe its experience in investing in CMBS, and provide any other information about the B-piece buyer or its retention of the B-piece "that is material to investors in light of the circumstances of the particular securitization transaction." The sponsor also must disclose the fair value of the amount of the B-piece retained by each initial third-party purchaser, the purchase price for the B-piece, the fair value of the eligible horizontal residual interest that the seller would have retained had it relied on that method, and describe the material terms of the B-piece. The sponsor must identify the operating advisor, describe any actual or potential material conflicts of interest with any other transaction party, identify the standards required of the operating advisor and describe how it complies with those standards. Finally, disclosure also is required regarding loan-level representations and warranties, whether any of the securitized loans do not comply with those representations and warranties, and what factors were used in determining that the affected loans should be included in the securitized pool notwithstanding such noncompliance.[35]

For ABCP with respect to which the risk retention requirement is satisfied by an originator-seller's retention of a residual interest, the sponsor must disclose to investors before or contemporaneously with the first sale of ABCP to each purchaser, and at least monthly thereafter to each holder, the name and form of organization of the regulated liquidity provider, the material terms of liquidity coverage, any failure to fund liquidity coverage, the asset class or a brief description of the pool assets, the SIC code for each originator-seller that retains a residual interest, and a description of the percentage amount and form of risk retention by the originator-seller. Upon request, the sponsor must provide to the SEC and the appropriate Banking Agency all of the information required to be provided to investors, as well as the name and form of organization of each originator-seller that retains an interest in the transaction.

For securities guaranteed by Fannie Mae or Freddie Mac as to which the risk retention requirement is satisfied by that guarantee, the sponsor must describe the manner in which it met its credit risk retention requirement.

If a CLOs were to rely on the open market CLO method of risk retention, the sponsor would be required to, a reasonable period of time before sale of the ABS, identify to investors the CLO manager, and at that same time and at least annually thereafter provide to investors (and on request provide to the SEC and the appropriate Banking Agency) a complete list of every asset held by the CLO (or before closing, in a warehouse facility), including the full legal name and SIC code and legal entity identifier (if applicable) of the obligor, and the name, face amount (of both the entire tranche and the amount held by the CLO), price and lead arranger of each loan tranche.

For tender option bond transactions relying on the qualified tender option bond method, the sponsor must, a reasonable period of time before sale of the ABS, provide to investors (and on request to the SEC and the appropriate Banking Agency) the name and form of organization of the tender option bond entity, and the form and subordination features of the retained interest in accordance with the disclosure requirements under the standard risk retention option. To the extent any portion of the retained interest

[35] What the Agencies intend here remains unclear. It is possible that this disclosure item is meant to address loan underwriting criteria rather than representations and warranties.

is claimed as an eligible horizontal residual interest, the sponsor must disclose its fair value. To the extent that any portion of the retained interest is claimed as an eligible vertical interest, the sponsor must disclose the percentage of ABS interests represented by that interest. To the extent that any portion of the retained interest is a municipal security held outside of the tender option bond entity, the sponsor must disclose the name and form of organization of the tender option bond entity, the issuer of the retained municipal securities, the face value of securities deposited into the tender option bond entity and the face value of the retained municipal securities.

Safe Harbor for Foreign Transactions

The rules include a safe harbor for certain foreign transactions. The risk retention requirements do not apply to a securitization transaction if:

- the securities are not required to be and are not registered under the Securities Act;
- no more than 10 percent of the dollar value (or equivalent if sold in a foreign currency) of all classes of ABS interests are sold or transferred to US persons or for the account or benefit of US persons;
- neither the sponsor nor the issuing entity is organized under the laws of the United States or a US state or territory, or is an unincorporated branch or office located in the United States of an entity not organized under the laws of the United States or a US state or territory; and
- no more than 25 percent (based on unpaid principal balance) of the securitized assets were acquired by the sponsor or issuing entity, directly or indirectly, from a majority-owned affiliate of the sponsor or issuing entity that is organized under the laws of the United States or a US state, or an unincorporated branch or office of the sponsor or issuing entity that is located in the United States.

For these purposes, a "US person" generally is:[36]

- a natural person resident in the United States;
- a partnership, corporation, limited liability company or other entity organized under the laws of any State or the United States;
- a trust of which the trustee is a US person;
- an estate of which an executor or administrator is a US person;
- a trust of which a trustee is US person;
- an agency or branch of a foreign entity located in the United States;
- any non-discretionary or similar account held by a dealer or fiduciary for the benefit or account of a US person;
- a discretionary or similar account held by a dealer or fiduciary organized or (if an individual) resident in the United States; or
- a partnership, corporation, limited liability company or other entity organized under foregoing law by a US person principally for the purpose of investing in unregistered securities.

[36] This definition is not completely identical to the definition of "US person" under Rule 902(k) of Regulation S.

There are various specific exemptions from the general definition of US person.

The foreign safe harbor is not available for any transaction or series of transactions that technically complies with the safe harbor but is part of a plan or scheme to evade the risk retention requirements of Section 15G and the rules.

Many commenters expressed significant concern about the narrow scope of the foreign safe harbor, including incompatibilities with the EU risk retention regime and the small margin for error afforded by the 10 percent limit on purchases by US persons. The Agencies declined to address these concerns, on the grounds that the safe harbor is meant "to exclude only those transactions with limited effect on US interests, underwriting standards, risk management practices, or US investors."

Periodic Review of QRM Definition and Certain Other Provisions

The Agencies will review the definition of QRM, the community-focused residential mortgage exemption, and the exemption for qualifying three-to-four unit residential mortgage loans no later than four years after the rules' effective date for residential mortgage-backed securities, five years after completion of that review, and at least every five years thereafter. The Agencies also will commence such a review on the request of any Agency, including as a result of any change in the CFPB's definition of QM or changes in the residential housing market. Any such review must be completed within six months of publication of notice of the review, and the results also will be published. If the Agencies decide to change the definition of QRM, that rulemaking process must be completed within 12 months from the publication of the results of their review.

This memorandum was authored by Charles A. Sweet.

CONTACTS

For assistance, please contact any of the following lawyers:

Reed D. Auerbach
Partner
reed.auerbach@morganlewis.com
+1.212.309.6200

Cory E. Barry
Partner
cory.barry@morganlewis.com
+1.202.739.5022

Harlyn Bohensky
Partner
harlyn.bohensky@morganlewis.com
+1.212.309.6260

Asa J. Herald
Partner
asa.herald@moganlewis.com
+1.202.739.5660

Keith L. Krasney
Partner
keith.krasney@morganlewis.com
+1.212.309.6776

Jeffrey R. Johnson
Partner
jeffrey.johnson@morganlewis.com
+1.202.373.6626

Matthew P. Joseph
Partner
matthew.joseph@morganlewis.com
+1.212.309.6770

Steve Levitan
Partner
steve.levitan@morganlewis.com
+1.212.309.6910

Mark R. Riccardi
Partner
mark.riccardi@morganlewis.com
+1.202.739.5023

Philip W. Russell
Partner
philip.russell@morganlewis.com
+1.212.309.6164

Edmond Seferi
Partner
edmond.seferi@morganlewis.com
+1.212.309.6845

Charles A. Sweet
Partner
charles.sweet@morganlewis.com
+1.202.739.5635

Connect with us:

www.morganlewis.com