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Securitization Reform under the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"), which was signed into law on July 21, 2010, includes substantial regulatory reforms for the asset-backed securitization process. The reforms are principally focused on risk retention and increased disclosure to investors.

Risk Retention

The Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation (collectively, the "Federal Banking Agencies"), together with the Securities and Exchange Commission, are required to jointly promulgate regulations requiring "securitizers" of asset-backed securities and mortgage-backed securities to retain a portion of the credit risk in securitized assets sold to investors. "Securitizer" is defined to include both an issuer of asset-backed securities and any "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." Securitizers are required to retain an economic interest of not less than 5% of the credit risk in any such asset that is transferred, sold, or conveyed to a third party through the issuance of an asset-backed security. Hedging or transferring away the required retained credit risk is prohibited by the Act and the Federal Banking Agencies and the SEC are required to determine the permissible forms and the minimum duration of the required risk retention. The Federal Banking Agencies and the SEC are also required to promulgate separate rules for risk retention in the case of collateralized debt obligations ("CDOs") and similar instruments collateralized by other asset-backed securities (including those collateralized by CDOs).

Importantly, the Act gives the Federal Banking Agencies and the SEC flexibility to adopt or issue exemptions, exceptions and adjustments to the prescribed risk retention rules for certain institutions or asset classes. Any such adjustment, exemption or exception must (A) help ensure high quality underwriting standards for securitizers and originators and (B) encourage appropriate risk management practices by securitizers and originators, improve the access of consumers and businesses to credit on reasonable terms or otherwise be in the public interest or for investor protection.

Certain government institutions, programs and assets are exempt from the risk retention requirements of the Act, such as the Farm Credit System, the Federal Agricultural Mortgage Corporation and any assets insured or guaranteed by the United States or an agency of the United States. Importantly, the Act specifically states that Fannie Mae, Freddie Mac and the federal home loan banks are not to be considered agencies of the United States, implying that, absent exemptions, these entities will be subject to the risk retention rules.

The Federal Banking Agencies and the SEC are required to promulgate final rules within 270 days of the enactment of the Act. The risk retention requirement must be effective no later

than two years after publication of such final rules in the Federal Register, in the case of asset-backed securities generally, and one year after publication, in the case of residential mortgage-backed securities.

Special Rules for Commercial Mortgage-Backed Securities

Securities backed by commercial mortgages are given special consideration under the Act. The SEC and the Federal Banking Agencies are required to specify the types, forms and amounts of risk retention for those assets, which may include:

- retention of a specified amount or percentage of the total credit risk of the asset;
- retention of a first-loss position by a third-party purchaser, provided that the third party holds adequate financial resources, performs specified due diligence and meets the same standards for risk retention required of the securitizer;
- a determination that the underwriting standards and controls for the asset are adequate; and
- adequate representations, warranties and enforcement mechanisms.

Exemption for "Qualified Residential Mortgages"

The Act requires the Federal Banking Agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency to jointly issue regulations to exempt "qualified residential mortgages" from the risk retention requirements.

However, it is important to note that only securities backed entirely by qualified residential mortgages are intended to be exempt. If an asset-backed security is backed by just one asset that is not a "qualified residential mortgage"—including, for example, mortgages that do not meet the criteria in the definition of "qualified residential mortgage" or tranches of other asset-backed securities—even if every other asset in the collateral pool is a "qualified residential mortgage," then the security will not be eligible for the exemption.

The Act requires the above agencies to take into account a number of underwriting and product factors when defining the term "qualified residential mortgage" that indicate a lower risk of default, based on historical performance data, including:

- documentation and verification of the financial resources relied upon to qualify the mortgagor;
- standards with respect to (i) the residual income of the mortgagor, (ii) the ratio of housing payments to monthly income of the mortgagor and (iii) the ratio of total monthly installment payments to monthly income of the mortgagor;
- product features and underwriting standards designed to mitigate potential for "payment shock" on adjustable rate mortgages;
- mortgage guarantee insurance or other credit enhancements; and
- limitation on features demonstrated to indicate a higher risk of borrower default, such as balloon payments, negative amortization, prepayment penalties and interest-only features.

Allocation of Risk Retention

The Federal Banking Agencies and the SEC are required to "reduce the percentage of risk retention obligations required of the securitizer by the percentage of risk retention obligations required of the originator." In performing such an allocation, the agencies and the SEC are required to consider whether the assets sold to the securitizer have terms, conditions and characteristics that indicate low credit risk and whether market conditions create incentives for imprudent origination standards. Additionally—short of allowing the retained credit risk to be transferred to a third party—the agencies and the SEC are required to consider the impact of such risk retention allocation on the access to credit by consumers and businesses at reasonable terms.

Disclosure

The Act requires enhanced reporting and disclosure by the issuer regarding the quality of the assets underlying the asset-backed securities. The Act requires the SEC to adopt regulations requiring each issuer of an asset-backed security to disclose information for the assets backing that security. In adopting such regulations, the SEC is required to:

- set data-format standards for asset-backed security disclosure, and
- require issuers to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including:
    - unique identifiers for loan brokers or originators;
    - the nature and extent of the compensation of the broker or the originator of the assets backing the security; and
    - the amount of risk retention by the originator and the securitizer.

The Act also requires securitizers to disclose repurchase requests of assets securitized across all trusts aggregated by the securitizer, so that investors may identify underwriting deficiencies. Issuers filing registration statements are also required to perform a due diligence review of the assets underlying an asset-backed security and to disclose those due diligence findings. Finally, the Act directs the SEC to adopt rules requiring credit rating agencies to include in their ratings reports a description of the representations, warranties and enforcement mechanisms available to investors in asset-backed securities and how they differ from those in issuances of similar securities.

Key Open Questions

- **What form will the final regulations take?** The Act sets out many broad guidelines, but gives few specific rules for the risk-retention and disclosure process. Many of the key implementational issues will require final regulations before securitizers can gain full confidence in the requirements of the Act, in particular what kinds of exceptions and exemptions will be created and what types of entities and transactions will be able to make use of them.

- **Harmonization with agency regulations.** The Act is not entirely consistent with existing regulatory proposals from federal agencies—namely the SEC. In a rule proposal issued on April 7, 2010 (the "Proposed Rules"), the SEC proposed a

number of regulatory reforms that would apply to all "structured finance products"—a term designed to be broader than the traditional definition of asset-backed security. The Proposed Rules include risk-retention requirements as well, but focus on a 5% test of each class of securities issued in a securitization—not merely 5% of the credit risk of the underlying collateral. As such, the Proposed Rules would require 5% retention of a "vertical slice" of a transaction—i.e. 5% of each tranche of securities issued, with exceptions for certain revolving asset classes such as credit card securitizations which already commonly incorporate vertical retention slices in the form of required transferor interests in excess of 5%. The Proposed Rules also establish significant additional disclosure standards, including significant data requirements and increased disclosure for privately-issued transactions in line with that required in a public, registered transaction. The FDIC has issued its own proposals as well, applying to banks in particular, which will also need to be harmonized with the Act.

- **Significant additional disclosure requirements.** The SEC will need to align its proposed regulations with the Act prior to their finalization, but it is clear that both the Act and the Proposed Rules favor significant new disclosure requirements and securitizers will need to comply with a significant new disclosure regime in whatever form the final rules may take. The Act also removes the ability of an asset-backed issuer to rely on the automatic suspension of reporting requirements under Section 15(d) of the Securities Exchange Act of 1934 if the securities of each class to which the issuer's registration statement relates are held by less than 300 persons (the Act authorizes the SEC to adopt separate suspension rules for asset-backed issuers). This provision, combined with the "public-like" disclosure requirement for privately-issued asset-backed transactions—if finalized as set forth in the Proposed Rules—could lead to significantly increased initial and ongoing disclosure requirements for a wide range of both public and private asset-backed transactions.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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