

SECURITIZATION REFORM

(as of July 7, 2011)

As we approach the one-year anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the most talked about piece of securitization reform required under the Dodd-Frank Act remains in the proposal phase. The proposed credit risk retention rule mandated under the Dodd-Frank Act (and outlined below) has yet to be finalized, with the joint federal regulators recently pushing back the comment deadline to August 1, 2011.

The other major piece of securitization reform, proposed revisions to Regulation AB’s registration, disclosure, and reporting requirements for asset-backed securities and other structured finance products (“Regulation AB II”), also has been put on hold by the SEC while it focuses on meeting Dodd-Frank rulemaking deadlines.¹ SEC Chairman Mary Shapiro recently announced that portions of the proposed revisions most likely will be reconsidered and re-released in the near future to account for concerns already addressed under the Dodd-Frank Act.

That doesn’t mean securitization reform isn’t well on its way. Most of the remaining securitization-related provisions under the Dodd-Frank Act have been finalized. And the FDIC released a proposed rule amending its “securitization rule” safe harbor to require financial institutions to retain more of the credit risk from securitizations and reflect recent accounting changes.² This was preceded by the FASB’s revisions to accounting rules relating to sales of financial assets and consolidation of certain off-balance sheet entities, revisions to bank capital rules to reflect the FASB’s accounting changes³ and the enactment of the Hiring Incentives to Restore Employment Act, which imposes a 30% withholding tax on foreign financial institutions, including certain offshore securitization vehicles.

The major elements of securitization reform that have been finalized under Dodd-Frank are:

Repurchase Requests, Representations and Warranties

- Credit rating agencies must explain, in reports accompanying credit ratings, representations, warranties, and enforcement mechanisms available to investors and how they differ from representations, warranties and enforcement mechanisms in similar issuances
- Issuers must disclose fulfilled and unfulfilled repurchase requests across all ABS transactions, including CDOs, GSE sponsored or guaranteed securities, and municipal entity securities (at time of offering and on an on-going basis)
- Applies to both registered and unregistered ABS

Issuer Review and Disclosure of Third-Party Reports

- Issuer must perform an asset review and disclose its findings in the registration statement. An independent third party may conduct the asset review if it either (i) it is named in the registration statement and consents to being deemed an “expert” for liability purposes under section 11 of the Securities Act, or (ii) the issuer adopts the findings and conclusions of the third party reviewer
- The review is meant to provide “reasonable assurance” that the asset pool disclosure in the registration statement is accurate in all material respects
- Issuers must make publicly available the findings and conclusions of any independent third party reviews performed for all registered and unregistered ABS offerings.

¹ See our news bulletin, *Historic Changes Proposed for ABS Offering Rules*, <http://www.mofo.com/files/Uploads/Images/100420ABS.pdf>.

² See <http://www.fdic.gov/news/news/press/2010/pr10112a.pdf>.

³ See our news bulletin, *Banking Agencies Issue Final Regulatory Capital Rule Related to FAS 166 and 167*, <http://www.mofo.com/files/Publication/0aa3db3e-76be-4c8b-97c7-457cb6db4f6f/Presentation/PublicationAttachment/91c76c44-a6f3-4460-8dd0-54b9cc560b53/BankingAgenciesIssueFinalRegulatoryCapitalRuleJan252010.pdf>.

The major elements of securitization reform that are still in the proposal phase under Dodd-Frank are:

Credit Risk Retention – Proposed Rule open for comment until August 1, 2011⁴

- 5% to be retained by the securitizer; however, if originator retains some amount of risk, only the remaining risk (up to 5% total) will be allocated to securitizer
- Risk retention can be in the form of “vertical” slice, “horizontal” first-loss position, an “L-shaped interest” hybrid of vertical and horizontal retention, a funded cash reserve account, or a representative sample
- Risk retention also to apply to CDOs, securities collateralized by CDOs and similar instruments
- Excess spread must be set aside in a premium capture reserve account to prevent sponsors from effectively reducing their economic exposure
- Specific risk retention types and forms for commercial mortgages, ABCP conduits and revolving master trusts
- Exemptions for qualified residential mortgages, ABS issued or guaranteed by the federal government (including ABS issued by Fannie Mae and Freddie Mac as long as they operate under the conservatorship or receivership of the FHFA), certain single-tranche resecuritizations, and certain qualifying commercial loans and auto loans
- Foreign transaction safe harbor if certain conditions are met
- No hedging or transfer of credit risk
- Regulations relating to credit risk retention requirements will become effective one year from adoption for residential mortgage assets, and will become effective two years from adoption for all other asset classes

Conflicts of Interest – Proposed SEC Rule not yet released for comment

- Prohibition on the underwriter, placement agent, initial purchaser, sponsor, or related subsidiaries or affiliates of any ABS from engaging in any transaction that involves or results in a material conflict of interest with respect to any investor in a transaction related to that activity.
- Exceptions for certain risk mitigating hedging activities, purchases and sales to provide liquidity, and bona fide market making

The major elements of securitization reform that are still in the proposal phase under Regulation AB II are:

Regulation AB II Required Disclosures

- Revise shelf registration eligibility criteria to include credit risk retention requirement, CEO certification, PSA repurchase provision requirement, and issuer undertaking to not hold any securities sold in registered transactions backed by the same pool of assets
- Asset-level or data-level detail, including data with unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or securitizer of such assets
- Fulfilled and unfulfilled repurchase requests across all trusts will be aggregated by the originator, so investors may identify originators with clear underwriting deficiencies
- Due diligence analysis must be performed by securitizer and provided to investors
- Same level of information must be provided upon investor request for any of the issuer’s ABS and structured product offerings conducted pursuant to Rule 144A or Regulation D

⁴ See our news bulletins, *U.S. Retained Credit Risk Rules Take Shape*, <http://www.mofo.com/files/Uploads/Images/110407-Credit-Risk-Rules.pdf> and *Credit Risk Rule Comment Period Extended*, <http://www.mofo.com/files/Uploads/Images/110610-Credit-Risk-Retention-Rule-Comments.pdf>