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REPORT

FINANCIAL REFORM

In the wake of the recent financial meltdown and the ensuing recession, lawmakers and the Obama administration are formulating proposals that would reform critical features of the financial system. In this analysis, the authors examine legislation the administration has advanced to assure that those who securitize assets have ''skin in the game'' and to bolster the regulatory regime for credit rating agencies.

Obama Administration's Securitization and Credit Rating Agency Reform Proposals

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On July 21 and 22 the Obama administration proposed legislation (the proposed legislation) to implement the securitization and rating agency reform proposals (the reform proposals) contained in its Financial Reform Plan announced June 17.[1]

The proposed legislation would implement the reform proposals' recommendations calling for risk retention by securitizers, increased disclosure and periodic Securities Exchange Act of 1934 (Exchange Act) reporting by issuers of asset-backed securities, and increased regulation of the use of representations and warranties in the asset-backed securities market. However, the administration did not include in the proposed legislation provisions that would implement several of the reform proposals' other recommendations (such as those calling for reforming compensation and fees of brokers, originators, sponsors, and others involved in the securitization process or changes in U.S. generally accepted accounting principles [GAAP] to eliminate ''gain on sale'' recognition by originators). The administration has not indicated how it plans to move forward with these recommendations.

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Risk Retention Requirement. The proposed legislation would require the federal bank regulatory agencies and the Securities and Exchange Commission (SEC) to jointly adopt regulations that require any ''securitizer'' of an ''asset-backed security'' to retain an economic interest in a ''material portion'' of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party (a securitized exposure).

The proposed legislation would require the adopted regulations to:

- require that a securitizer retain ''*at least*'' 5 percent of the credit risk of any securitized exposure;
- prohibit a securitizer from hedging (or otherwise transferring) the retained risk;
- specify how the retention requirement should be satisfied (*e.g.*, whether by retention of a first-loss piece or a vertical slice) and the minimum duration of the retention requirement;
- provide for a total or partial exemption for securitizations of assets issued or guaranteed by the United States, any agency of the United States, or a government-sponsored enterprise;
- provide for a total or partial exemption from these requirements when in the public interest or for the protection of investors; and
- provide for the allocation of risk retention obligations between a securitizer and an ''originator'' (which is defined as ''a person who sells an asset to a securitizer'') in cases where a securitizer purchases assets from an originator.

The proposed legislation defines ''securitizer'' to mean ''an issuer or underwriter of an asset-backed security.'' The proposed legislation does not clearly define ''issuer'' and ''underwriter'' for this purpose, but it may have been the intention that those terms be defined by reference to the Securities Act of 1933 (Securities Act) and Rule 191 thereunder. (Under this rule, the depositor for an asset-backed security, acting solely as depositor to the issuing entity, is the issuer for purposes of that asset-backed security.) In addition, the proposed legislation does not make clear the circumstances in which an underwriter, rather than an issuer, should be subjected to its risk retention requirement.

The proposed legislation defines ''asset-backed security'' by reference to Regulation AB under the Securities Act which defines an asset-backed security as ''a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.''[2]

In addition, under Regulation AB, in order to qualify as an asset-backed security, the issuing entity must be limited to passively owning and holding pools of assets; no non-performing assets can be part of the asset pool as of the cut-off date; and the amount of delinquent assets and the residual value of leases in the asset pool are subject to specified thresholds. Further, the ''discrete pool'' requirement in the Regulation AB definition has the effect of limiting the use of prefunding and other features. Securities that do not meet these requirements would not qualify as asset-backed securities under Regulation AB. In addition, synthetic asset-backed securities and asset-backed commercial paper would generally not qualify as asset-backed securities under Regulation AB. Accordingly, under the literal terms of the proposed legislation, such securities would not be subject to a risk retention requirement. Whether this result was intended is not clear.

Under the proposed legislation, the federal bank regulatory agencies would have the authority to jointly issue exemptions or adjustments for classes of institutions or assets with respect to the risk retention requirement and the prohibition on hedging. Any exemptions and adjustments would be required to ensure quality underwriting standards for securitizers and originators and to improve risk management practices or the terms of consumer access to credit. The proposed legislation is unclear as to whether the SEC would be permitted to issue exemptions and adjustments for non-bank securitizers.

Under the proposed legislation, the Federal Deposit Insurance Corporation (FDIC) would be responsible for enforcement of the risk retention requirement with respect to any securitizer that is an FDIC-insured depository institution, and the SEC would be responsible for enforcing the requirement with respect to any other securitizer. The proposed legislation does not make clear who is responsible for enforcing the requirement with respect to originators.

Proposals for Better Disclosure, ABS Issuer Reporting. Under Section 15(d) of the Exchange Act, an offering of asset-backed securities registered under the Securities Act triggers reporting obligations under the Exchange Act with respect to such securities. The Section 15(d) reporting obligations are automatically suspended if such securities are 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 publicly-offered asset-backed securities are able to cease reporting to the SEC under the automatic suspension.

Under the proposed legislation, the reporting obligations of issuers of asset-backed securities (as defined in Regulation AB) would no longer be eligible for the Section 15(d) automatic suspension. However, the SEC would be authorized to adopt new suspension schemes for different classes of issuers of asset-backed securities under terms and conditions as it deems necessary for the protection of investors.

The proposed legislation would also require the SEC to adopt regulations requiring issuers of asset-backed securities to disclose asset-level information on a class-by-class basis, including, at a minimum:

- loan-level data necessary for investors to independently perform due diligence, as well as 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 or securitizer of the assets.

Representations and Warranties in ABS Offerings. The proposed legislation would require the SEC to prescribe regulations on the use of representations and warranties in the asset-backed securities market that would require the rating agencies to describe the representations and warranties and enforcement mechanisms available to investors and how they differ from representations, warranties, and enforcement mechanisms in similar issuances in a report accompanying each credit rating. It would also require disclosure on fulfilled repurchase requests across trusts aggregated by originators so that investors may identify asset originators who have clear underwriting deficiencies.

ISSN 0092-6884

Repeal of Section 4(5) Exemption of the Securities Act. The proposed legislation would repeal the transactional exemption from the Securities Act's registration and prospectus delivery requirements, contained in Section 4(5) thereof, for the sale of certain 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 may have prompted its proposed repeal.

Rating Agency Reform. The proposed legislation contains a number of provisions, similar in content to those proposed by the Financial Reform Plan, aimed at managing perceived rating agency conflicts of interest and addressing other perceived deficiencies in the ratings process.

Significantly, as with the Financial Reform Plan, the proposed legislation would require credit rating agencies to register with the SEC and require the SEC to adopt rules requiring the rating agencies to differentiate the credit ratings assigned to structured and non-structured credit products, a provision which is strongly opposed by many market participants. The SEC would be required to establish an office to administer SEC rules with respect to the practices of rating agencies and to conduct annual reviews of their credit ratings and policies, procedures, and methodologies. To discourage ratings shopping, the proposed legislation would require each issuer to disclose any preliminary credit ratings received from a rating agency for both structured and non-structured securities.

To address concerns about the ''revolving door'' nature of employment at the rating agencies, if a rating agency employee is hired by an issuer and the employee worked on ratings for the issuer, the proposed legislation would require a one-year lookback on any ratings issued to determine if a credit rating was influenced by a conflict of interest. If necessary, a credit rating that had been influenced would have to be revised.

Additional proposed reforms are aimed at improving:

- management and disclosure of conflicts;
- qualitative and quantitative disclosure of the risks measured in any ratings;
- disclosure of the rating agency's assessment of data reliability used in rating a security; and
- disclosure of, and prompt ratings action with respect to, any changes in ratings methodology.

Under the proposed legislation, any third-party diligence provider used by a rating agency, issuer, or underwriter in a transaction with a rated security would be required to provide a written certification as to the diligence conducted. The rating agency would be required to publicly disclose the certification at the time the credit rating is issued.

The proposed legislation is also noteworthy for what it does *not* do in the area of rating agency reform. In this regard, the proposed legislation would not specifically require changes to the model (blamed by some as having significantly undermined the integrity of the ratings of asset-backed and other securities and, in turn, the credit markets) under which ratings of asset-backed and other securities are paid for by the issuer of such securities. However, the proposed legislation would require the SEC to adopt rules to establish a system of payment for each rating agency requiring that payments are structured to ensure that the rating agency conducts accurate and reliable surveillance of ratings over time and that incentives for accurate ratings are in place. Additionally, the proposed legislation would require the SEC to promulgate rules requiring the rating agencies to disclose in each credit report the fees charged by the rating agency for the specific rating and during the preceding two years to the issuer and its affiliates.

In addition, the proposed legislation would not require any immediate change in the use of ratings to set capital requirements and other regulatory thresholds. Instead, it would require the Comptroller General to undertake a study of the use of ratings by banking and securities regulators in determining capital and other requirements. In its fact sheet relating to the proposed legislation, the administration further indicates that the Treasury Department will work with the President's Working Group and the SEC to determine where references to ratings can be removed from regulations.

Further, in contrast to similar proposed rating agency reform legislation introduced in the Senate by Senator Jack Reed in May 2009,[3] the proposed legislation would not provide investors with a private right of action against the rating agencies.

[1]The proposed legislation to implement the securitization reform proposals is available at http://www.financialstability.gov/docs/regulatoryreform/07222009/titleIX.pdf.

The proposed legislation to implement the rating agency reform proposals is available at http://www.financialstability.gov/docs/regulatoryreform/titleIX_subtC.pdf.

The proposed legislation to implement other aspects of the Financial Reform Plan is available at http://www.financialstability.gov/roadtostability/regulatoryreform.html.

For a summary of the reform proposals and other aspects of the Financial Reform Plan, see Sidley Austin LLP, Financial Regulatory Reforms Update, ''The Administration's Financial Regulatory Reform Proposals,'' available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4059.

[2] 17 C.F.R. § 229.1101(c).

[3]See http://reed.senate.gov/newsroom/details.cfm?id=313172.