



STRUCTURED FINANCE AND SECURITIZATION UPDATE

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FDIC Issues Advance Notice of Possible Safe Harbor Rule for Securitizations and Participations after March 31, 2010

At its December 15, 2009 meeting, the Federal Deposit Insurance Corporation ("FDIC") issued an Advance Notice of Proposed Rulemaking Regarding Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After March 31, 2010 (the "ANPR").¹ Based on statements made at the FDIC's November 2009 board meeting, the FDIC had been expected to issue a notice of proposed rulemaking on the subject. However, because following the November 2009 board meeting FDIC Board members were unable to reach a consensus on approach (particularly as to preconditions for a securitization being eligible for the rule), the FDIC instead issued the ANPR (a more preliminary action than a notice of proposed rulemaking). Comments on the ANPR are due 45 days after publication in the *Federal Register*, which is expected shortly.

The ANPR follows the FDIC's issuance at its November 2009 meeting of an interim rule ("Interim Rule"), which amended the FDIC's original rule on the subject adopted in 2000 (the "Original Rule"). The Original Rule provided safe harbor clarification on the circumstances under which the FDIC would refrain from using its statutory powers to disaffirm or repudiate contracts in order to reclaim assets transferred in a securitization. The Original Rule was conditioned on, among other things, transfers into the securitization meeting the requirements for sale accounting treatment (other than the legal isolation requirement) under generally accepted accounting principles ("GAAP"). Although the Original Rule dealt largely with the FDIC's repudiation powers, it has generally been viewed by the credit rating agencies and market participants as providing broader comfort that the FDIC, as conservator or receiver, would not challenge legal isolation of assets in rule-compliant securitizations. The Interim Rule confirms that securitizations issued on or before March 31, 2010 in reliance on the Original Rule are "grandfathered" and continue to be protected by the Original Rule despite changes to GAAP adopted by the Financial Accounting Standards Board and set forth in Statement of Financial Accounting Standards No. 166 ("FAS 166") and Statement of Financial Accounting Standards No. 167 ("FAS 167"), which will result in many securitizations no longer qualifying for sale accounting treatment under GAAP. In a November 13, 2009 Press Release related to the Interim

¹The ANPR is available at <http://www.fdic.gov/news/board/DEC152009no5.pdf>.

Rule, the FDIC further clarified that it will not treat assets transferred into a securitization that is covered by the Interim Rule as property of a failed bank or its receivership estate, and consequently such assets are not subject to the stay provision of the Federal Deposit Insurance Act (the “Stay”). That provision, enacted in 2006, bars persons from exercising rights to terminate or accelerate, or declare a default under, a contract with a failed bank or from exercising any control over property of the bank or affecting contractual rights of the bank for 45 days after the appointment of a conservator or 90 days after the appointment of a receiver. If assets in a securitization were subject to the Stay, payments on the related asset-backed securities as well as the ability of investors to exercise rights with respect to the assets in the securitization could be affected.

In the ANPR, the FDIC solicits public comment on a draft safe harbor rule (which it makes clear is not to be viewed as a formal proposal) covering securitizations issued after March 31, 2010 (“Post-March 31 Securitizations”). The draft safe harbor rule sets forth the protections the FDIC may be willing to provide for such securitizations. The ANPR also requests comment on 35 questions relating to possible preconditions and other requirements for securitizations to be eligible for safe harbor protection under the rule.

Scope of the Possible Safe Harbor Protections for Post-March 31 Securitizations

The draft safe harbor rule sets forth the scope of possible safe harbor protections for Post-March 31 Securitizations, both where a transfer qualifies as an accounting sale under FAS 166 and FAS 167 and where it does not. Whether these protections will be deemed adequate by rating agencies and market participants remains to be seen.

Post-March 31 Securitizations Not Meeting Sale Accounting Requirements: For Post-March 31 Securitizations that do not qualify as accounting sales under FAS 166 and FAS 167 and that meet the preconditions and other requirements for being covered by the draft safe harbor rule, the rule would provide that the FDIC as conservator or receiver grants advance consent to the exercise of contractual rights and powers, including the exercise of self-help remedies, with respect to the

securitization during the Stay period if (1) the FDIC as conservator or receiver is in monetary default under the securitization and remains in monetary default for 10 business days after the delivery to the FDIC of a written request to exercise contractual rights because of such monetary default or (2) the FDIC as conservator or receiver provides written notice of repudiation of the securitization agreements, and the FDIC does not pay statutory damages owing with respect to the repudiation within 10 business days of the notice. During the Stay period, the FDIC as conservator or receiver would allow the payment of regularly scheduled payments to investors made in accordance with the securitization documents and would also allow any servicing activity with respect to a securitization that meets the requirements of the rule.

The above provisions would not provide comfort with respect to non-monetary defaults during the Stay period. They would also not provide comfort that the FDIC would not repudiate a securitization when the market value of the assets in the securitization is not sufficient to pay principal and interest owed on the related asset-backed securities. In addition, the provisions would provide no comfort that securitization investors exercising remedies after the 10 business day period would not be limited to collecting, out of the assets backing the securitization (assuming their market value is sufficient), principal plus accrued interest on the related asset-backed securities to the date of appointment of the conservator or receiver (as opposed to the date thereafter on which the investors actually receive payment). Without clarification, that remains uncertain, because the FDIC has generally interpreted the provision of the Federal Deposit Insurance Act governing damages for repudiation as limiting damages to actual damages as of the date of appointment of the conservator or receiver and as not covering post-appointment interest and other damages.

Post-March 31 Securitizations That Meet Sale Accounting Requirements: For Post-March 31 Securitizations that meet the preconditions and other requirements for use of the rule and qualify as accounting sales under FAS 166 and FAS 167, the ANPR would provide that the FDIC would not, in the exercise of its statutory powers to disaffirm or repudiate contracts, reclaim or recover assets transferred in the securitization. However, the

ANPR does not provide explicit comfort that the assets in such securitizations would not be deemed to be part of the conservator or receivership estate of the failed bank or that the Stay would not apply to such securitizations.

Possible Preconditions for Eligibility of Securitizations to Use the Rule

In the ANPR, the FDIC states that it would be imprudent for the FDIC to provide consent or other clarification of its application of its receivership powers without imposing conditions on securitizations designed to address defects in the securitization process. Accordingly, the possible preconditions for use of the rule focus largely on reforming securitization practices rather than addressing traditional legal isolation issues. (Indeed, a number of the possible preconditions, such as the possible risk-retention requirement, have traditionally been viewed as weighing against legal isolation and could result in making common law true sales in bank securitizations more difficult to achieve.) Further, as commented on at the December 15 meeting by two of the FDIC Board members, imposing the possible preconditions has the potential for creating an uneven playing field between FDIC-insured banks and other institutions that participate in the securitization market and for conflicting with the securitization reform provisions that are contained in the recent House of Representatives-passed financial reform bill or are being considered by the Senate, the SEC and the other bank regulatory agencies.²

The ANPR sets forth the following possible conditions for application of the draft safe harbor rule:

Risk-retention/skin-in-the game:

- Requiring a bank to retain a “material portion” (defined as not less than 5%) of the credit risk on the assets transferred

² In connection with the ANPR, FDIC Board member and Comptroller of the Currency John Dugan issued a statement detailing a number of other significant concerns he had with the ANPR, including the possible risk-retention requirement, barring of external credit support, and limit on the number of tranches in certain securitizations (discussed below).

See <http://www.occ.treas.gov/ftp/release/2009-158a.pdf>.

in the securitization, not to be hedged or transferred for the life of the securitization; and

- With respect to securitizations that include residential mortgage loans (“Residential Mortgage Securitizations”), requiring the underlying loans to be seasoned loans that were originated not less than twelve months prior to the transfer and were originated in compliance with statutory, regulatory and originator underwriting standards.

Compensation: With respect to Residential Mortgage Securitizations, requiring that any fees or other compensation for services payable to the lender, sponsor, credit rating agencies, or underwriters be payable, in part, over five years based on the performance of the assets, with no more than 80% of the total estimated compensation due to any party at closing.

Capital Structure and Assets:

- Prohibiting resecuritizations unless certain disclosures are provided to investors at the inception and throughout the life of the securitization;
- Requiring payment of principal and interest to be based primarily on performance of the financial assets and not be contingent upon market or credit events extraneous to the assets;
- Excluding synthetic or unfunded securitizations; and
- With respect to Residential Mortgage Securitizations:
 - Prohibiting the securitization from having more than six credit tranches; and
 - Prohibiting the asset-backed securities from being enhanced at the issuer or pool level through external credit support (other than liquidity facilities or credit support at the loan level).

Disclosure:

- Requiring Regulation AB-compliant disclosure even in a privately placed transaction;
- Prior to issuance of the asset-backed securities, requiring various disclosures regarding the structure of the securitization and the credit and payment performance of the asset-backed securities, including the capital or tranche

structure, the priority of payments and specific subordination features;

- While the asset-backed securities are outstanding, requiring the availability of information on the performance of the asset-backed securities and the percentage of each tranche in relation to the securitization as a whole;
- In connection with the issuance of the securitization, and thereafter if the information changes, providing specified information regarding the nature and amount of compensation paid to the originator, sponsor, rating agency, third-party advisor, mortgage broker and the servicer; and
- Requiring additional disclosures regarding Residential Mortgage Securitizations, including specified loan level information and affirmations of compliance with applicable statutory and regulatory standards and guidance.

Documentation:

- Requiring use of any available standard documentation;
- For all securitizations, requiring documentation that complies with industry best practices with respect to representations and warranties and clearly defines rights and responsibilities;
- With respect to Residential Mortgage Securitizations:
 - Requiring servicers to have full authority, subject to the contractual oversight of a master servicer or oversight advisor, to mitigate losses on the underlying assets consistent with maximizing the net present value of the assets and to modify assets; and
 - Requiring that the servicer act for the benefit of all investors and not a single class, and limiting servicer advances of principal and interest to no more than

three payment periods unless financing or reimbursement facilities are available.

Additional Requirements

The ANPR also sets forth for comment the following possible additional requirements for use of the draft safe harbor rule:

- The securitization must satisfy the rule’s definition of “securitization,” which has been broadened from the definition in the Original Rule and the Interim Rule;
- The securitization must be arms-length and cannot be sold “predominantly” to an affiliate or insider;
- The securitization must meet certain written agreement requirements;
- The securitization must be an ordinary-course-of-business transaction, with no intent to hinder, delay or defraud the bank or its creditors;
- The transfer to the securitization must be for adequate consideration;
- The transfer must be properly perfected under applicable law;
- The transfer and duties of the sponsor must be evidenced in a separate agreement from the agreement governing the sponsor’s duties as a servicer, custodian, paying agent or credit support provider or in other capacities (thus suggesting that pooling and servicing agreements would need to be bifurcated into two agreements, presumably so that the FDIC as conservator or receiver could deal separately with the non-transfer-related document without having to repudiate the document effecting the transfer); and
- The bank would have to segregate any financial assets and records that relate to the securitization from the bank’s general assets and records.

If you have any questions about any of these items, please contact your regular Sidley Austin LLP contact.

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