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SECURITIZATION UPDATE

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# Securitization Reform Legislation - House Approves Dodd-Frank Wall Street Reform and Consumer Protection Act; Senate Still to Act

Since December 2009, both the House and the Senate have passed versions of financial reform legislation – H.R. 4173, the "Wall Street Reform and Consumer Protection Act of 2009," passed by the House on December 11, 2009 (the "House Reform Bill"),[1] and S. 3217, the "Restoring American Financial Stability Act of 2010," passed by the Senate on May 20, 2010 (the "Senate Reform Bill").[2] The two versions were reconciled by a conference committee, and on June 30, 2010, the House passed the reconciled version of the bill which is now known as the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act").[3] The Senate is expected to pass the reconciled version during July. If the Senate approves the Act, it is expected that it would then be signed into law by President Obama.

Securitization reform has been a central theme of the financial reform proposals put forth over the last year with changes aimed at addressing perceived flaws which the Administration, members of Congress and others blame for having undermined the

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1 These provisions are summarized in the Sidley Austin LLP, Financial Regulatory Reforms Update, dated December 21, 2009, "Financial Regulatory Reform Bill approved by the House; Senate action expected early next year," available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4271.

2 These provisions are summarized in the Sidley Austin LLP, Financial Regulatory Reforms Update, dated May 24, 2010, "Senate Passes Financial Regulation Reform Bill by a 59 to 39 Vote; Conference Committee to Address Major Differences with House Bill," available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4436.

3 The text of the Conference Report as voted on by the House (and to be voted on by the Senate) is available at http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/Conference_report_final_3.pdf. References herein to provisions of the Act are based on this version of the Act. We summarize the Act in the Sidley Austin LLP, Financial Regulatory Reforms Update, dated June 30, 2010, "House Approves Conference Report on Dodd-Frank Wall Street Reform and Consumer Protection Act," available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4479 (the "Financial Reform Update").

securitization market and, in turn, the credit markets more generally. Generally, these flaws are seen to be the general erosion of lending standards resulting from the "originate and distribute" business model practiced in the lending market; the lack of adequate information about underlying assets; over-reliance by investors on credit rating agencies in making investment decisions; and weaknesses in credit rating agency practices.

The Act's securitization provisions (the "ABS Provisions") are substantially similar to earlier legislative proposals in that they contain a risk retention requirement and increased disclosure and reporting requirements for issuers of asset-backed securities. In addition to the legislative proposals on securitization reforms, in April 2010, the Securities and Exchange Commission (the "SEC") released proposed rules (the "SEC proposed rules") that would significantly modify and expand the regulations governing structured finance securities[4] and in May 2010, the Federal Deposit Insurance Corporation (the "FDIC") issued a Notice of Proposed Rulemaking which proposes a number of securitization reforms (including risk retention and asset-level disclosure) (the "FDIC proposed rules") as part of proposed changes to its securitization conservatorship and receivership safe harbor rule for FDIC-insured depository institutions.[5] Many of the securitization reform provisions of the Act are similar to the provisions in the SEC proposed rules and the FDIC proposed rules. It remains to be seen how, and if, these various reform proposals will be reconciled.

In addition to the specific securitization reforms, the Act also includes amendments with respect to credit rating agencies registered with the SEC ("NRSROs") that will affect securitization transactions, as well as amendments to the Truth in Lending Act of 1968 ("TILA") with respect to mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards and prepayments. The Act also expands the definition of a "high-cost mortgage" under TILA and imposes new requirements on high-cost mortgages and new disclosure, reporting and notice requirements for residential mortgage loans, as well as new requirements with respect to escrows and appraisal practices.

Although beyond the scope of this update, the Act also contains the so-called "Volcker Rule" which generally prohibits "banking entities," as defined in the Act,[6] from engaging in proprietary trading and from sponsoring or investing in "hedge funds" or "private equity funds" – which are broadly defined to include any issuer that would be considered an investment company (as defined in the Investment Company Act of 1940, as amended (the "Investment Company Act")) but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act, or "similar funds" as the regulators, by rule, may determine.[7] The Volcker Rule also requires systemically important nonbank financial companies to hold additional capital and to comply with certain other limitations in connection with these activities, although it does not prohibit such companies from engaging in them. While the Act provides that the Volcker Rule provisions are not to be construed to limit or restrict the ability of a banking entity or nonbank financial company subject to the Volcker Rule "to sell or securitize loans in a manner otherwise permitted by law," it is not clear that such provisions would not affect

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4 We summarized the SEC's proposed rules in the Sidley Austin LLP, Structured Finance and Securitization Update, dated April 19, 2010, "Summary of SEC Proposals Regarding Asset-Backed Securities and Other Structured Finance Securities," available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4394.

5 We summarized the FDIC proposed rules in the Sidley Austin LLP, Structured Finance and Securitization Update, dated May 17, 2010, "FDIC Proposes Revised Safe Harbor for Securitizations," available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4426.

6 A "banking entity" is defined as any insured depository institution, any company that controls an insured depository institution or that is treated as a bank holding company under Section 8 of the International Banking Act of 1978 and any affiliate or subsidiary of such entity.

7 *See* Section 619 of the Act.

securitizations in other respects. For example, it is not clear that they would not limit banking entities from securitizing non-loan assets through Section 3(c)(1) or 3(c)(7) exempt entities or from investing in (as opposed to selling or securitizing loans through) securitizations whose issuers rely on those exemptions.

The Act also contains an orderly liquidation regime, under which the FDIC can be appointed as receiver for failing systemically important financial companies as an alternative to their being resolved under the United States Bankruptcy Code or other normally-applicable bankruptcy regime.[8] This raises the possibility that the legal isolation of securitizations by such companies will need to be analyzed under both the United States Bankruptcy Code or other normally-applicable bankruptcy regime *and* under the Act's orderly liquidation regime, because either could apply. This could have significant implications for securitizations by such companies. We discuss the Volcker Rule and the new orderly liquidation regime in more detail in the Financial Reform Update.

While the Act imposes many new requirements, a number of which will have far reaching effects on securitization transactions, a majority of the provisions will not be effective until final regulations with respect to those provisions are adopted under the Act. Moreover, we understand that the House expects to do a "corrections bill" addressing technical amendments and corrections to address provisions that as written have unintended consequences. Until a corrections bill is enacted and final regulations are adopted it should be expected that many details of financial reform will remain unclear and continue to evolve as they have over the last year.

## Securitization Risk Retention Requirement

### Application of the Risk Retention Requirement; Allocation Among Parties

Under the Act, the Federal banking agencies (*i.e.*, the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve Board (the "Federal Reserve Board") and the FDIC) and the SEC (and, in cases of transactions involving residential mortgage assets, the Federal Housing Finance Agency (the "FHFA") and the Secretary of Housing and Urban Development) (the "applicable regulators") must jointly adopt regulations requiring securitizers to retain an unhedged economic interest in a portion of the credit risk on the assets they transfer, sell or convey through the issuance of asset-backed securities, subject to the exemptions and exceptions discussed below. The Act does not limit the definition of an "asset-backed security" by reference to the SEC's Regulation AB and would include transactions such as collateralized debt obligations and collateralized loan obligations that do not meet the definition of "asset-backed security" under Regulation AB.[9] A "securitizer" is defined as an issuer of an asset-backed security or 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 (similar to the definition of a "sponsor" under Regulation AB).[10]

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[8] *See* Title II of the Act.

[9] Under the Act, "asset-backed security" is defined as any fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including: (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security.

[10] The Act excludes from the risk retention requirements securitizers of securities issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

The Act also requires that the applicable regulators adopt regulations providing for the allocation, as the Federal banking agencies and the SEC jointly determine to be appropriate, of the risk retention obligation between a securitizer and an originator if the securitizer purchases assets from an originator. An "originator" is defined as a person who creates a financial asset (through the extension of credit or otherwise) that collateralizes an asset-backed security and who sells that asset directly or indirectly to a securitizer. In determining how to allocate the risk retention between a securitizer and an originator, the Federal banking agencies and the SEC must reduce the percentage of risk retention imposed on a securitizer by the risk retention allocated to an originator. Additionally, in making the allocation, the Federal banking agencies and the SEC must consider whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms (which may not include the transfer of credit risk to a third party).[11]

In contrast to the Act, the FDIC proposed rules on risk retention would apply only to a sponsor in a securitization that seeks to qualify for the FDIC's safe harbor for securitizations and the SEC proposed rules would apply only to sponsors in shelf-registered asset-backed securities transactions. Neither the FDIC proposed rules nor the SEC proposed rules provide for allocation of the risk retention requirement between the sponsor and other entities. While the SEC proposed rules would permit an affiliate of the sponsor to retain the required risk, the FDIC proposed rules would preclude risk retention by an entity other than the sponsor – even an affiliate of the sponsor. It seems particularly ironic that a safe harbor aimed at providing certainty as to the legal isolation of assets, should, without possibility for exemption or exception, require a sponsor to retain 5% of the credit risk – a feature that would generally be considered a negative factor when evaluating whether a legal true sale has occurred.

#### Risk Retention Amount; Exemption for "Qualified Residential Mortgages"

The Act requires that the applicable regulators jointly adopt regulations that set the minimum level of risk retention at not *less* than 5% of the credit risk or, if the originator of the assets meets certain prescribed underwriting standards, less than 5% of the credit risk (which presumably could include 0%). The underwriting standards for assets that would qualify for less than 5% risk retention are to be established by the Federal banking agencies and must specify the loan terms, conditions and characteristics that indicate a low credit risk with respect to loans within each asset class for which the applicable regulators have established separate rules.

Additionally, under regulations to be adopted jointly by the Federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the FHFA, securitizations of "qualified residential mortgages" will be exempt from the risk retention requirement if the issuer certifies to the SEC 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 securities are qualified residential mortgages.

The term "qualified residential mortgage" will be defined jointly by the regulators taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as documentation and verification of financial resources, standards with respect to debt-to-income ratio and limits on features (*e.g.*, negative amortization or interest-only mortgage loans). However, the adopted definition can be no broader than the definition of "qualified mortgage" adopted under Title XIV of the Act with respect to TILA. *See* "Minimum Standards for Mortgages—Ability to Repay" below.

[11] Note that the Act appears to link the risk retention requirement to the securitization of the assets, while the House Reform Bill would have imposed a risk retention requirement on any creditor transferring a loan in the secondary market regardless of whether the loan was securitized.

The exemption for qualified residential mortgage loans does not apply to asset-backed securities collateralized by other asset-backed securities (such as CDOs or other re-securitizations of RMBS with underlying qualified residential mortgages) or to asset-backed securities collateralized by a combination of qualified residential mortgages and other assets – such as a pool of prime and Alt-A mortgage loans.

Notably, neither the SEC proposed rules nor the FDIC proposed rules permit any reduction of the risk retention amount below 5%.

### Hedging

The Act requires that regulations to be adopted by the applicable regulators prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk required to be retained under the regulations, subject to the exemptions discussed below. The FDIC proposed rules would not permit a sponsor to directly or indirectly hedge its risk. In contrast, under the SEC proposed rules, hedge positions not directly related to the securities or exposures taken by the sponsor or affiliate would not be counted against the sponsor's risk retention requirement, such that the sponsor could have hedges related to overall market movement, such as movements of market interest rates, or to the overall value of a particular broad category of asset-backed securities (such as an ABX index so long as the particular asset-backed securities were not included in the ABX index).

### Asset Classes

Under the Act, the applicable regulators are required to adopt regulations to establish asset classes with separate rules for securitizers of different asset classes, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the SEC deem appropriate. The FDIC proposed rules would distinguish securitizations of residential mortgage loans from other asset types and, in securitizations of residential mortgage loans, would require, in addition to the 5% risk retention requirement, establishment of a reserve fund equal to at least 5% of the cash proceeds of the securitization payable to the sponsor to cover, during the first year of the securitization, repurchase of any of the securitized assets required for breach of representations and warranties. In contrast, the SEC risk retention proposal does not vary by asset class (although the SEC proposed rules would distinguish between asset classes with respect to disclosure and reporting obligations).

### Permissible Forms of Risk Retention

The Act leaves the determination as to permissible forms of risk retention to the applicable regulators. The SEC proposed rules would require the sponsor (or an affiliate) in a shelf-registered issuance of securities to retain a vertical slice of 5% of each tranche of securities issued in the transaction (or, in the case of a master trust transaction, 5% of the nominal amount of the securitized exposures) net of any directly related hedge positions. The FDIC proposed rules would require that 5% of each of the credit tranches sold or transferred to investors (or, that a "representative sample" of the securitized assets equal to not less than 5% of the principal amount of the financial assets at transfer) be retained.

In addition, the Act requires the applicable regulators to adopt regulations with respect to commercial mortgages, specifying the permissible types, forms and amounts of risk retention that would meet the risk retention requirement, which in the determination of the Federal banking agencies and the SEC may include:

- retention of a specified amount or percentage of the total credit risk of the asset;

- retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first-loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities and meets the same standards for risk retention as the Federal banking agencies and the SEC require of the securitizer;
- a determination by the Federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate; and
- provision of adequate representations and warranties and related enforcement mechanisms.

Note that in contrast to the Senate Reform Bill, which would have appeared to require the Federal banking agencies and the SEC to treat the foregoing as permissible forms and types of risk retention, the Act leaves to the Federal banking agencies and the SEC the determination as to whether such features will constitute permissible forms and types of risk retention.

Finally, in a change from prior legislative proposals, the regulations to be adopted by the applicable regulators under the Act must establish appropriate standards for retention of an economic interest with respect to CDOs, securities collateralized by CDOs and similar instruments collateralized by other asset-backed securities.

#### Exemptions from the Risk Retention Requirement

Under the Act, the Federal banking agencies and the SEC may jointly adopt or issue exemptions, exceptions or adjustments for classes of institutions or assets with respect to the risk retention requirement and the prohibition on hedging. Any exemptions, exceptions and adjustments are required to ensure quality underwriting standards for securitizers and originators of assets that are securitized or available for securitization and to encourage appropriate risk management practices, improve access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.

Additionally, the applicable regulators are required to adopt regulations that provide for a total or partial exemption from the risk retention requirements:

- for any securitization, as may be appropriate in the public interest and for the protection of investors;
- for any securitization where the assets securitized are assets issued or guaranteed by the United States, or an agency of the United States (other than Fannie Mae or Freddie Mac) as determined by the Federal banking agencies and the SEC to be appropriate in the public interest and for the protection of investors; or
- for any securitization where the asset-backed security is issued or guaranteed by any State of the United States (or political subdivision or public instrumentality thereof) and the security is exempt from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act") pursuant to Section 3(a)(2), or is a security defined as a qualified scholarship funding bond under the Internal Revenue Code of 1986, as amended, as may be appropriate in the public interest and for the protection of investors.

Finally, the Act specifically exempts from the risk retention requirement any loan or other financial asset made, insured, guaranteed or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation. Any residential, multi-family or health care facility mortgage loan asset, or securitization based directly or

indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the Untied States (other than Fannie Mae, Freddie Mac and the Federal Home Loan Banks), is also exempted from the risk retention requirement.

In contrast to the Act, neither the SEC proposed rules nor the FDIC proposed rules would provide any type of exemption or exceptions with respect to the risk retention requirements.

#### Duration

Under the Act, the duration of the risk retention requirement will be established by regulations jointly to be adopted by the applicable regulators. The SEC proposed rules would require the risk to be retained so long as an unaffiliated entity owns securities issued in the transaction and the FDIC proposed rules would require that the sponsor retain the risk for the life of the transaction.

#### Enforcement

Under the Act, the appropriate Federal banking agency will be responsible for enforcing the risk retention requirement with respect to any securitizer that is an insured depository institution, and the SEC will be responsible for enforcing the requirement with respect to any other securitizer.

#### Risk Retention Studies

The Act also requires a study and report (within 180 days of the Act's enactment) by the Chairperson of the Financial Stability Oversight Council (the "Oversight Council") on the macroeconomic effects of the risk retention requirements (with particular emphasis placed on the potential beneficial effects with respect to stabilizing the real estate market) and an analysis on the feasibility of minimizing real estate price bubbles by proactively adjusting the risk retention requirements and mortgage origination requirements. In addition, the Act requires a study and report (within 90 days of the Act's enactment) by the Federal Reserve Board (in consultation with the OCC, the Office of Thrift Supervision, the FDIC and the SEC) on the combined impact of the ABS Provisions' risk retention requirements, including the effect the risk retention requirements have on increasing the market for Federally subsidized loans, and Statement of Financial Accounting Standards Nos. 166 and 167. The report must include recommendations for eliminating any negative impacts on the continued viability of the securitization markets and on the availability of credit for new lending.

#### Effective Date of Risk Retention Regulations

The Act requires the risk retention regulations to be adopted within 270 days of the Act's passage and to become effective one year, in the case of securities backed by residential mortgages, or two years, for all other asset-backed securities, after the date of publication of the final regulations in the Federal Register. The Chairperson of the Oversight Council will coordinate all joint rulemaking required under the risk retention provisions.

### Increased Disclosure and Reporting by Issuers

Under Section 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), an issuer of asset-backed securities registered under the Securities Act has reporting obligations under the Exchange Act with respect to such securities. The Section 15(d) reporting obligations are automatically suspended if each class of such securities is held of record by fewer than 300 investors at the beginning of a fiscal year (other than the year of issuance). As most asset-backed securities are currently held of record by fewer than 300 persons, most issuers of registered asset-backed securities are able to cease reporting to the SEC under the automatic

suspension. Under the Act, Section 15(d) is amended to exclude all registered asset-backed securities from the automatic reporting suspension provisions. This amendment to Section 15(d) will subject all issuers of registered asset-backed securities to ongoing Exchange Act reporting requirements. The SEC proposed rules would impose ongoing reporting obligations equivalent to Exchange Act reporting on issuers using shelf registration (independent of the ability to suspend reporting under Section 15(d)) and require that issuers of structured finance products relying on the Rule 144A safe harbor commit to make such information available upon request.[12] The Act authorizes the SEC to adopt new suspension or termination schemes for different classes of registered asset-backed securities under terms and conditions as it deems necessary or appropriate in the public interest or for the protection of investors.

Of immediate concern for securitizers, while the Act authorizes the SEC to adopt a new suspension or termination scheme for asset-backed securities, the Act does not delay the amendment to Section 15(d) until the effectiveness of the final regulations. As a result, it appears issuers of asset-backed securities will be subject to ongoing reporting requirements from the time the Act is enacted. Moreover, the Act excludes all registered asset-backed securities from the Section 15(d) suspension provisions, including those for which the issuer (*i.e.*, the depositor) previously ceased reporting under Section 15(d). Unless clarified, this arguably will require issuers of asset-backed securities in thousands of transactions that have ceased reporting to once again file reports under Section 15(d).

Additionally, the SEC is required to impose registration statement disclosure requirements on asset-backed securities issuers with respect to asset-level information, including requiring loan-level data, if such data are necessary for investors to independently perform due diligence, including:

- loan-level data with unique loan broker and originator-identifiers;
- the nature and extent of the compensation of the broker or originator of the assets; and
- the amount of risk retention by the originator and the securitizer of the assets.

With the exception of the broker/originator compensation, the SEC proposed rules largely would address the disclosure requirements of the ABS Provisions. Note that while the Act amends Section 7 of the Securities Act as it relates to registration statements, the disclosure requirements under the SEC proposed rules would apply to sales of registered securities and would also require issuers of structured finance products relying on the Rule 144A and Rule 506 safe harbors (or for purposes of meeting the "current public information" requirement under Rule 144) to commit to make the same information available to investors upon request. In contrast, the FDIC proposed rules would extend the disclosure requirements of Regulation AB to *all* securities offerings seeking to rely on the FDIC safe harbor, including statutory private placements and exempt offerings under Section 3(a) of the Securities Act.

### New Asset Review

In contrast to the other proposals, the Act requires the SEC (within 180 days of the Act's enactment) to adopt rules requiring an issuer of registered asset-backed securities to perform a review of the assets underlying the asset-backed securities and to disclose the nature of the review in the issuer's registration statement. While the FDIC proposed rules would require a third-party diligence report on compliance with applicable statutory and regulatory standards for the origination of mortgage loans and compliance with representations and warranties in residential mortgage-backed transactions, there is no direct corollary in the SEC proposed rules.

[12] Additionally, to meet the "current public information" requirement under Rule 144, an issuer of structured finance products would have to commit to make such information available.

*See also* the discussion below regarding the requirement to disclose diligence reports publicly under "Credit Ratings of Structured Finance Securities—Due Diligence Reports."

### Representations and Warranties

The Act requires the SEC to adopt regulations (within 180 days of the Act's enactment) requiring a description and comparison of the representations, warranties and enforcement mechanisms available to investors to be included in a report accompanying each rating by an NRSRO of an asset-backed security. No such requirement appears in the SEC proposed rules, although a securitizer must disclose if it has or has not made a representation relating to fraud in the origination of the underlying assets.

### Repurchase Requests

The Act requires the SEC to adopt regulations (within 180 days of the Act's enactment) requiring a securitizer to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer. This is similar to the SEC's proposal to require sponsors and originators that have originated more than 20% of the pool assets to disclose the number of repurchase or replacement demands the entity has received in the last three years and the percentage of those where it did not repurchase or replace the asset. However, the Act limits this requirement to securitizers only, whereas the SEC proposed rules also would apply to originators of more than 20% of the pool assets that are not securitizers.

### Repeal of the Securities Act Section 4(5) Exemption

The Act repeals the transactional exemption from the Securities Act's registration and prospectus delivery requirements, contained in Section 4(5) thereof, for the sale of certain promissory notes secured by first liens on residential and commercial real estate and participation interests therein. Since the Section 4(5) exemption has rarely been used, it is not clear what (other than such fact) may have prompted its proposed repeal.

### Securitization Conflicts of Interest

Under Title VI of the Act, underwriters, placement agents, initial purchasers and sponsors (and their affiliates and subsidiaries) of asset-backed securities, as defined in the Act, and synthetic asset-backed securities are prohibited from engaging in any transaction during the one-year period following the date of the first closing of the sale of such securities that would involve or result in any material conflict of interest with respect to any investor in the transaction.

This prohibition does not apply to:

- risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase or sponsorship of asset-backed securities or synthetic asset-backed securities if such activities are designed to reduce the specific risks to the related entities associated with positions or holdings arising out of such activities; or
- purchases or sales of asset-backed securities or synthetic asset-backed securities made pursuant to and consistent with:
    - commitments of the underwriter, placement agent, initial purchaser or sponsor (or their affiliates or subsidiaries) to provide liquidity for such securities; or
    - bona fide market-making in such securities.

The SEC is required to issue final rules, within 270 days of the Act's passage, to implement this prohibition.

## Credit Ratings of Structured Finance Securities

Generally, the Act will subject NRSROs to greater oversight by the SEC.[13] In addition to imposing new requirements with respect to internal controls and transparency with respect to ratings methodologies, assumptions, volatility and limitations, the Act requires the SEC to establish an Office of Credit Ratings to administer the SEC's rules relating to NRSROs, to promote accuracy in NRSRO credit ratings and to ensure that credit ratings are not unduly influenced by conflicts of interest. Additionally, the Act removes certain statutory references to ratings issued by NRSROs.

Many of the changes brought about through the Act could significantly alter the terms of the relationship between issuers of asset-backed securities and NRSROs as new considerations regarding disclosures and liability will need to be addressed.

### Due Diligence Reports

The Act requires the issuer or underwriter of an asset-backed security to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. Additionally, if a third-party due diligence service is employed by an NRSRO, an issuer, or an underwriter, the person providing the due diligence service must provide to any NRSRO that produces a rating to which such services relate, a written certification in a form established by the SEC to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for an NRSRO to provide an accurate rating. The SEC must adopt rules requiring an NRSRO, at the time at which it rates the security, to publicly disclose the certification such that the public can determine the adequacy and level of due diligence services provided by a third party.

Note that the Act does not specify to whom or how an issuer or underwriter must disclose a diligence report and does not specifically contemplate a regulatory scheme with respect to this provision of the Act, raising the concern that these reports are required to be published upon enactment of the Act.

### NRSROs Assigning Structured Product Ratings

Although Senator Al Franken's proposal in the Senate Reform Bill to establish a self-regulatory organization to assign NRSROs to rate structured finance products is not part of the Act, the SEC is required to conduct a study of the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and subscriber-pay compensation models. The SEC must consider the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine the credit ratings of structured finance products and alternative means for compensating NRSROs that would create incentives for accurate ratings. The SEC must submit its report and recommendations to Congress not later than 24 months after enactment of the Act. Following the study, the SEC will issue rules, as the SEC determines necessary or appropriate in the public interest or for the protection of investors, creating a self-regulatory organization to assign NRSROs (including potentially through a lottery or rotating assignment system) unless it determines that an alternative mechanism would better serve the public interest and investor protection.

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[13] The NRSRO reforms are discussed in more detail in the Financial Reform Update under "Title IX—Investor Protections and Improvements to the Regulation of Securities—Subtitle C—Improvements to the Regulation of Credit Rating Agencies."

#### Rule 436(g)

Notably, the Act repeals Rule 436(g) under the Securities Act, which, in effect, exempts NRSROs from the requirement to file a consent as an expert for purposes of registered offerings of debt securities and preferred stock.[14] As a result, because Item 1120 of Regulation AB requires registration statement disclosure of the rating of any asset-backed security where the issuance or sale of the security is conditioned on the assignment by an NRSRO of a particular rating, it appears that it will be necessary to obtain a consent for filing with the SEC from all NRSROs rating registered asset-backed securities once the Act is signed into law.

#### Regulation FD

The Act also requires that within 90 days of the enactment date, the SEC adopt regulations modifying Regulation FD to remove the exception for disclosure of material non-public information regarding an issuer or its securities if the entity receiving the information is an entity whose primary business is the issuance of credit ratings.[15] As a result, issuers and sponsors should ensure that any NRSRO rating their securities (or otherwise in receipt of material non-public information) expressly agrees to treat the disclosed information in confidence in order to ensure that disclosures to NRSROs do not violate Regulation FD.

### Effective upon Enactment

Note that the following provisions appear to be effective immediately upon the enactment of the Act:

- Inability of issuers of registered asset-backed securities to suspend reporting obligations under Section 15(d) of the Exchange Act. *See* "Increased Disclosure and Reporting by Issuers" above.
- Repeal of Rule 436(g) of the Securities Act. *See* "Credit Ratings of Structured Finance Securities—Rule 436(g)" above.
- Obligation of issuer and underwriter to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. *See* "Credit Ratings of Structured Finance Securities—Due Diligence Reports" above.

These provisions are discussed in more detail in the sections noted and raise immediate concerns for issuers of asset-backed securities.

### Covered Bonds

The Act does not include the comprehensive framework for covered bonds proposed by Representative Scott Garrett. Although offered by the House, the Senate rejected the proposal because the U.S. Department of the Treasury and the FDIC were said to have expressed concerns about the framework. Senator Dodd promised to hold a hearing in the coming months to further explore covered bonds and Representative Frank promised to hold a mark up of Garrett's covered bond bill in July.

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[14] Prior to the adoption of Rule 436(g), it was generally believed that inclusion of a rating in a registration statement would require the consent of the issuing rating agency.

[15] Note that the Act appears to refer to Rule 100(b)(2)(iii) as in effect prior to the February 2, 2010 amendments to that rule to address concerns with respect to the information-posting requirements under Section 17g-5 of the Exchange Act.

## Residential Mortgage Loan Origination Standards

### Prohibited Payments to Mortgage Originators

Intending to prohibit "yield-spread premiums," the Act prohibits a mortgage originator[16] from receiving compensation that varies based on the terms of the residential mortgage loan (other than the principal amount) or from receiving any origination fee or charge from any person other than the consumer except where (i) no compensation is received directly from the consumer and (ii) unless otherwise waived or exempted by the Federal Reserve Board, the consumer does not make an upfront payment of discount points, origination points or fees (other than bona fide third party charges not retained by the mortgage originator or creditor or affiliate of either).

### Steering

Under regulations to be adopted by the Federal Reserve Board, mortgage originators will also be prohibited from steering a consumer to loans that a creditor is prohibited from making as described below under "Minimum Standards for Mortgages—Ability to Repay" or that have predatory characteristics or effects.

## Minimum Standards for Mortgages

### Ability to Repay

Title XIV of the Act requires the Federal Reserve Board to adopt regulations prohibiting a creditor from making residential mortgage loans (other than reverse mortgages and bridge loans) unless it reasonably and in good faith determines, based on verified and documented information of the consumer's financial resources (other than the equity in the property), that at the time the loan is consummated the consumer has a reasonable ability to repay the loan according to its terms, as well as all applicable taxes, insurance (including mortgage guarantee insurance) and assessments. The creditor's determination must be made using a payment schedule that fully amortizes the residential mortgage loan over the term of the loan, and if the creditor knows, or has reason to know, that one or more residential mortgage loans secured by the same property will be made to the consumer, it must make the determination with respect to the combined amount owed.

A creditor of a residential mortgage loan, and any assignee of the loan subject to liability under TILA, is presumed to have met the ability to repay determination requirement if the loan is a "qualified mortgage." For this purpose, a "qualified mortgage" includes a residential mortgage loan that (i) is fully amortizing, (ii) limits the terms of balloon loans and deferred principal payments, (iii) requires verification of financial resources, (iv) limits points and fees charged and (v) complies with thresholds with respect to debt-to-income level. The Act also includes standards for determining a consumer's ability to repay under "nonstandard loans" including variable rate, interest-only and negative amortization loans.

The Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture and the Rural Housing Service may exempt from these requirements a refinancing of a loan made, guaranteed or insured by it under certain circumstances.

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[16] The Act defines "mortgage originator" as any person who, for direct or indirect compensation or gain (or in expectation thereof), takes a residential mortgage loan application, assists a consumer in obtaining or applying to obtain a residential mortgage loan or offers or negotiates terms of a residential mortgage loan.

### Liability and Foreclosure Defense

The Act, unlike the House Reform Bill, does *not* create a private right of action for rescission of a loan made in violation of the origination requirements described above.[17] However, violations of the origination and repayment verification standards set forth in Title XIV can be asserted as a defense to foreclosure by recoupment or set-off without regard for the time limit on a private action for damages.

### Prepayment Penalties

The Act prohibits prepayment penalties on all residential mortgage loans other than "qualified mortgages." Qualified mortgages for purposes of this provision exclude residential mortgage loans with an adjustable interest rate or with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction (as of the date the interest rate is set) by prescribed amounts. Prepayment penalties are prohibited on qualified mortgages after year three of the loan. Prior to year three, a prepayment penalty on a qualified mortgage loan cannot exceed 3% of the outstanding balance of the loan in year one, 2% in year two and 1% in year three. The Act also requires creditors offering a consumer a residential mortgage loan with a prepayment penalty to offer the consumer the option of a residential mortgage loan without a prepayment penalty.

### Additional Standards and Requirements; Other Provisions

The Act also imposes limits on creditors financing (in connection with any residential mortgage loan) any credit life, credit disability, credit unemployment or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreements or contracts, and imposes disclosure requirements with respect to a creditor's policies with respect to partial payments; negative amortization loans; residential mortgage loans subject to protection under any state anti-deficiency law; and other disclosure and periodic reporting requirements with respect to residential mortgage loans.

The Act also expands the definition of a "high-cost mortgage" under TILA and imposes new requirements on high-cost mortgages, including with respect to origination practices and loan terms, and adds provisions regarding appraisal practices and escrow accounts, imposing substantive requirements as well as new disclosure rules.

These provisions are discussed in more detail in the Financial Reform Update under "Title XIV – Mortgage Reform and Anti-Predatory Lending Act."

### Effective Date of Regulations and Amendments

The regulations to implement the new requirements under TILA must be in final form within 18 months of the date designated for transfer of functions to the Consumer Financial Protection Bureau in accordance with the Act and the related amendments will take effect on the date the final regulations take effect (which must be within one year of the date the regulations are issued in final form). If regulations are not issued in final form in accordance with the preceding sentence, the amendments will take effect 18 months after the designated transfer date.

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[17] The House Reform Bill would have allowed rescission to be sought against an assignee as well as the originator, but not against a securitization trust or pool. However, a securitizer would have been obligated to retain the right to acquire a loan in the event of a violation of these provisions, and to provide appropriate relief to the borrower.

## Conclusion

Although the Act has been passed by the House, the Senate has yet to act and it is expected that such action may be delayed until mid-July due to the recent passing of Senator Byrd and the July 4th Congressional recess. If ultimately passed by the Senate and signed by President Obama, the provisions outlined above will have significant effects on the securitization markets, from the origination of residential mortgage loans to the disclosure and reporting documents of securitization transactions. However, until final regulations are adopted under the Act the exact form of the securitization requirements will remain unclear.

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