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Will the Proposed US Credit Risk Retention Rules Apply to Your Transaction?

In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act generally mandates broad changes to the financial regulatory system in the United States to redress perceived flaws in the system highlighted during the recent credit crisis. Section 941(b) of the Dodd-Frank Act addresses the asset-backed securitization market and sets forth criteria aimed at aligning the interests of the parties originating the assets collateralizing asset-backed securities ("ABS") with those of the investors. As discussed further below, the defined term for ABS may include a number of securities that are not traditionally thought of as ABS and includes privately issued securities.

Section 15G of the Securities Exchange Act of 1934 (the "Exchange Act"), created pursuant to Section 941(b) of the Dodd-Frank Act, requires the Department of the Treasury, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission (collectively, the "Agencies") to propose regulations to implement the risk retention requirements set forth in Section 941(b) of the Dodd-Frank Act. In response, the Agencies made available the proposed rules[1] (the "Proposed Rules") at the end of March 2011. The Proposed Rules require a sponsor of an ABS securitization to keep "skin in the game" by retaining 5 percent of the credit risk associated with any ABS that it transfers, sells or conveys to a third party.

A key assumption underlying the mandated credit risk retention is that, by requiring a sponsor of ABS to retain an economic interest in its ABS transactions, the sponsor's interest will be more closely aligned with the interests of the ABS investors. If a sponsor behaves in a manner that protects its economic interest in the transaction, by extension, it will provide investors with that same protection, while reducing investor losses attributable to poor financial asset-origination practices or undue risk-taking by the sponsor.[2] In addition to ensuring that sponsors have the necessary economic interests to achieve this goal by requiring them to maintain credit risk exposure of 5 percent of the value of the ABS, the Proposed Rules also generally prohibit sponsors from hedging or otherwise transferring that risk.[3]

The Proposed Rules apply to registered and unregistered (i.e., privately placed) ABS transactions.[4] Below is a discussion of some basic aspects of the Proposed Rules, including (i) what ABS will trigger risk retention rules, (ii) who will be considered a "sponsor" thereunder and (iii) the limited exemptions available for certain ABS assets and ABS transactions. The risk retention requirements of the Dodd-Frank Act and the

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Proposed Rules are broad and complicated; they are not always easily applied to specific situations. Our intention here is to make clients aware of the breadth of the risk retention regime, and we encourage clients to contact us with specific questions relating to the applicability or scope of the Dodd-Frank Act and the Proposed Rules.

What Is an "Asset-Backed Security" Under the Proposed Rules?

The definition of "asset-backed security" under the Proposed Rules refers to the definition set forth in the Exchange Act: "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."[5]

The term "financial asset" is not defined, but the enumerated list and historical context[6] of the term likely means it will be interpreted broadly. The term financial asset is used in its singular form, meaning a security secured by one self-liquidating asset (i.e., one loan or one lease) is included. The only limiting factor placed upon the type of financial asset is that the asset be "self-liquidating", which will likely require that the asset convert to cash by its own terms in some finite time period.[7] ABS derived from synthetic securitizations do not fall under the scope of this definition, as such ABS were determined to not be collateralized by self-liquidating financial assets under the Proposed Rules.[8]

The use of the term "primarily" in the definition appears to tie credit worthiness of the security directly to the performance of the financial asset. In other words, it is not sufficient that financial assets are one component of an operating business that generates the cash used to make payments on the securities; the holder must receive payments that depend primarily on cash flow generated by the asset. We note that, under many circumstances, investors may have more than one source of credit for repayment, requiring issuers to determine what "primarily" means in this context and complicating the analysis of whether the risk retention rules apply to the issuer's sponsor.[9]

Who Is a "Sponsor" Under the Proposed Rules?

In the Proposed Rules, a "sponsor" is treated as being synonymous with the Dodd-Frank Act's term "securitizer."[10] The Dodd-Frank Act, however, defines a "securitizer" as both "(A) an issuer of an asset-backed security; or (B) 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."[11] Noting that the second prong of the "securitizer" definition substantially mirrors the definition of "sponsor" in the Commission's Regulation AB that deals with registered ABS offerings under the Securities Act of 1933, as amended (the "Securities Act"), the Agencies dropped the "issuer" from a person required to retain credit risk under the Proposed Rules.[12] Thus, the determination of whether a credit risk retention obligation exists is determined by the Proposed Rules' definition of "sponsor":

> "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[.]"[13]

A plain read of the definition provides: to be a sponsor, and therefore to be required to retain credit risk, a party to a securitization must both (1) organize and initiate an asset-backed securities transaction and (2) do so by selling or transferring assets to the issuer (whether directly or indirectly). The use of the phrase "by selling or transferring assets" appears to require the organizing and initiating of a transaction to be related to the act of selling or transferring assets.

The Proposed Rules will require sponsors to retain credit exposure and, in most cases, these entities will be required to wholly satisfy the Proposed Rules' retention requirements. However, in the event that the sponsor meets its risk retention requirements through certain options (such as the vertical or horizontal risk retention options), the parties (or potentially the Agencies) may elect to allocate a portion of the sponsor's risk retention to an ABS originator[14] who has contributed at least 20 percent of the underlying assets to the ABS pool. In such cases, the originator would retain a percentage of the risk allocation not to exceed the percentage of assets it contributed to the pool (with a minimum of 20 percent). Originators who agree to take on a portion of the sponsor's retained risk should be aware that all transfer restrictions on the credit risk retained that apply to the sponsor will also apply to originators.[15]

Are Any Securitizations Exempt?

The Proposed Rules provide limited exemptions for certain types of ABS transactions. The Agencies believe that these exemptions work in tandem with their desire to ensure high-quality underwriting standards, to encourage appropriate risk management practices among both sponsors and originators and to serve the greater public interest.[16] The primary transaction exemptions are for non-US securitizations, certain resecuritizations and securitizations related to US government debt.

The transaction exemption for non-US securitizations is described as the "safe harbor for certain foreign-related transactions". The safe harbor provides for a full exemption from credit risk retention requirements for transactions that are "predominantly foreign-based" with limited connection to the United States and US investors.[17] The exemption provides that neither the sponsor nor the issuer of the ABS may be (1) a US-chartered, organized, or incorporated entity; (2) an unincorporated branch or affiliate of a US company; or (3) an unincorporated branch or affiliate of a non-US company. In addition, the securitization must be a foreign-related transaction in which (i) no more than 10 percent of the value of the proceeds of the ABS interest are sold to US Persons, or otherwise benefit them, and (ii) no more than 25 percent of the assets underlying the ABS were acquired by the sponsor from a US-located consolidated affiliate of the sponsor.[18] The Agencies have reserved the right in the Proposed Rules to deny this exemption if they feel that, although it meets the requirements of the safe harbor exemption, the foreign-related transaction was structured simply to bypass the proposed Section 15G.[19]

The Proposed Rules also provide for limited exemptions for certain types of qualifying assets, including residential mortgages, commercial loans, commercial real estate loans and automobile loans, in each case so long as the loans meet the prescribed underwriting, financial and qualitative requirements set forth in the Proposed Rules.

Where Can I Go for Further Information?

The above discussion sets forth the basic framework for understanding whether an ABS transaction will be subject to the risk retention requirements as set forth in the Proposed Rules. If you believe your transaction falls under the risk retention regime, we are available to discuss the mechanics of the risk retention options with you. The comment period with respect to the Proposed Rules ends on June 10, 2011. We encourage you to contact us with any questions you may have and will be happy to discuss the Proposed Rules in greater detail as your specific needs require.

[1] Credit Risk Retention (proposed Mar. 29, 2011) (to be codified at 12 C.F.R. pt. 86, 12 C.F.R. pt. 244, 12 C.F.R. pt. 373, 17 C.F.R. pt. 246 and 12 C.F.R. pt. 1234) [hereinafter Credit Risk Retention].

[2] Credit Risk Retention at 18.

[3] *Id.* at 34-5.

[4] *Id.* at 28.

[5] The Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78c(a)(77).

[6] The term "financial asset" is also used in the definition of "eligible assets" in Rule 3a-7 of the Investment Company Act (as amended, the "40 Act"). In the adopting release for that rule, the Securities and Exchange Commission (the "Commission") stated the term should cover "virtually all assets that can be securitized (i.e., which produce cash flows of the type that may be statistically analyzed by rating agencies and investors)[.]" Combining the parenthetical in Part (A) with the Commission's prior guidance will provide for an extremely broad interpretation of the term in the statute.

[7] When defining "eligible assets" for purposes of Rule 3a–7, the Commission included those financial assets which are "either fixed or revolving, that by their terms convert into cash within a finite time period[.]" Interestingly, the release adopting Rule 3a-7 inserts the words "self-liquidating" in front of the word asset when describing eligible assets, but the definition of eligible assets does not include those same words.

[8] Credit Risk Retention at 26 & n. 32.

[9] In some cases, it may be the expectation that cash flows generate sufficient amounts to repay investors, but that other credit support (e.g., other non-financial collateral, a guaranty or a keep-well agreement) exists to provide the ultimate creditworthiness of the security.

[10] Credit Risk Retention at 29-30.

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) § 941(b) (as codified at § 15G (a)(3) of the Exchange Act).

[12] Credit Risk Retention at 29-30 & n. 40, citing the Commission's Regulation AB, Item 1101 (17 C.F.R. pt. 229.1101) (defining a sponsor as "a person who organizes and initiates an asset-backed securities transation by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.").

[13] *See* Proposed Rules at §_.2.

[14] Credit Risk Retention at 32. An "originator" is someone who creates a financial asset that collateralizes an ABS and then sells it directly or indirectly to a securitizer. Note that this term applies only to the "creator" of the loan and not a subsequent purchaser or transfer of the loan.

[15] *Id.*

[16] *Id.* at 183.

[17] *Id.* at 197.

[18] *Id.* at 197-8.

[19] *Id.* at 316-7.

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