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Final Rule to Implement Dodd-Frank Risk Retention Requirement

EXECUTIVE SUMMARY

Overview

On October 21, 2014, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Federal Deposit Insurance Corporation (FDIC), the U.S. Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD) (collectively, the Agencies) issued a joint release (the Joint Release) on the joint final rule (the Final Rule) implementing the credit risk retention requirements of Section 15G (Section 15G) of the Securities Exchange Act of 1934 (the Exchange Act)[1] added by Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Final Rule was adopted by three of the Agencies on October 21, 2014, and the remaining Agencies on October 22, 2014. The complete text of the Joint Release including the Final Rule can be found here.

The credit risk retention requirements of Section 15G were originally proposed by the Agencies in April 2011 (the Original Proposal) and were re-proposed by the Agencies in August 2013 (the Re-Proposed Rule).[2] The Re-Proposed Rule made a significant number of modifications to the Original Proposal in response to comments received on the Original Proposal. The Final Rule maintains the credit risk retention framework proposed by the Re-Proposed Rule with a smaller number of modifications, many of which are technical in nature. The Joint Release explains the Agencies' reasoning in making modifications to the Re-Proposed Rule in addition to their reasoning for declining to make many of the changes proposed by commenters over the public comment period that preceded the release of the Final Rule.

The objective of the credit risk retention requirements of Section 15G is to align the interests of securitizers with those of other securitization transaction participants by requiring securitizers to retain a specified percentage of the credit risk of the assets they securitize or, as it has popularly been referred to, for securitizers to have "skin in the game." Section 15G generally requires a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer transfers, sells or conveys to one or more third parties through the issuance of asset-backed security (ABS) interests. Section 15G does not distinguish between transactions that are required

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[1] *See* Securities Exchange Act of 1934 § 15G, 15 U.S.C. § 78o-11.

[2] *See* "First Notice of Proposed Rulemaking to Implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Credit Risk Retention)," 76 Fed. Reg. 24090 (Apr. 29, 2011), for the Original Proposal, and "Second Notice of Proposed Rulemaking to Implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Credit Risk Retention)," 78 Fed. Reg. 183 (Sept. 20, 2013), for the Re-Proposed Rule.

to be registered with the SEC and those that are exempt from SEC registration. Consequently, the risk retention requirements promulgated pursuant to Section 15G apply to both public and private ABS transactions.

The features of the credit risk retention framework introduced in the Original Proposal or the Re-Proposed Rule that have been retained in the Final Rule include alternative permissible forms for the economic interest required to be retained, provisions for the application of the risk retention requirements to specific types of securitization transactions, certain limited exemptions from the standard risk retention requirements, and reduced retention requirements for securitizations of certain qualifying types of securitized assets (including in particular a category of qualified residential mortgages satisfying the conditions of a "QRM" that will be completely exempt from the risk retention requirements).[3] The Final Rule retains the credit risk retention framework introduced in the Re-Proposed Rule that requires a sponsor[4] to retain either an eligible vertical interest or an eligible horizontal residual interest (or a combination of an eligible vertical interest and an eligible horizontal residual interest) that is generally required to equal at least 5 percent of the "fair value" of the securitization transaction in the aggregate, determined using a fair value calculation methodology acceptable under generally accepted accounting principles (GAAP), provided that if the sponsor opts for a strictly vertical economic interest, the fair value methodology is no longer applied and the sponsor retains 5 percent of each class of ABS interests (which may include an interest that consists of at least 5 percent of each class of ABS interests). An eligible horizontal residual interest is a first loss position with respect to the entire asset pool that is securitized, which is generally understood to mean the most subordinate class of ABS interests representing the residual interest in the asset pool. The Final Rule permits the sponsor to substitute an eligible horizontal cash reserve account for an eligible horizontal residual interest as the most subordinate interest in meeting the standard risk retention requirement.

The Final Rule eliminates the restriction that would have limited the rate of payment on an eligible horizontal residual interest held by a sponsor to the rate of principal amortization of the transaction as a whole (what has been popularly referred to as the "cash throttle"). The Agencies recognized that limiting the right of the most subordinate class of ABS interests from receiving payments on a current basis would be inconsistent with certain types of otherwise acceptable securitization transactions. However, the Final Rule does not incorporate the proposal by commenters to add back the provision included in the Original Proposal to permit sponsors to hold a representative sample of assets equaling at least 5 percent of the unpaid principal balance of the pool assets initially included in the securitization (what has been popularly referred to as the "representative sample" option) as an alternative to the standard risk retention option.

The Final Rule retains the "menu of options" approach proposed in the Re-Proposed Rule for permissible forms of risk retention that purports to take into account transaction-specific features of securitization transactions involving revolving pool securitizations, asset-backed commercial paper (ABCP) conduits, commercial mortgage-backed securities (CMBS), open market collateralized loan obligations (CLOs), mortgage-backed securities issued and guaranteed by government-sponsored enterprises (such as Fannie Mae and Freddie Mac) and tender option bonds.

The Final Rule prohibits a sponsor from directly or indirectly hedging or otherwise selling or transferring the retained interest that the sponsor is required to retain under the Final Rule until a specified date, determined in the manner provided in the Final Rule.[5] However, the Final Rule generally permits the sponsor to hold the retained interest through a majority-owned affiliate (which is defined to exclude

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[3] *See* "Qualified Residential Mortgages and Related Exemptions" for a description of the category of qualified residential mortgages that are exempt from the risk retention requirements.

[4] The Final Rule substitutes the term "sponsor" for "securitizer" and defines it in the manner described herein under "Definitions and Scope."

[5] *See* "Hedging, Transfer and Financing Prohibitions — Sunset on Hedging and Transfer Prohibitions" for an explanation of the date on which the hedging, transfer and financing prohibitions on a covered securitization transaction will no longer apply.

the issuing entity). Furthermore, the sponsor or its permitted affiliates may pledge the retained interest as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) as long as the obligation is full recourse to the sponsor or such affiliate. In this manner, a sponsor is permitted to finance the retained interest either directly or indirectly through an affiliate as long as the financing is full recourse to the sponsor or the affiliate.

The Final Rule is expected to be published in the U.S. Federal Register (the Federal Register) within 60 days following the date on which the Agencies adopted the Final Rule. However, securitization market participants will not be required to comply with the risk retention requirements until one year following the publication of the Final Rule in the Federal Register, in the case of residential mortgage-backed securitizations, or two years following such date, in the case of all other types of securitizations (the applicable date on which securitization market participants are required to comply with the risk retention requirements imposed by the Final Rule being referred to herein as the Effective Date). Securitization transactions that have closed prior to the Effective Date will not be required to comply with the risk retention requirements imposed by the Final Rule on the Effective Date. However, the parties to securitization transactions that close prior to the Effective Date will nevertheless be affected by the risk retention requirements following the Effective Date in certain situations, such as the issuance of additional notes or the refinancing or re-pricing of existing classes of notes in a CLO following the Effective Date.

The Joint Release explains the Agencies' reasoning in declining proposals made by commenters to grandfather the securitization of certain asset types originated prior to the Effective Date, including loans transferred to CLOs, loans and receivables in ABCP conduits, and assets securitized in revolving pool securitizations. The Final Rule does include a "seasoned loan" exemption pursuant to which securitization transactions that are collateralized solely by seasoned loans meeting the conditions specified in Section 19(b)(7) of the Final Rule and servicing assets are exempt from the risk retention requirements of the Final Rule.[6] However, this "seasoned loan" exemption is expected to be of limited use to securitization market participants because of the narrow manner in which "seasoned loan" is defined and other conditions which are inconsistent with current market practice.

In addition to the foregoing, proposals by commenters to fully exempt certain types of securitizations from the risk retention requirements, including open market CLOs, were declined.[7] Instead, a far more limited number of exemptions from the risk retention requirements are provided in the Final Rule, including the securitization of qualified residential mortgages satisfying the conditions of a "QRM" and the "seasoned loan" exemption referred to above.

While the Final Rule provides some additional clarity as to the scope and nature of the credit risk retention framework applicable to all securitization transactions and the risk retention requirements applicable to specific types of securitization transactions, many of the concerns raised by commenters during the public comment period preceding the release of the Final Rule have not been resolved to the satisfaction of the commenters and are expected to make the consummation of specific types of securitization transactions significantly more challenging. In particular, while the Final Rule has the stated objective of being responsive to the concerns of commenters, it continues to be highly prescriptive and does not give credit for many forms of risk retention or alignment of incentives in securitization transactions that have been commonly used in the past.

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[6] *See* "General Exemptions — Other Exemptions from the Risk Retention Requirements — Seasoned Loans" for a discussion of the seasoned loan exemption.

[7] *See* "Risk Retention Options for Specific Securitization Structures — Open Market Collateralized Loan Obligations" for a discussion of the reasoning provided by the Agencies in the Joint Release for applying the risk retention requirements to open market CLOs.

The Final Rule does not mandate periodic review by the Agencies other than a specified time frame for review of the risk retention requirements strictly as they relate to securitizers and originators of ABS interests collateralized by qualified residential mortgages, which will be no later than four years after the Effective Date of the Final Rule and then five years following the completion of such initial review and every five years thereafter. In addition, the Agencies will commence a review at any time upon the request of any one of the Agencies. Consequently, there is no further opportunity for public comment to petition the Agencies for relief of the risk retention requirements mandated by the Final Rule, and no further changes to the Final Rule are anticipated in the immediate future.

We have highlighted certain significant changes made by the Agencies to the Re-Proposed Rule in approving the Final Rule in the following section, followed by a more detailed discussion of the key provisions of the Final Rule.

Highlighted Changes in the Final Rule

Set forth below is a summary of certain significant changes made by the Agencies to the Re-Proposed Rule in approving the Final Rule:

Elimination of Cash Flow Restrictions. The Final Rule eliminates the restrictions on payments of cash flow on an eligible horizontal residual interest while the senior ABS interests remain outstanding (the so-called "cash throttle" referred to above). The Re-Proposed Rule required that payments of cash flow on the eligible horizontal residual interest not exceed the rate of principal amortization of the securitization transaction as a whole. The Agencies were responsive to comments that these restrictions were inconsistent with the manner in which certain types of securitizations are structured, including in particular CMBS and CLO transactions.

Vertical Risk Retention Calculation. The Final Rule eliminates the requirement to determine the fair value of the economic interest retained by the sponsor in the issuing entity when the sponsor opts for a strictly vertical economic interest. Instead, it is sufficient for the sponsor to retain 5 percent of each class of ABS interests issued by the issuing entity. The Final Rule preserves the requirement to apply the "fair value" calculation methodology in accordance with GAAP when the sponsor opts for an eligible horizontal residual interest.

Modifications to Horizontal Risk Retention Measurement and Fair Value Disclosures. Where the sponsor is required to apply a "fair value" valuation methodology acceptable in accordance with GAAP to its retained interest, the Final Rule maintains the requirement set forth in the Re-Proposed Rule that the sponsor disclose the sponsor's valuation methodology prior to the sale of the ABS interests. However, recognizing that any valuation information disclosed prior to the sale of the ABS interests may be preliminary, the Final Rule allows sponsors to provide a range of fair values of an eligible horizontal residual interest prior to the sale of the ABS interests if the specific amounts, prices or rates of interest of each tranche of the securitization are not available. The Final Rule also requires the sponsor to disclose certain information to investors after closing, including the actual fair value of an eligible horizontal residual interest the sponsor retains at closing, based on the actual sale prices and finalized tranche sizes.

Revolving Pool Securitizations. The Final Rule replaces the term "revolving master trust" with "revolving pool securitization" to reflect that the issuing entities for revolving pools may not be organized in the form of master trusts. The Final Rule makes other changes to the provisions specifically applicable to revolving pool securitizations, including:

- The seller's interest is permitted to be either *pari passu* with or subordinate in identical or varying amounts to each series of outstanding investor ABS interests issued with respect to the allocation of all distributions and losses prior to early amortization. This is consistent with the allocation

methodology of most revolving pool securitizations, which allocate principal disproportionately in favor of investor ABS interests during any amortization period instead of only following early amortization. The Joint Release notes that the additional flexibility provided under the Final Rule is intended to accommodate current market practice.

- The definition of "revolving pool securitization" is amended to exclude the monetization of excess spread and fees from the securitized assets.
- Clarification is provided that sponsors of revolving pool securitizations are required to maintain, and not simply retain, a seller's interest of not less than 5 percent.
- A cure period is provided if the revolving pool securitization fails to meet the 5 percent test as of a seller's interest measurement date. In such circumstances, the 5 percent test must be met within the earlier of one month after the seller's interest measurement date or the cure period specified in the securitization transaction documents.

ABCP Conduits. The Final Rule clarifies that the sponsor of an ABCP conduit is not limited to relying on the risk retention option tailored specifically to ABCP conduits described herein under "Risk Retention Options for Specific Securitization Structures — Asset-Backed Commercial Paper Conduits." Instead, the sponsor of an ABCP conduit may apply the standard risk retention requirements described herein under "Risk Retention Requirements."

CMBS. The Final Rule makes certain substantive changes to the provisions specifically applicable to CMBS, including that:

- To qualify for the risk retention requirements applicable to CMBS, a CMBS securitization transaction must be collateralized solely by commercial real estate loans and servicing assets.
- An early sunset on the hedging, transfer and financing prohibitions is provided for third-party purchasers when all loans collateralizing the outstanding ABS interests have been defeased. A loan is deemed to be defeased when (i) cash or cash equivalents have been pledged to the issuing entity as collateral for the loan and are in such amounts necessary to timely generate cash sufficient to make all remaining debt service payments due on the loan, and (ii) the issuing entity has an obligation to release its lien on the loan.

Elimination of QM-plus. The Final Rule does not adopt the more stringent alternative approach to exemptions from the risk retention requirements for securitizations of residential mortgage loans proposed in the Re-Proposed Rule (what was popularly referred to as the "QM-plus" approach). QM-plus would have required, among other things, a 30 percent down payment and more stringent credit history metrics. The Agencies sought comment in the Re-Proposed Rule for QM-plus as an alternative to QRM as the standard for exempting securitizations of residential mortgage loans from the risk retention requirements. In the Joint Release, the Agencies explain that QM-plus was not adopted because of concerns it would place additional constraints on mortgage credit availability and might have a disproportionate impact on low- and moderate-income, minority, or first-time homebuyers.

Additional Exemptions for Specified Types of Residential Mortgages. The Final Rule exempts certain types of closed-end loans secured by residential buildings and community-focused residential mortgages that do not qualify for the exemption for the specified category of QRM and were not exempted under the Re-Proposed Rule, subject to the obligation of the relevant Agencies to review the exemptions as part of their periodic review of the risk retention requirements strictly as they relate to ABS interests collateralized by residential mortgages.

Tender Option Bonds. The Final Rule makes certain substantive changes to the provisions specifically applicable to tender option bond programs, including that:

- The notice period for holders of tender option bonds to tender such bonds to the issuing entity for purchase has been changed from 30 days to 397 days.

- The definition of a qualified tender option bond has been changed to remove the requirement that the tender option bond have the necessary features to qualify for purchase by money market funds under the Investment Company Act of 1940, as amended.
- The sponsor of an issuance of qualified tender option bonds is permitted to rely on any combination of the permitted risk retentions options (including the standard risk retention option) to satisfy its risk retention requirements, provided that the sum of the interests retained in each form equals at least 5 percent.

Majority-Owned Affiliate. The Final Rule clarifies that if an originator, an originator-seller and/or a third-party purchaser is required to retain the minimum required risk retention, it may retain the risk retention through a majority-owned affiliate in the same manner as a sponsor.

Cutoff Date for Disclosure. The Final Rule clarifies that sponsors are permitted to use data about the securitized assets prepared as of a specified cutoff date in making certain calculations and disclosures required under the Final Rule:

- A sponsor retaining an eligible horizontal residual interest pursuant to the standard risk retention option may use data prepared no more than 60 days prior to the date of first use with investors in its calculation of fair value. For a subsequent issuance of ABS interests by the same issuing entity with the same sponsor that makes distributions to investors on a quarterly or less frequent basis, the sponsor may use data prepared no more than 135 days prior to the date of first use with investors.
- The sponsor of a revolving pool securitization may use data about the revolving pool's collateral prepared as of a specified cutoff date to determine the closing-date percentage of a seller's interest. The cutoff date generally may not exceed 60 days prior to the date of first use with investors. Revolving pool securitizations that make distributions to investors quarterly or less frequently may use a cutoff date of 135 days prior to first use.
- The sponsor of an ABCP conduit may rely on data prepared no more than 60 days prior to the date of first use with investors in making its periodic disclosures to investors.

ABS Interest. The Final Rule modifies the definition of an "ABS interest" to exclude (i) a non-economic residual interest issued by a REMIC,[8] and (ii) an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors.

No Significant Changes in the Final Rule as Applied to Open Market CLOs

The Final Rule does not make any significant changes to the application of the risk retention requirements to CLOs despite intense industrywide scrutiny and the significant number of comments received by the Agencies on the application of the risk retention requirements to open market CLOs in particular. The Joint Release explains the Agencies' reasoning for interpreting "securitizer" to include the party acting as the CLO manager despite the fact that CLO managers do not legally own, possess or control the loans that are securitized and for extending the risk retention requirements to open market CLOs even though they are outside of the originate-to-distribute model for securitization transactions.[9] Consequently, the securitizers of balance sheet CLOs will be required to apply the

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[8] A **REMIC** is a real estate mortgage investment conduit, which is defined for the purposes of the Final Rule to be consistent with the definition in 26 U.S.C. § 860D. Generally, a REMIC is an entity that holds a fixed pool of mortgages and issues multiple classes of ABS interests to investors.

[9] *See* "Risk Retention Options for Specific Securitization Structures — Open Market Collateralized Loan Obligations" for the definition of "CLO manager" under the Final Rule together with a discussion of the Agencies' analysis of the treatment of CLO managers as securitizers and the application of the risk retention requirements to open market CLOs.

standard risk retention requirements that apply generally while the securitizers of open market CLOs will be permitted to elect between the standard risk retention requirements that apply generally and an option that applies specifically to open market CLOs added pursuant to the Re-Proposed Rule and which is described herein under "Risk Retention Options for Specific Securitization Structures — Open Market Collateralized Loan Obligations."[10] The alternative option that applies specifically to open market CLOs is expected to be of limited use to CLO market participants because the conditions to the exemption, which, among other things, would require the lead arrangers of a loans sold to the CLO to retain at least 5 percent of the face amount of the term loan tranches acquired by the CLO, are inconsistent with current market practice and would likely be less attractive to the lead arrangers than alternative forms of financing in the market. The "seasoned loan" exemption for securitization transactions is also expected to be of limited use to CLO market participants because it will not generally be feasible to limit a CLO to seasoned loans of the type required by the exemption.

The elimination of the so-called "cash throttle" referred to above provides at least some relief to the CLO market as the limitations imposed by the cash throttle on the payment of cash flow to the most subordinated interest in a CLO would have been inconsistent with the manner in which the most subordinated ABS interest in a CLO is customarily structured (as investors in the most subordinated ABS interest in a CLO expect to be paid the excess interest generated by the CLO on a current basis).

Unfortunately, perhaps in part due to the contentious debate concerning whether the credit risk retention requirements of Section 15G should be applied to open market CLOs at all, the Final Rule has some significant omissions with respect to how it is intended to be applied in practice to CLO managers as the sponsors of the CLOs. These include a failure to address the consequences if a CLO manager resigns or is removed pursuant to the related collateral management agreement, or a lender forecloses on its security interest in a CLO manager's retained interest in the CLO (which the CLO manager is permitted to pledge on a full recourse basis). The somewhat tendentious views of the Agencies expressed in the Joint Release may also leave lingering concerns for CLO managers that seek to adapt their capital structures to comply with the burdensome risk retention requirements imposed by the Final Rule in the most advantageous manner as to how the Agencies will analyze and police the CLO managers' compliance efforts.

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[10] The Joint Release describes a balance sheet CLO as securitizing loans already held by a single institution or its affiliates in a portfolio (including assets originated by the institution or its affiliates) and an open market CLO as securitizing assets purchased on the secondary market in accordance with investment guidelines.

CONTENTS

DEFINITIONS AND SCOPE

The Final Rule applies only to the issuance of asset-backed securities for which purpose the Final Rule uses the definition of asset-backed security in Section 3(a)(79) of the Exchange Act. Section 3(a)(79) provides in relevant part that an **asset-backed security** is "a 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."[11] Section 15G does not distinguish between transactions that are registered with the SEC under the Securities Act of 1933, as amended (the Securities Act) and those that are exempt from registration under the Securities Act. Consequently, the Final Rule applies to both public and private ABS transactions.

The Final Rule defines an **ABS interest** as any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest,[12] payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity other than certain specified residual interests.[13]

The Final Rule defines an **issuing entity** as the trust or other entity that owns or holds the pool of assets to be securitized and in whose name the ABS interests are issued.

The Final Rule generally imposes the risk retention requirements on a **sponsor**, which it defines as a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.[14]

In some circumstances, a portion of the risk retention may be retained by an **originator**, which the Final Rule defines as a person who (i) through an extension of credit, creates an asset that collateralizes an asset-backed security, and (ii) sells the asset directly or indirectly to a securitizer or issuing entity.

In addition, where the Final Rule requires a credit risk in securitized assets to be retained and held by any person, whether a sponsor, an originator, an originator-seller or a third-party purchaser, except as otherwise provided, the risk may be acquired and held by any of such person's majority-owned affiliates. A **majority-owned affiliate** of a person is defined as an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. **Majority control** for purposes of this definition means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined in accordance with GAAP. Any reference herein to a sponsor retaining risk includes such other persons permitted to retain risk under the applicable provisions of the Final Rule.

RISK RETENTION REQUIREMENTS

Minimum Risk Retention Requirement

The Final Rule generally requires a sponsor (or its majority-owned affiliate) to retain an economic interest equal to at least 5 percent of the aggregate credit risk of the assets collateralizing an issuance

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[11] 15 U.S.C. § 78c(a)(79).

[12] The Final Rule modifies the definition of ABS interest to exclude certain residual interests. Specifically, the Final Rule excludes (i) a noneconomic residual interest issued by a REMIC, and (ii) an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors.

[13] The definition of ABS interests also does not include common or preferred stock, limited liability interests, partnership interests, trust certificates or similar interests that (i) are issued primarily to evidence ownership of the issuing entity, and (ii) the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity. The definition also does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.

[14] The Final Rule defines **securitizer**, with respect to a securitization transaction, as either (i) the depositor of the asset-backed securities (if the depositor is not the sponsor), or (ii) the sponsor of the asset-backed securities.

of ABS.[15] The standard forms of risk retention are an eligible horizontal residual interest, an eligible vertical interest or a combination of the two. The Final Rule also includes asset-specific risk retention options intended to accommodate different asset-specific transaction structures that have developed in the market. Generally, a sponsor may not hedge its retained interest and must hold the retained interest until the applicable sunset date provided in the Final Rule.

Standard Risk Retention

Under the Final Rule's standard risk retention option, a sponsor may satisfy the 5 percent risk retention requirement by retaining interests in the form of an eligible vertical interest (which would be an interest in each class of ABS interests and may be held in the form of a single security), an eligible horizontal residual interest (or eligible horizontal cash reserve account, which would be the most subordinate interest) or any combination thereof, determined on the closing date of the securitization transaction. Under the Final Rule, if the sponsor retains only an eligible horizontal residual interest, the amount of the retained interest must equal at least 5 percent of the fair value of all ABS interests in the issuing entity issued as part of the securitization transaction, determined using a fair value measurement framework in accordance with GAAP.[16] As discussed above, the Final Rule has eliminated the Re-Proposed Rule's restrictions on payments of cash flow to holders of an eligible horizontal residual interest.

Horizontal Risk Retention. The sponsor of a securitization transaction may satisfy the risk retention requirement by retaining an "eligible horizontal residual interest," which may be held as an interest in a single class or multiple classes, provided that each interest, individually or in the aggregate, qualifies as an eligible horizontal residual interest. The Final Rule defines **eligible horizontal residual interest** as an ABS interest in the issuing entity:

- with respect to which, on any payment date or allocation date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments or any other governing contractual provision; and
- that, with the exception of any non-economic REMIC residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity.

In lieu of retaining all or any part of an eligible horizontal residual interest, the sponsor may fund an eligible horizontal cash reserve account in the amount equal to the fair value of the eligible horizontal residual interest otherwise required to be held. The account must be maintained by a trustee, and the amounts in the account may be invested only in cash and cash equivalents.[17] Until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved, amounts in the eligible horizontal cash reserve account can be released only to:

- satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest; or

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[15] If there is more than one sponsor, each sponsor must ensure that at least one of the sponsors (or at least one of their majority-owned affiliates or wholly owned affiliates, as applicable) retains an economic interest in the credit risk of the securitized assets that satisfies the requirements of the Final Rule.

[16] Unlike the Re-Proposed Rule, which required fair value calculations for both vertical and horizontal risk retention options, the Final Rule requires fair value calculations only for eligible horizontal residual interests.

[17] The Joint Release notes that the types of permissible investments are restricted to cash and cash equivalents to ensure that the account will not incur investment losses and reduce the capacity of the account to absorb losses of the securitization transaction. The Agencies interpret "cash equivalents" to mean high-quality, highly liquid short-term investments, the maturity of which corresponds to the securitization's expected maturity or potential need for funds and that are denominated in the currency that corresponds to either the securitized assets or the ABS interests.

- pay critical expenses unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses, if such expenses, in the absence of available funds, would be paid prior to any payments to holders of ABS interests, and if such payments are made to parties that are not affiliated with the sponsor.

Vertical Risk Retention. Under the Final Rule, a sponsor may satisfy the 5 percent risk retention requirement by retaining an **eligible vertical interest**, defined as either (i) an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same proportion of each such class, or (ii) a single vertical security. **Single vertical security** is defined as an ABS interest entitling the sponsor to a specified percentage of the amounts paid on each class of ABS interests in the issuing entity (other than such single vertical security).

Combination Risk Retention. A sponsor may satisfy the risk retention requirement by retaining any combination of eligible vertical interests and eligible horizontal residual interests, so long as the percentage of the fair value of the eligible horizontal residual interest and the percentage of the eligible vertical interest combined equal at least 5 percent.

Disclosures. Under the Final Rule, a sponsor must provide certain information to potential investors a reasonable period of time prior to the sale of the ABS and, upon request, to the SEC and its appropriate federal banking agency,[18] if any, until three years after all ABS interests are no longer outstanding.

For an eligible horizontal residual interest, a sponsor must disclose:

- a reasonable period of time prior to the sale of ABS interests issued in the same offering of ABS interests:
  - the fair value[19] of the eligible horizontal residual interest that the sponsor expects to retain (or the amount to be placed in the eligible horizontal cash reserve account) at the closing of the securitization transaction. If the specific prices, sizes or rates of interest of each tranche of the securitization are not available, the sponsor must disclose a range of fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest of each tranche of the securitization;[20]
  - a description of the material terms of the eligible horizontal residual interest (or the eligible horizontal cash reserve account) to be retained by the sponsor;
  - a description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests;
  - all the key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests and the fair value of the eligible horizontal residual interest to be retained by the sponsor, including quantitative information about discount rates, loss given default (recovery), prepayment rates, default rates, lag time between default and recovery, and the basis of forward interest rates used, as applicable;[21]
  - a summary description of the reference data set or other historical information used to develop these key inputs and assumptions, including loss given default and default rates; and

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[18] The Final Rule defines the **appropriate Federal banking agencies** as the OCC, Federal Reserve Board and FDIC.

[19] The fair value is expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and the dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable).

[20] A sponsor disclosing a range of fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest of each tranche of the securitization also must disclose the method by which it determined any range of prices, tranche sizes or rates of interest.

[21] The disclosure rules require, at a minimum, descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculation.

- a reasonable period of time after the closing of the securitization transaction:
  - the fair value of the eligible horizontal residual interest that the sponsor retained at the closing of the securitization transaction, based on actual sale prices and finalized tranche sizes;
  - the fair value of the eligible horizontal residual interest that the sponsor is required to retain (or to fund through the eligible horizontal cash reserve account); and
  - the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.

For an eligible vertical interest, a sponsor must disclose:

- a reasonable period of time prior to the sale of ABS interests issued in the same offering of ABS interests:
  - the form of the eligible vertical interest;
  - the percentage that the sponsor is required to retain as a vertical interest; and
  - a description of the material terms of the vertical interest and the amount that the sponsor expects to retain at the closing of the securitization transaction; and
- a reasonable period of time after the closing of the securitization transaction, the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount disclosed prior to the transaction.

Allocation of Risk Retention to an Originator

The Final Rule permits a sponsor that chooses to retain risk under the standard risk retention option to offset the amount of its risk retention requirement by the amount of the eligible interests acquired by an originator of one or more of the securitized assets. To qualify for this offset of risk to an originator, the following conditions must be met at the closing of the securitization transaction:

- the originator acquires the eligible interest from the sponsor and retains the interest in the same manner and proportion (as between horizontal and vertical interests) as the sponsor under the standard risk retention option, as such interest was held prior to the acquisition by the originator;
- the ratio of the percentage of eligible interests acquired and retained by the originator to the percentage of eligible interests otherwise required to be retained by the sponsor under the standard risk retention option does not exceed (i) the unpaid principal balance of all the securitized assets originated by the originator, to (ii) the unpaid principal balance of all the securitized assets in the securitization transaction;
- the originator acquires and retains at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor under the standard risk retention option; and
- the originator purchases the eligible interests from the sponsor at a price that is equal, on a dollar-for-dollar basis, to the amount by which the sponsor's required risk retention is reduced, by payment to the sponsor either in cash or as a reduction in the price received by the originator from the sponsor or depositor for the assets sold by the originator to the sponsor or depositor[22] for inclusion in the pool of securitized assets.

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[22] The Final Rule defines a **depositor** as (i) the person that receives or purchases and transfers or sells the securitized assets to the issuing entity, (ii) the sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity, or (iii) the person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

Hedging, Transfer and Pledging. The originator and each of its affiliates must comply with the hedging prohibitions discussed below as if it were the retaining sponsor.

Sponsor's Duty to Comply. The sponsor is responsible for compliance with the risk retention requirements and must maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by each originator. In the event the sponsor determines that any originator no longer complies with any of these requirements, the sponsor must promptly notify the holders of the ABS interests of such noncompliance.

Disclosures. In addition to the disclosures required under the standard risk retention option, the sponsor must provide to potential investors a reasonable period of time prior to the sale of the ABS interests and, upon request, to the SEC and its appropriate federal banking agency, if any, the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction (including a description of the form, amount and nature of the interest), as well as the method of payment for such interest.

HEDGING, TRANSFER AND FINANCING PROHIBITIONS[23]

Prohibited Transfers and Pledges. Under the Final Rule, a retaining sponsor[24] may not sell or otherwise transfer any interest or assets that the sponsor is required to retain pursuant to the Final Rule, except to an entity that is and remains the sponsor's majority-owned affiliate, until the applicable sunset date as set forth below. Each such majority-owned affiliate is subject to the same prohibitions. In addition, neither a retaining sponsor nor any of its affiliates may pledge any ABS interest that the sponsor is required to retain as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) unless the obligation is with full recourse to the sponsor or such affiliate, as applicable.

Prohibited Hedging. Under the Final Rule, a retaining sponsor is prohibited from hedging the credit risk that the sponsor is required to retain until the applicable sunset date as set forth below. A retaining sponsor, its affiliates and the issuing entity may not purchase or sell a security or other financial instrument, or enter into an agreement, derivative or other position, if (i) payments on the security or other financial instrument are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain or one or more of the securitized assets that collateralize the ABS, and (ii) the security, instrument, agreement, derivative or position in any way reduces or limits the financial exposure of the sponsor to the credit risk. This is a two-part test which requires that a position be both "materially related" to the credit risk and actually reduce that risk.

In the Joint Release, the Agencies explain that the sponsor is required to retain meaningful credit exposure to the securitized assets and may not use indirect methods to reduce its financial exposure to the credit risk that it is required to retain. The Agencies interpret the hedging restrictions of the Final Rule to prohibit a retaining sponsor from engaging in, directing or controlling transactions to add credit enhancement to the securitized assets, except to the extent that such instruments are designed to benefit all investors. The Agencies take the position that the hedging prohibition limits the ability of a retaining sponsor to benefit from asset-level or pool-level insurance covering 100 percent of the credit risk of the securitized assets, unless the sponsor's right to receive insurance proceeds is subordinated to the payment in full of all investors. Similarly, under the Agencies' interpretation of the Final Rule, a

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[23] The general prohibitions on hedging, transfers and financing are modified in their application to sponsors of revolving pool securitizations and third-party purchasers of commercial mortgage-backed securities. These general prohibitions do not apply to a sponsor relying on the risk retention option for government-sponsored enterprises.

[24] A **retaining sponsor** is defined as a sponsor that has retained or caused to be retained an economic interest in the credit risk of the securitized assets.

retaining sponsor may not benefit from bond insurance or from a pool insurance policy that references amounts payable to a specific class of ABS interests unless, at the time of distribution, all other ABS interests have been paid all amounts then due to them.

Permitted Hedging. A retaining sponsor is not prohibited from acquiring hedge positions that are not "materially related" to the particular interests or assets that the sponsor is required to retain, such as hedge positions related to overall market movements. Under the Final Rule, the following activities constitute permitted hedging:

- hedging the interest rate risk (which does not include the spread interest rate risk associated with the ABS interest that is otherwise considered a part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests required to be retained by the sponsor (or any of its majority-owned affiliates) or one or more of the particular securitized assets that underlie the ABS; and
- purchasing or selling a security or other financial instrument or entering into an agreement, derivative or other position where payments thereon or thereunder are based, directly or indirectly, on an index of instruments that includes ABS if:
  - any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index; and
  - all classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor (or any of its majority-owned affiliates) is required to retain an interest and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index.

Transfer and Hedging Exception for Conservator or Receiver. A conservator or receiver of the sponsor (or any other person holding risk retention pursuant to the Final Rule) may sell or hedge any economic interest in a securitization transaction if the conservator or receiver has been appointed pursuant to any provision of federal or state law (or regulation promulgated thereunder) that provides for the appointment of the FDIC, or an agency or instrumentality of the United States or of a state, as conservator or receiver.

Sunset on Hedging and Transfer Prohibitions

The Final Rule adopts as proposed the Re-Proposed Rule's limits on the period for which the transfer and hedging prohibitions apply. The Agencies have enacted two sets of sunset provisions on the transfer and hedging prohibitions: one for residential mortgage-backed securities (RMBS) and one for other types of ABS.

RMBS. If all of the assets that collateralize a securitization transaction are residential mortgages, the prohibitions on sale and hedging by the sponsor and its affiliates (other than the prohibitions relating to hedging by the issuing entity) expire no later than seven years after the date of the closing of the securitization transaction, but may expire earlier on the date that is the later of (i) the date that is five years after the closing date, and (ii) the date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25 percent of the total unpaid principal balance of such residential mortgages on the closing date.

Other ABS. For non-RMBS securitizations, the prohibitions on the sale and hedging by the sponsor and its affiliates (other than the prohibitions relating to hedging by the issuing entity) expire on or after the date that is the latest of (i) the date on which the total unpaid principal balance of the securitized assets

(if applicable) that collateralize the securitization transaction has been reduced to 33 percent of the total unpaid principal balance of the securitized assets as of the cutoff date of the securitization transaction, (ii) the date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction have been reduced to 33 percent of the total unpaid principal obligations of the ABS interests on the closing date, and (iii) two years after the closing date.

RISK RETENTION OPTIONS FOR SPECIFIC SECURITIZATION STRUCTURES

Revolving Pool Securitizations

The Final Rule provides a specific risk retention option for securitizations collateralized by assets held in a revolving pool securitization, such as typical credit card securitizations.[25] Revolving pool securitizations were termed "revolving master trusts" under the Re-Proposed Rule. The change in terminology under the Final Rule reflects an expanded definition: The term revolving pool securitization includes securitization structures with issuing entities not organized in the form of a master trust. The Final Rule on revolving pool securitizations includes a number of other technical refinements over the Re-Proposed Rule, as described below.

Under the Final Rule, the sponsor of a revolving pool securitization may satisfy its risk retention requirement by maintaining a seller's interest representing at least 5 percent of the aggregate unpaid principal balance of all outstanding ABS interests held by investors in the issuing entity.[26] The Final Rule uses the principal balance of the securitized assets rather than the fair value of outstanding ABS interests for this test. The 5 percent test must be satisfied at the closing of each issuance by the revolving pool securitization and at every seller's interest measurement date specified under the securitization transaction documents (not less than monthly), until no ABS interest in the issuing entity is held by any person who is not a wholly owned affiliate of the sponsor.[27] The Final Rule provides for a cure period if the revolving pool securitization fails to meet the 5 percent test as of a seller's interest measurement date. The 5 percent test must be met within the earlier of one month after the seller's interest measurement date or the cure period specified in the securitization transaction documents, if any.

The seller's interest may be combined with either a standard eligible horizontal residual interest or a residual ABS interest in excess interest and fees applicable only to revolving pool securitizations that meets certain conditions described below.

Seller's Interest. A **seller's interest** is an ABS interest:

- collateralized by the securitized assets[28] and servicing assets owned or held by the issuing entity, other than:
  - servicing assets that have been allocated as collateral only for a specific series in connection with administering the revolving pool securitization (such as a principal accumulation or interest reserve account); and

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[25] A **revolving pool securitization** is defined as an issuing entity established to issue on multiple issuance dates more than one series, class, subclass or tranche of ABS interests that are collateralized by a common pool of securitized assets that will change in composition over time, and that does not monetize excess interest and fees from its securitized assets.

[26] The seller's interest can be held by the sponsor or by one or more wholly owned affiliates of the sponsor, including one or more depositors of assets into the revolving pool securitizations. The Final Rule excludes from the calculation of outstanding investor ABS interests those ABS interests that are held for the life of such interests by the sponsor or its wholly owned affiliates.

[27] The Re-Proposed Rule required the sponsor of a revolving pool securitization to "retain" a seller's interest of at least 5 percent. The Final Rule clarifies that sponsors are required to "maintain" a seller's interest of at least 5 percent.

[28] **Servicing assets** are rights or other assets designed to assure the timely distribution of proceeds to ABS interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

- assets that are not eligible under the terms of the securitization transaction to be included when determining whether the revolving pool securitization holds aggregate securitized assets in specified proportions to aggregate outstanding investor ABS interests issued;

- that is *pari passu* with, or partially or fully subordinate in identical or varying amounts to, each series of outstanding investor ABS interests issued with respect to the allocation of all distributions and losses prior to early amortization;[29] and

- that adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

Significantly, under the Re-Proposed Rule, sponsors were not permitted to subordinate the seller's interest in varying amounts to one or more series of investor ABS interests prior to early amortization. This requirement was inconsistent with the allocation methodology of most revolving pool securitizations, which allocate principal disproportionately in favor of investor ABS interests during any amortization period instead of only following early amortization. The Joint Release notes that the additional flexibility provided under the Final Rule is intended to accommodate current market practice.

Legacy Trusts. If one revolving pool securitization issues a collateral certificate representing a beneficial interest in all or a portion of the securitized assets held by that securitization to another revolving pool securitization, the sponsor may satisfy the risk retention requirement by retaining the seller's interest for the assets represented by the collateral certificate through either of the revolving pool securitizations, so long as both are retained at the direction of the same sponsor. If the sponsor retains the seller's interest associated with the collateral certificate at the level of the revolving pool securitization that issues that certificate, the proportion of the seller's interest that must be retained at that level must equal the proportion that the principal balance of the securitized assets represented by the collateral certificate bears to the principal balance of the securitized assets in the revolving pool securitization that issues the ABS interests.

Offset for Pool-Level Excess Funding Account. The 5 percent seller's interest required on each measurement date may be reduced on a dollar-for-dollar basis by the balance of an excess funding account as of such date. The excess funding account must be a segregated account that:

- is funded in the event of a failure to meet the minimum seller's interest requirements or other requirement to maintain a minimum balance of securitized assets under the securitization transaction documents by distributions otherwise payable to the holder of the seller's interest;

- is invested only in the types of assets in which funds held in an eligible horizontal cash reserve account are permitted to be invested (*i.e.*, cash and cash equivalents); and

- in the event of an early amortization, makes payments of amounts held in the account to holders of investor ABS interests in the same manner as payments to holders of investor ABS interests of amounts received on securitized assets.

Combined Retention With Horizontal Interest. The seller's interest risk retention requirement may be reduced to a percentage lower than 5 percent to the extent that, for all series of investor ABS interests issued by the revolving pool securitization after the Effective Date of the Final Rule, the sponsor (or a wholly owned affiliate of the sponsor) retains a corresponding percentage of the fair value of ABS interests issued in each series held in the form of (i) an eligible horizontal residual interest meeting the standard risk retention requirements, or (ii) a residual ABS interest in excess interest and fees meeting the following requirements:

- each series distinguishes between the series' share of the interest and fee cash flows and the series' share of the principal repayment cash flows from the securitized assets;

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[29] The Joint Release notes that the seller's interest may include elements of conditional subordination, but the seller's interest may not be senior to any investor ABS interests with respect to the allocation of distributions.

- the residual ABS interest's claim to any of the series' share of the interest and fee cash flows for any interest payment period is subordinated to all accrued and payable interest due on the payment date to more senior ABS interests in the series for that period, and further reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving pool securitization (whether incurred in that period or carried over from prior periods), to the extent that such payments would have been included in amounts payable to more senior interests in the series; and
- the revolving pool securitization continues to revolve.

The residual ABS interest in excess interest and fees may be certificated or uncertificated and held in a single or multiple classes, subclasses or tranches, so long as it meets, individually or in the aggregate, the requirements described above.

Early Amortization of All Outstanding Series. If the sponsor's seller's interest falls below the required amount after the revolving pool securitization commences early amortization of all series of outstanding investor ABS interests pursuant to the terms of the securitization transaction documents, such a decline does not violate the Final Rule's risk retention requirements, provided that each of the following four requirements is met:

- the sponsor was in full compliance with the risk retention requirements on all measurement dates before the commencement of early amortization;
- the terms of the seller's interest continue to make it *pari passu* with or subordinate in identical or varying amounts to each series of outstanding investor ABS interests with respect to the allocation of distributions and losses;
- the terms of any horizontal interest the sponsor is relying upon to offset the minimum seller's interest amount continue to require the interests to absorb losses; and
- the revolving pool securitization issues no additional ABS interests after early amortization is initiated to any person not a wholly owned affiliate of the sponsor, either at the time of issuance or during the amortization period.

Disclosures. Under the Final Rule, a sponsor relying on the seller's interest option to satisfy the risk retention requirements must provide the following disclosures to potential investors, in written form, under the caption "Credit Risk Retention":

- a reasonable period of time prior to the sale of an ABS, a description of the material terms of the seller's interest, and the percentage of the seller's interest that the sponsor expects to retain at closing, measured either as a percentage of the aggregate unpaid principal balance of all outstanding investor ABS interests issued, or as a percentage of the aggregate unpaid principal balance of outstanding investor ABS interests for one or more series issued, as required by the terms of the securitization transaction;
- a reasonable period of time after closing of the securitization transaction, the amount of seller's interest the sponsor retained at closing, if that amount is materially different from the amount disclosed prior to sale;
- a description of the material terms of any horizontal residual interests offsetting the seller's interest; and
- disclosure of the fair value of any such horizontal residual interests retained by the sponsor for the series being offered, as a percentage of the fair value of the outstanding investor ABS interests issued in the same manner and within the same time frame required for disclosure of the fair values of eligible horizontal residual interests pursuant to the standard risk retention option.

Under the Final Rule, sponsors are permitted to use data about the securitized assets prepared as of a specified cutoff date to determine the closing-date percentage of a seller's interest. The cutoff

date generally may not exceed 60 days prior to the date of first use with investors. (Revolving pool securitizations that make distributions to investors quarterly or less frequently may use a cutoff date 135 days prior to first use with investors.)

Asset-Backed Commercial Paper Conduits

The Final Rule contains a specific risk retention option for eligible ABCP structures. Under the Final Rule, an ABCP conduit sponsor satisfies the risk retention requirement where the ABCP is issued by an eligible ABCP conduit and, for each ABS interest the ABCP conduit acquires from an intermediate special purpose vehicle (SPV), the intermediate SPV's originator-seller retains an economic interest in the credit risk of the assets collateralizing the ABS interests.[30] The risk retained by the originator-seller must be in the same amount and manner as the sponsor would be required to retain under the standard risk retention option or the revolving pool securitization risk retention option, if applicable.[31] Sponsors of ABCP conduits are permitted to elect between the risk retention requirements specifically tailored to ABCP conduits described here and the risk retention requirements that apply to sponsors of securitizations, more generally described under "Risk Retention Requirements."

Eligible ABCP Conduit. An eligible ABCP conduit must meet the following conditions:

- the ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV;
- the ABCP conduit must acquire the ABS interests that collateralize the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV (i) directly from the intermediate SPV, (ii) from an underwriter of the ABS interests issued by the intermediate SPV, or (iii) from another person who acquired the ABS interests directly from the intermediate SPV;
- the ABS interests acquired by the eligible ABCP conduit must be:
- ABS interests collateralized solely by assets originated by an originator-seller and by servicing assets;
    - special units of beneficial interest (or similar ABS interests) in a trust or an SPV that retains legal title to leased property underlying leases originated by an originator-seller that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases and by servicing assets;
    - interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller and by servicing assets; or
    - ABS interests that are collateralized, in whole or in part, by assets acquired by an originator-seller in a business combination that qualifies for business combination accounting in accordance with GAAP, and if collateralized in part, the remainder of such assets are assets described above in this definition; and
- the ABCP conduit is collateralized solely by ABS interests that meet the criteria described above and by servicing assets; and

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[30] **Originator-seller** means an entity that originates assets and sells or transfers those assets directly, or through a majority-owned affiliate, to an intermediate SPV, and includes any affiliate of the originator-seller that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, an originator-seller.

[31] Additionally, to satisfy the ABCP risk retention option requirements, the ABCP conduit sponsor must approve each originator-seller and intermediate SPV; establish criteria governing the ABS interests and the securitized assets underlying the ABS interests; administer and monitor the ABCP conduit; and maintain and adhere to policies and procedures to ensure compliance with ABCP risk retention option requirements.

- a regulated liquidity provider[32] must have entered into a legally binding commitment to provide 100 percent liquidity coverage[33] to all the ABCP issued by the ABCP conduit if funds are required to repay any maturing ABCP.

ABCP Maturity. The ABCP must have a maturity at the time of issuance of no more than 397 days (exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited). This maximum permitted maturity is consistent with how ABCP has customarily been structured as ABCP is a form of short-term borrowing that typically has a term of less than three months without extending past 397 days (the maximum length of time U.S. money market funds may hold ABCP).

Intermediate SPV. To qualify as an intermediate SPV, an SPV must:

- be a direct or indirect wholly owned affiliate of the originator-seller, or have nominal equity owned by a trust or corporate service provider that specializes in providing independent ownership of SPVs, and such trust or corporate service provider is not affiliated with any other transaction parties;
- be bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit, and from each originator-seller and each majority-owned affiliate in each case that, directly or indirectly, sells or transfers assets to such intermediate SPV;
- acquire assets from the originator-seller that are originated by the originator-seller or acquired by the originator-seller in the acquisition of a business that qualifies for business combination accounting in accordance with GAAP or acquires ABS interests issued by another intermediate SPV of the originator-seller that are collateralized solely by such assets; and
- issue ABS interests collateralized solely by such assets, as applicable.

The Joint Release notes that an intermediate SPV may sell ABS interests that it issues to parties other than ABCP conduits.[34]

Sponsor's Duty to Comply. The ABCP conduit sponsor is responsible for compliance with the requirements of the ABCP risk retention option and must maintain policies designed to monitor compliance by each originator-seller which is satisfying a risk retention obligation with respect to ABS interests acquired by an eligible ABCP conduit. The ABCP conduit sponsor must promptly notify the holders of the ABCP and upon request (although the Final Rule does not specify whose request), the SEC and its appropriate federal banking agency, if any, of the identity of any originator-seller that fails to retain the minimum required risk, hedges (directly or indirectly through an intermediate SPV) its risk retention or otherwise violates the risk retention obligation, and certain other information regarding the originator-seller, including the amount of ABS interests issued by an intermediate SPV of such originator-seller and held by the ABCP conduit, and the remedial action to be taken by the ABCP conduit sponsor. The remedial action taken by the ABCP conduit sponsor may include removing from the ABCP conduit the ABS interests issued by the intermediate SPV of the originator-seller that fails to satisfy the risk retention obligation. It is uncertain how ABCP conduit sponsors will effectively implement these policies and procedures, including in particular the monitoring of compliance by originator-sellers.

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[32] **Regulated liquidity provider** means (i) a depository institution (as defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813)), (ii) a bank holding company (as defined in 12 U.S.C. § 1841), or a subsidiary thereof, (iii) a savings and loan holding company (as defined in 12 U.S.C. § 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. § 1843(k), or a subsidiary thereof, or (iv) a foreign bank whose home country supervisor (as defined in Section 211.21 of the Federal Reserve Board's Regulation K (12 C.F.R. § 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

[33] The liquidity provider is obligated to pay an amount equal to any shortfall. The total amount that may be due is 100 percent of the amount of the ABCP outstanding at any time plus accrued and unpaid interest. Amounts due pursuant to the required liquidity coverage are not permitted to be subject to credit performance of the ABS interests held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit. Liquidity support that only funds performing loans or receivables or performing ABS interests does not satisfy the liquidity coverage requirement.

[34] However, the Agencies emphasize that, except as otherwise provided for loans or receivables acquired as part of certain business combinations, the ABS interests acquired by the conduit cannot be collateralized by securitized assets otherwise purchased or acquired by the intermediate SPV from unaffiliated originators or sellers.

Originator-Seller Compliance With Risk Retention. The use of the ABCP risk retention option by an ABCP conduit sponsor does not relieve the originator-seller that sponsors ABS interests acquired by an eligible ABCP conduit from such originator-seller's independent obligation to comply with its own risk retention obligations. The Joint Release notes that the originator-seller will be the sponsor of the ABS interests issued by an intermediate SPV and will therefore be required under the Final Rule to hold an economic interest in the credit risk of the assets collateralizing the ABS interests issued by the intermediate SPV.

Sale or Transfer of ABS Interests Between Eligible ABCP Conduits. At any time, an eligible ABCP conduit that acquired an ABS interest in accordance with the ABCP risk retention option requirements may transfer, and another eligible ABCP conduit may acquire, such ABS interest, if (i) the sponsors of both eligible ABCP conduits are in compliance with the ABCP risk retention option requirements; and (ii) the same regulated liquidity provider has entered into one or more legally binding commitments to provide 100 percent liquidity coverage to all of the ABCP issued by both eligible ABCP conduits.

Disclosures. The ABCP conduit sponsor must provide certain information to each purchaser of ABCP, before or at the time of the first sale of ABCP to such purchaser. In addition, at least monthly thereafter, the ABCP conduit sponsor must provide certain information to each holder of ABCP. This information includes:

- the name and form of organization of the regulated liquidity provider (including a description of the material terms of such liquidity coverage, and notice of any failure to fund); and
- with respect to each ABS interest held by the ABCP conduit: (i) the asset class or brief description of the underlying securitized assets, (ii) the standard industrial category code for the originator-seller that will retain or has retained an interest in the securitization transaction, and (iii) a description of the percentage amount of risk retention pursuant to the Final Rule by the originator-seller, and whether it is in the form of an eligible horizontal residual interest, an eligible vertical interest or a revolving pool securitization seller's interest, as applicable.

The ABCP conduit sponsor is permitted to use in its disclosures data prepared not more than 60 days prior to the date of first use with investors. Upon request, an ABCP conduit sponsor also must provide this information to the SEC and its appropriate federal banking agency, if any, as well as the name and form of organization of each originator-seller that will retain or has retained an interest in the securitization transaction.

Commercial Mortgage-Backed Securities

The Final Rule provides a specific risk retention option for commercial mortgage loan securitizations. Under the CMBS option, a sponsor may satisfy some or all of its risk retention requirements if a third party purchases and holds for its own account an eligible horizontal residual interest in the issuing entity in the same form, amount and manner as the sponsor would be required to hold under the standard risk retention option. To comply with the CMBS option,[35] the following conditions must be met:

Number of Third-Party Purchasers. There may be no more than two third-party purchasers. If there are two third-party purchasers, each must be *pari passu* with the other's interest.

Composition of Collateral. The securitization transaction may be collateralized only by commercial real estate (CRE) loans and servicing assets.[36]

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[35] The Final Rule clarifies that, just as a sponsor may have the eligible horizontal residual interest held by its majority-owned affiliates, any majority-owned affiliate of the third-party purchaser is permitted to hold the eligible horizontal residual interest.

[36] Under the Re-Proposed Rule, a **commercial real estate loan** was defined as a loan secured by a property with five or more single-family units or by nonfarm nonresidential real property, where the primary source of repayment for the loan is expected to be either the proceeds of sale or other financing of the property or rental income associated with the property. The Final Rule amends the definition of a CRE loan to include a loan secured by improved land where the obligor owns the fee interest in the land but a lessor owns all the improvements on the land (and the improvements are nonresidential or residential with five or more single-family units).

Source of Funds. Each third-party purchaser must pay for the eligible horizontal residual interest in cash at the closing of the securitization transaction. No third-party purchaser may obtain financing, directly or indirectly, for the purchase of such interest from any other person that is a party to, or an affiliate of a party to, the securitization transaction (other than a special servicer[37] affiliated with the third-party purchaser or a person that is a party to the transaction solely as an investor).

Third-Party Review. Each third-party purchaser must conduct an independent review of the credit risk of each securitized asset prior to the sale of the ABS. This review must include a review of the underwriting standards, collateral and expected cash flows of each CRE loan that is collateral for the ABS.

Affiliation and Control Rights. No third-party purchaser may be affiliated with any party to the securitization transaction other than: (i) investors; (ii) the special servicer; and (iii) one or more originators of the securitized assets, provided that the assets originated by such originators collectively comprise less than 10 percent of the unpaid principal balance of the securitized assets at the cutoff date of the securitization transaction. There is no prohibition on third-party purchasers having control rights related to servicing.

Operating Advisor. An **Operating Advisor** must be appointed to act in the best interest of, and for the benefit of, investors as a collective whole. The Operating Advisor may not be affiliated with other parties to the securitization transaction and may not have, directly or indirectly, any financial interest in the securitization transaction (other than in fees from its role as Operating Advisor).

The Operating Advisor is responsible for reviewing the actions of the special servicer. When the eligible horizontal residual interest has been reduced by principal payments, realized losses and appraisal reduction amounts (which amounts are determined in accordance with the securitization transaction documents) to a principal balance of 25 percent or less of its initial principal balance, the special servicer must consult with the Operating Advisor before making any material decision in connection with its servicing of the securitized assets. The Operating Advisor must issue periodic reports to investors (and any third-party purchasers) and the issuing entity concerning whether the Operating Advisor believes that the special servicer is operating in compliance with the standards required of the special servicer in the securitization transaction documents.

If the Operating Advisor determines, in its sole discretion exercised in good faith, that the special servicer has failed to comply with a standard required of the special servicer in the applicable securitization transaction documents and that a replacement of the special servicer would be in the best interest of the investors as a collective whole, the Operating Advisor may recommend that the special servicer be replaced. The special servicer will be replaced upon such a recommendation and the affirmative vote of a majority of the outstanding principal balance of all ABS interests voting on the matter.[38]

Hedging, Transfer and Pledging. For the first five years after the closing of a CMBS transaction, each third-party purchaser and its affiliates must comply with the hedging, transfer and other prohibitions of the Final Rule as if it were the retaining sponsor and had acquired the eligible horizontal residual interest pursuant to the standard risk retention option. However, on or after the date that is five years after the date of the closing of the CMBS transaction, an initial third-party purchaser or a sponsor that acquired an eligible horizontal residual interest at the closing of the securitization transaction may transfer that interest to a subsequent third-party purchaser. A subsequent third-party purchaser may transfer its interest to a different third-party purchaser at any time. At the time of transfer, the acquiring

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[37] **Special servicer** is defined to mean, with respect to any securitization of CRE loans, any servicer that, upon the occurrence of one or more specified conditions in the servicing agreement, has the right to service one or more assets in the transaction.

[38] The Final Rule requires the securitization transaction documents to specify the percentage of the outstanding principal balance of ABS interests that shall constitute a quorum for the purposes of a vote to replace the special servicer. The securitization transaction documents may not specify a quorum of more than 20 percent of the outstanding principal balance of ABS interests, and the quorum must include at least three ABS interest holders that are not affiliated with each other.

third-party purchaser must satisfy the same criteria as an initial third-party purchaser was required to satisfy at the time the securitization transaction closed (including conducting an independent review of the credit risk of each securitized asset).

The Final Rule provides an additional exception to the generally applicable hedging, transfer and financing prohibitions for third-party purchasers and their majority-owned affiliates. The hedging and other prohibitions will not apply on or after the date that each loan that serves as collateral for outstanding ABS interests has been defeased. A loan is deemed to be defeased when (i) cash or cash equivalents have been pledged to the issuing entity as collateral for the loan and are in such amounts necessary to timely generate cash sufficient to make all remaining debt service payments due on the loan, and (ii) the issuing entity has an obligation to release its lien on the loan.

Sponsor's Duty to Comply. The sponsor is responsible for compliance with the requirements of the CMBS option by itself and for compliance by each initial or subsequent third-party purchaser that acquired an eligible residual interest. If the sponsor determines that a third-party purchaser no longer complies with any of these requirements, the sponsor must promptly notify the holders of the ABS interests issued in the securitization transaction of such noncompliance.

Disclosures. The sponsor is required to provide the following information to potential investors and, upon request, to the SEC and its appropriate federal banking agency, in written form under the caption "Credit Risk Retention":

- the name and form of organization of each initial third-party purchaser;
- a description of each initial third-party purchaser's experience in investing in CMBS and any other information regarding each initial third-party purchaser that is material to investors;
- the purchase price paid by each initial third-party purchaser;
- a description of the material terms of the eligible horizontal residual interest retained by each initial third-party purchaser;
- a description of the fair value of the eligible horizontal residual interest that will be retained (or was retained) by each initial third-party purchaser, and the fair value of the eligible horizontal residual interest in the securitization transaction that the sponsor would have retained pursuant to the standard risk retention option if the sponsor had relied on that option and retained an eligible horizontal residual interest;
- the material terms of the securitization transaction documents relating to the Operating Advisor (including the name and form of organization of the Operating Advisor, the terms of the Operating Advisor's compensation and the standards required of the Operating Advisor with respect to its experience, expertise and financial strength, as well as a description of how the Operating Advisor satisfies each of the standards);
- a description of any material conflict of interest or material potential conflict of interest between the Operating Advisor and any party to the transaction;
- the representations and warranties concerning the securitized assets, a schedule of any securitized assets that do not comply with such representations and warranties, and what factors were used to make the determination that such securitized assets should nevertheless be included in the pool; and
- any other information regarding each initial third-party purchaser or each initial third-party purchaser's retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular securitization transaction.

Government-Sponsored Enterprises

Under the Final Rule, the guarantee provided by Fannie Mae or Freddie Mac (each an Enterprise) as a sponsor satisfies the risk retention requirements, provided the Enterprise is operating under the conservatorship or receivership of the FHFA with capital support from the U.S. government. Similarly, an equivalent guarantee provided by a limited-life regulated entity that succeeds to the charter of an Enterprise also satisfies the risk retention requirements, if the entity operates under the authority and oversight of the FHFA with capital support from the U.S. government. An Enterprise or a successor would be required to choose a different retention option if it began to operate other than as described in the Final Rule. The hedging provisions described above in "Hedging, Transfer and Financing Prohibitions" do not apply to (i) a sponsor relying on the Enterprise risk retention option, (ii) an affiliate of such a sponsor, or (iii) the issuing entity in a securitization transaction where the sponsor relies on this risk retention option. A sponsor relying on this risk retention option must disclose to investors and, upon request, to the FHFA and the SEC, a description of the manner in which it has satisfied the risk retention requirements.

Open Market Collateralized Loan Obligations

As noted above, the Joint Release explains the Agencies' reasoning for treating CLO managers as falling within the statutory definition of "securitizer" set forth in Section 15G despite not legally owning, possessing or controlling the loans that are securitized and for extending the risk retention requirements to open market CLOs even though they do not fall within the originate-to-distribute model for securitization transactions. In the Joint Release, the Agencies explain that CLO managers of open market CLOs fall with the definition of "securitizers" pursuant to subpart (a)(3)(B) of Section 15G, which begins the definition of "securitizer" by describing a securitizer as a "person who organizes and initiates an asset-backed securities transaction."[39] The Agencies reason that CLO managers "organize and initiate" CLOs, because a CLO manager "typically negotiates the primary deal terms of the transaction and the primary rights of the issuing entity and uniformly directs the CLO to acquire the commercial loans that comprise the collateral pool."[40] The Agencies went on to explain that CLO managers meet the condition that an organizer and initiator "sells or transfers assets either directly or indirectly, including through an affiliate" by having authority to select the loans, direct the purchase of the loans and manage the loans such that the loans would not have been acquired by the CLO without their efforts. The Agencies conclude that legal ownership of the loans by the CLO manager or any of its affiliates is not required in the view of the Agencies. From a policy perspective, the Agencies note that, contrary to commenters' suggestions, CLOs pose many of the same incentive alignment and systemic risk concerns that the risk retention requirements imposed by Section 15G were intended to address. In particular, the Agencies note that the rapid growth of the CLO market has paralleled growth in leveraged loans, which it described as the primary assets purchased by most CLOs. The Agencies describe the leveraged loan market as subject to "widespread loosening of underwriting standards" representing similar dynamics to the originate-to-distribute model that were a major factor in the financial crisis that Section 15 was meant to address.

The application of the risk retention requirements to open market CLO managers is expected to adversely impact open market CLOs, as open market CLO managers typically do not retain 5 percent of the credit risk associated with the ABS interests issued by an open market CLO. Most open market CLO managers have been described by commenters on the Original Proposal and the Re-Proposed

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[39] The Final Rule defines a **CLO** as "a special purpose entity that (i) issues debt and equity interests and (ii) whose assets consist primarily of loans that are securitized assets and servicing assets" and defines a **CLO manager** as "an entity that manages a CLO, which entity is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. § 80b-1 et seq.), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser."

[40] The Agencies note that CLOs meet the definition of "asset-backed security" set forth in Section 3 of the Exchange Act, as amended.

Rule as lacking sufficient capital to fund the purchase of the minimum required retained interests. Financing or other sources of capital may not be available to the open market CLO managers on terms that are favorable enough to continue acting as CLO managers. Consequently, a significant portion of open market CLO managers may exit the market for open market CLOs, reducing the number of open market CLOs that are closed and reducing competition in the market for open market CLOs, which in turn could reduce financing or make financing more expensive in the leveraged loan market and negatively impact the businesses and industries that depend on leveraged loan financing. Commenters on the Re-Proposed Rule asserted that even those open market CLO managers capable of funding or financing the minimum required retained interest may find the terms imposed on their retention of the minimum required interest and the other terms and conditions imposed by the Final Rule to be too onerous to continue participating in open market CLOs. While the institutions that originate the loan portfolios transferred to a balance sheet CLO are more likely to retain 5 percent of the credit risk associated with the ABS interests issued by the balance sheet CLO, and in their separate capacities as the CLO managers (if applicable) of the balance sheet CLO may have greater ability to fund and finance the acquisition and maintenance of the 5 percent interests, the manner in which the risk retention requirements apply to them may make alternative forms of financing more attractive.

The application of the risk retention requirements to CLO managers is further complicated by the fact that it does not address what happens if the CLO manager resigns or is removed and replaced with or without cause pursuant to the applicable collateral management agreement. To the extent that the substitute CLO manager is required to meet the risk retention requirements, this would impede replacing the outgoing CLO manager in a timely manner, as the universe of substitute CLO managers that can fund or otherwise finance the acquisition of the retained interest is expected to be limited. One alternative to address this issue may be to condition the resignation or removal and replacement of a CLO manager — except in the case of bankruptcy or insolvency proceedings — on the retention by the substitute CLO manager or its majority-owned affiliate of the minimum required retained interest (which could include the assignment of the outgoing CLO manager's retained interest on market terms).

In addition to the foregoing, the parties to CLOs that close prior to the Effective Date may be affected by the risk retention requirements following the Effective Date in certain situations, such as the issuance of additional notes or the refinancing or re-pricing of existing classes of notes following the Effective Date (which would appear to be subject to the risk retention requirements as written to the same extent as the notes issued in a CLO transaction that closed on or after the Effective Date). It is uncertain how the risk retention requirement applicable to a CLO manager in respect of the issuance of additional notes or the refinancing or repricing of existing classes of notes would be met where the issuance of the additional notes or the refinancing or repricing of existing classes of notes is at the direction of one or more of the existing classes of notes without requiring the consent of the CLO manager.

As noted in the Executive Summary, the elimination of the so-called "cash throttle" provides at least some relief to the CLO market as the limitations imposed by the cash throttle on the payment of cash flow to the most subordinated interest in a CLO would have been inconsistent with the manner in which the most subordinated ABS interest in a CLO is customarily structured (as investors in the most subordinated ABS interest in a CLO expect to be paid the excess interest generated by the CLO on a current basis).

The Final Rule maintains the alternative risk retention option available exclusively to sponsors of CLOs that qualify as an "open market CLO" as defined in the Final Rule, subject to certain technical modifications to the conditions and definitions. Under this alternative risk retention option, the open market CLO manager will not be required to meet the standard risk retention requirement in its capacity as the sponsor of the open market CLO if the applicable lead arranger retains at least 5 percent of the face amount of each of the loans purchased by the CLO. For a CLO manager in its capacity as the sponsor to rely on this alternative, the following conditions must be met:

- the open market CLO does not acquire or hold any assets other than CLO-eligible loan tranches that meet the requirements of this alternative and servicing assets;
- the governing documents of the open market CLO require that, at all times, the assets of the open market CLO consist of senior, secured syndicated loans that are CLO-eligible loan tranches and servicing assets;
- the open market CLO does not invest in ABS interests or in credit derivatives other than hedging transactions that are servicing assets to hedge risks of the open market CLO;
- all purchases of CLO-eligible loan tranches and other assets by the open market CLO issuing entity or through a warehouse facility used to accumulate the loans prior to the issuance of its ABS interests are made in open market transactions on an arms-length basis; and
- the CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the CLO issues its ABS interests.

CLO-Eligible Loan Tranche. Under the Final Rule, to qualify as a CLO-eligible loan tranche, it must be a term loan of a syndicated credit facility to a commercial borrower that has the following features:[41]

- a minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the lead arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default or bankruptcy default of such CLO-eligible loan tranche, provided that such lead arranger complies with limitations on hedging, transfer and pledging described in "Hedging, Transfer and Financing Prohibitions" above with respect to the interest retained by the lead arranger;
- lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of the securitization transaction documents, including but not limited to adverse changes to the calculation or payments of amounts due to the holders of the CLO-eligible tranche, alterations to *pro rata* provisions, changes to voting provisions, and waivers of conditions precedent; and
- the pro rata provisions, voting provisions and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranches are not materially less advantageous to the holder(s) of such CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

Lead Arranger. Under the Final Rule, a lead arranger means, with respect to a CLO-eligible loan tranche, an institution that:

- is active in the origination, structuring and syndication of commercial loan transactions and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche;[42]
- has taken an allocation of the funded portion of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20 percent of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group that funded at origination has taken a greater allocation; and

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[41] The Final Rule defines a **commercial borrower** as an obligor under a corporate credit obligation (including a loan).

[42] The Final Rule defines **commercial loan transaction** as a secured or unsecured loan to a company or an individual for business purposes, other than any (i) loan to purchase or refinance a one- to four-family residential property, or (ii) commercial real estate loan (as such term is defined in the Final Rule).

- is identified in the applicable agreement governing the CLO-eligible loan tranche; represents therein to the holders of the CLO-eligible loan tranche and to any holders of participation interests in such CLO-eligible loan tranche that such lead arranger satisfies the requirements of the first clause of this definition and, at the time of initial funding of the CLO-eligible tranche, will satisfy the requirements of the second clause of this definition; further represents therein (solely for the purpose of assisting such holders to determine the eligibility of such CLO-eligible loan tranche to be held by an open market CLO) that in the reasonable judgment of such lead arranger, the terms of such CLO-eligible loan tranche are consistent with the requirements of the second and third clauses of the definition of "CLO-eligible loan tranche" set forth above; and covenants therein to such holders that such lead arranger will fulfill the requirements of the first clause of the definition of "CLO-eligible loan tranche" set forth above.

Open Market CLO. Under the Final Rule, an open market CLO means a CLO (i) whose assets consist of senior, secured syndicated loans acquired directly from the sellers thereof in open market transactions and of servicing assets, (ii) that is managed by a CLO manager, and (iii) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO manager or originated by originators that are affiliates of the CLO or the CLO manager.

Open Market Transaction. Under the Final Rule, an open market transaction means:

- either an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller;[43] or
- a reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

Senior, Secured Syndicated Loan. Under the Final Rule, a senior, secured syndicated loan means a loan made to a commercial borrower that:

- is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower;
- is secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan; and
- ensures that the value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO manager exercised at the time of investment) to repay the loan and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO manager certifies, on or prior to each date that it acquires a loan constituting part of a new CLO-eligible tranche, that it has policies and procedures to evaluate the likelihood of repayment of loans acquired by the CLO, and it has followed such policies and procedures in evaluating each CLO-eligible loan tranche.

Disclosures. A sponsor relying on this alternative risk retention option must provide to potential investors a reasonable period of time prior to the sale of the ABS interests and at least annually with respect to the information described in clause (1) below and, upon request, to the SEC and its appropriate federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

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[43] The Final Rule defines **initial loan syndication transaction** as a transaction in which a loan is syndicated to a group of lenders and a **secondary market transaction** as the purchase of a senior, secured syndicated loan not in connection with an initial loan syndication transaction but in the secondary market.

(1) a complete list of every asset held by the open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing), including the following information:

- the full legal name, Standard Industrial Classification (SIC) category code, and legal entity identifier (LEI) issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (if an LEI has been obtained by the obligor) of the obligor of the loan or asset;
- the full name of the specific loan tranche held by the CLO;
- the face amount of the entire loan tranche held by the CLO and the face amount of the portion thereof held by the CLO;
- the price at which the loan tranche was acquired by the CLO; and
- for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions; and

(2) the full legal name and form of organization of the CLO manager.

The disclosure requirements set forth above are broader in some respects than under the Re-Proposed Rule. In addition, the certifications required to be made by the lead arranger and the CLO manager set forth above are different in some respects than under the Re-Proposed Rule.

This alternative risk retention option may be of limited use to the market for open market CLOs because it is contrary to current market practices for open market CLOs by requiring lead arrangers to meet the conditions set forth above in originating and syndicating the loans in addition to requiring the lead arrangers to retain 5 percent of the face amount of the CLO-eligible loan tranche in the manner described above. Commenters on the Re-Proposed Rule noted that requiring lead arrangers to hold a portion of a loan would increase the costs associated with arranging the loan, which would be passed on to borrowers. Restricting the manner in which lead arrangers hedged or otherwise limited their credit risk associated with individual loans was perceived as increasing credit risk to lead arrangers. This could make CLOs a less attractive means of financing the origination of loans by the lead arrangers and by their borrower customers than other alternative forms of financing. As a result, few loans originated in the loan market would be expected to meet the definition of "CLO-eligible loan tranche." Consequently, sponsors of open market CLOs that remain in the market are anticipated to utilize the standard risk retention option that applies to sponsors of securitization transactions generally.

Qualified Tender Option Bonds

The Final Rule provides additional risk retention options for sponsors of qualified tender option bond (TOB) programs. Under the Final Rule, a TOB is defined as a security that entitles the holders to tender their bonds to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase price equal to the approximate amortized cost of the security, plus accrued interest, if any.[44]

The sponsor of a TOB program may satisfy its risk retention requirements through retention of any combination of the following interests and securities, as long as the sum of the percentages equals at least five:

- an eligible vertical interest or eligible horizontal residual interest or any combination thereof, pursuant to the standard risk retention option;

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[44] Under the Final Rule, the definition of a qualified tender option bond is amended to remove the requirement that the TOB have the necessary features to qualify for purchase by money market funds under the Investment Company Act of 1940, as amended.

- an interest that upon issuance meets the requirements of an "eligible horizontal residual interest" but that upon the occurrence of a "tender option termination event" (as defined in Section 4.01(5) of IRS Revenue Procedure 2008-80)[45] will meet the requirements of an "eligible vertical interest;" or
- municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

In order to avail itself of the additional risk retention options for TOB programs, a sponsor must use an issuing entity that meets the following conditions of a **qualified tender option bond entity:**

- the issuing entity is collateralized solely by servicing assets and by municipal securities[46] that have the same municipal issuer and the same underlying obligor or source of payment (determined without regard to any third-party credit enhancement), and such municipal securities are not subject to substitution;
- the issuing entity issues no securities other than (i) a single class of TOBs with a preferred variable return payable out of capital, and (ii) one or more residual equity interests that, in the aggregate, are entitled to the remaining income of the issuing entity. These types of securities must constitute ABS;
- the underlying municipal securities held as assets by the issuing entity are issued in compliance with Section 103 of the Internal Revenue Code of 1986, as amended (the Internal Revenue Code), such that the interest payments made on those securities are excludable from the gross income of the owners;
- the terms of all of the securities issued by the issuing entity are structured so that all holders of such securities who are eligible to exclude interest received on such securities will be able to exclude that interest from gross income pursuant to Section 103 of the Internal Revenue Code or as "exempt-interest dividends" pursuant to Section 852(b)(5) of the Internal Revenue Code in the case of regulated investment companies under the Investment Company Act of 1940, as amended;
- the issuing entity has a legally binding commitment from a regulated liquidity provider to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding TOBs; and
- the issuing entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003-84, as amended.

Hedging, Transfer and Pledging. The prohibitions on transfers and hedging described in "Hedging, Transfer and Financing Restrictions" above apply to any municipal securities retained by the sponsor of a TOB program that satisfies its risk retention obligations by holding municipal securities as set forth above.

Disclosures. A sponsor relying on one of the alternative risk retention options for TOB programs to satisfy the risk retention requirements must provide the following disclosures to potential investors and, upon request, to the SEC and its appropriate federal banking agency, if any, in written form under the caption "Credit Risk Retention":

- the name and form of organization of the qualified tender option bond entity;
- a description of the form and subordination features of the sponsor's retained interest;

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[45] Section 4.01(5) of IRS Revenue Procedure 2008-80 defines a tender option termination event as (i) a bankruptcy filing by or against a tax-exempt bond issuer, (ii) a downgrade in the credit rating of a tax-exempt bond and a downgrade in the credit rating of any guarantor of the tax-exempt bond, if applicable, to a rating below investment grade, (iii) a payment default on a tax-exempt bond, or (iv) a final judicial determination or a final IRS administrative determination of taxability of a tax-exempt bond for federal income tax purposes.

[46] The term **municipal security** or **municipal securities** has the same meaning as municipal securities in Section 3(a)(29) of the Exchange Act and any rules promulgated pursuant to such section.

- to the extent any portion of the retained interest is an eligible horizontal residual interest, the fair value of that interest;
- to the extent that any portion of the retained interest is an eligible vertical interest, the percentage of ABS interests issued represented by the eligible vertical interest; and
- to the extent that any portion of the retained interest claimed by the sponsor is a municipal security held outside of the qualified tender option bond entity, the identity of the issuer of the municipal securities, the face value of the municipal securities deposited in the qualified tender option bond entity, and the face value of the municipal securities retained by the sponsor.

GENERAL EXEMPTIONS

Pursuant to Section 15G(c)(1)(G) and Section 15G(e) of the Exchange Act, the Agencies must provide a complete or partial exemption from the risk retention requirements for certain types of ABS or securitization transactions.

Exemption for Certain Resecuritization Transactions

The Final Rule adopts as proposed the Re-Proposed Rule's provisions for an exemption from the risk retention requirements for ABS interests issued in certain resecuritization transactions (resecuritization ABS) that meet the requirements for a "pass-through resecuritization" or a "first-pay-class securitization." A pass-through resecuritization must meet three conditions:

- the resecuritization transaction is collateralized solely by ABS issued in a securitization transaction for which credit risk was retained as required under the risk retention requirements, or which was otherwise exempted from the risk retention requirements (compliant ABS), and by servicing assets;
- the resecuritization transaction is structured so that it involves the issuance of only a single class of ABS interests; and
- the resecuritization transaction provides for a pass-through of all principal and interest payments received on the underlying ABS interests (net of expenses of the issuing entity) to the holders of the resecuritization ABS interests.

The Final Rule also contains an exemption from the risk retention requirements for first-pay class securitizations of residential mortgage-backed securities. To qualify for the exemption, a first-pay-class securitization[47] must meet the following conditions:

- the transaction is collateralized solely by first-pay classes of ABS interests which are compliant ABS interests collateralized by first-lien residential mortgages on properties located in any state;
- all ABS interests issued in the securitization transaction share pro rata in any realized principal losses based on the current unpaid principal balance of the ABS interests issued in the securitization transaction at the time the loss is realized;
- the transaction is structured to reallocate pre-payment risk and does not reallocate credit risk (other than credit risk reallocated only as a collateral consequence of reallocating pre-payment risk); and
- the resecuritization transaction does not include any inverse floater[48] or any similarly structured class of ABS interests.

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[47] A **first-pay class** is defined as a class of ABS interests for which all interests in the class are entitled to the same priority of payment and that, at the time of the closing of the transaction, is entitled to repayments of principal and payments of interest prior to or *pro rata* with all other classes of securities collateralized by the same pool of first-lien residential mortgages until such class has no principal or notional balance remaining.

[48] An **inverse floater** is defined as an ABS interest issued as part of a securitization transaction for which interest or other income is payable to the holder based on a rate or formula that varies inversely to a reference rate of interest.

Federally Insured or Guaranteed Residential, Multifamily and Health Care Mortgage Loan Assets

The Final Rule adopts as proposed the Re-Proposed Rule's total exemption from the risk retention requirements for any securitization transaction that:

- is collateralized solely by residential, multifamily or health care facility mortgage loan assets that are insured or guaranteed in whole or in part as to the payment of principal and interest by the U.S. or an agency thereof and by servicing assets; or
- involves the issuance of ABS interests that are (i) insured or guaranteed as to the payment of principal and interest by the U.S. or an agency thereof, and (ii) collateralized solely by one of the categories of assets listed in the bullet above.

The Agencies declined commenters' requests to expand the exemption for assets issued, guaranteed or insured by foreign government entities or to securitization transactions of multifamily loans by the Enterprises.

Securitizations of Assets Issued, Insured or Guaranteed by the U.S. or Any Agency of the U.S. and Other Exemptions

The Final Rule adopts as proposed the Re-Proposed Rule's total exemption from the risk retention requirements for any securitization transaction if the ABS interests issued are:

- Either (i) collateralized solely by obligations issued by the U.S. or an agency thereof and by servicing assets, (ii) collateralized solely by assets that are fully insured or guaranteed as to the payment of principal and interest by the U.S. or an agency thereof (other than the residential, multifamily or health care facility mortgage loan securitizations discussed in "Federally Insured or Guaranteed Residential, Multifamily and Health Care Mortgage Loan Assets" above) and by servicing assets, or (iii) fully guaranteed as to the timely payment of principal and interest by the U.S. or any agency thereof;
- collateralized solely by loans or other assets 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 and by servicing assets;
- issued or guaranteed by any state of the U.S., by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act by reason of Section 3(a)(2) of the Securities Act; or
- securities that meet the definition of a "qualified scholarship funding bond" in Section 150(d)(2) of the Internal Revenue Code.[49]

Like the Re-Proposed Rule, the Final Rule specifically excludes from the exemptions described in this section securitization transactions involving the issuance of ABS interests that are issued, insured or guaranteed by, or collateralized by obligations issued by, or loans that are issued, insured or guaranteed by Fannie Mae, Freddie Mac or a federal home loan bank.

Federal Family Education Loan Program and Other Student Loan Securitizations

The Final Rule adopts as proposed the Re-Proposed Rule's following exemptions from the risk retention requirements for Federal Family Education Loan Program (FFELP) loans:

- a full exemption for any securitization transaction collateralized solely by FFELP loans that are guaranteed as to 100 percent of defaulted principal and accrued interest and by servicing assets;

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[49] *See* 26 U.S.C. § 150(d)(2).

- a reduced risk retention requirement of 2 percent for any securitization transaction collateralized solely by FFELP loans that are guaranteed as to at least 98 percent of defaulted principal and accrued interest and by servicing assets;[50] and
- a reduced risk retention requirement of 3 percent for any securitization transaction collateralized solely by FFELP loans that are guaranteed as to at least 97 percent of defaulted principal and accrued interest and by servicing assets.

The Agencies declined to expand this exemption to cover student loans other than FFELP student loans.

Other Exemptions From the Risk Retention Requirements

Utility Legislative Securitizations. The Final Rule adopts as proposed the Re-Proposed Rule's exemption for securitization transactions where the ABS interests are issued by an entity that is wholly owned, directly or indirectly, by an investor-owned utility company that is subject to the regulatory authority of a state public utility commission or other appropriate state agency, subject to a requirement that the ABS interests are secured by the intangible property right to collect charges for certain specified costs and other assets of the entity.

Seasoned Loans. The Final Rule adopts as proposed the Re-Proposed Rule's exemption for securitization transactions that are collateralized solely by servicing assets and seasoned loans that have not been modified since origination and have never been delinquent for 30 days or more in addition to other conditions set forth in the definition of "seasoned loans" in Section 19(b)(7) of the Final Rule. For residential mortgage loans, a **seasoned loan** is a loan that (i) has been outstanding and performing for the longer of five years or the period until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance, or (ii) has been outstanding and performing for at least seven years. For all other asset classes, a **seasoned loan** is a loan that has been outstanding and performing for the longer of (i) two years, or (ii) the period until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance. The Agencies declined commenters' requests to expand the definition of "seasoned loans" to allow for modified residential mortgage loans, loans that have had delinquencies up to 60 days, or loans that have had delinquencies 30 days or longer but have been current for a specified period of time.

Other Requested Exemptions. In response to the Re-Proposed Rule, commenters urged the Agencies to create exemptions for legacy loan securitizations (for securitizations and resecuritizations of loans made before the Effective Date), corporate debt repackagings and servicer advance receivables. The Agencies declined to include specific exemptions for these transactions in the Final Rule. The Agencies noted that service advance facilities may be able to avail themselves of the option for revolving pool securitizations.[51]

Safe Harbor for Foreign Securitization Transactions

The Final Rule contains an exemption from the risk retention requirements for ABS interests issued in certain securitization transactions by foreign entities that is substantially similar to that in the Re-Proposed Rule. The exemption is available if:

- the securitization transaction is not required to be and is not registered under the Securities Act;

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[50] These include FFELP loans with first disbursement between October 1993 and June 2006.

[51] *See* "Risk Retention Options for Specific Securitization Structures — Revolving Pool Securitizations" herein.

- no more than 10 percent of the dollar value by proceeds (or equivalent amount in the currency in which the ABS interests are issued, as applicable) of all classes of ABS interests sold in the securitization transaction are sold or transferred to U.S. persons[52] or for the account or benefit of U.S. persons;
- neither the sponsor of the securitization transaction nor the issuing entity is a U.S.-located entity; and
- if the sponsor or issuing entity is chartered, incorporated or organized under the laws of a jurisdiction other than the United States or any state, no more than 25 percent (based on the unpaid principal balance) of the assets collateralizing the ABS interest sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from (i) a majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the United States or any state, or (ii) an unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any state.

The safe harbor is not available for any foreign securitization transaction that meets the technical conditions of the safe harbor but is part of a plan or scheme to evade the risk retention requirements.

Federal Deposit Insurance Corporation Securitizations

The Final Rule adopts as proposed the Re-Proposed Rule's exemption from risk retention for securitization transactions that are sponsored by the FDIC acting as conservator or receiver under any provision of the Federal Deposit Insurance Act or of Title II of the Dodd-Frank Act.

EXEMPTIONS FROM THE RISK RETENTION REQUIREMENTS FOR QUALIFYING COMMERCIAL LOANS, COMMERCIAL REAL ESTATE LOANS AND AUTOMOBILE LOANS

The Final Rule includes exemptions from the risk retention requirements for securitizations of qualifying commercial loans, qualifying commercial real estate (QCRE) loans and qualifying automobile loans which are substantially similar to the exemptions proposed in the Re-Proposed Rule. To qualify for these exemptions, the following conditions must be satisfied:

- the assets must meet the underwriting standards described below;
- the depositor must make the certification described in "Internal Controls and Cure or Buyback Requirement" below;
- the securitization transaction must be collateralized solely by loans of the same asset class and by servicing assets;
- the securitization transaction must not permit reinvestment periods; and
- the sponsor must provide the disclosure described below.

As discussed in further detail in "Blended Pools of Qualifying and Non-Qualifying Loans" below, securitization transactions collateralized by blended pools of qualifying and non-qualifying loans can qualify for a reduction of up to half of the 5 percent risk retention requirement.

The sponsor must disclose to potential investors a reasonable period of time prior to the sale of ABS interests and, upon request, to the SEC and to its appropriate federal banking agency, if any, a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying commercial loans, QCRE loans or qualifying automobile loans with 0 percent risk retention.

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[52] For the purposes of this safe harbor provision, the definition of a **U.S. person** is substantially similar to the definition for "U.S. person" under Regulation S of the Securities Act.

The exemption from the risk retention requirements for securitizations of qualifying commercial loans, QCRE loans and qualifying automobile loans may be of limited use to securitization market participants as they impose conditions on loans that do not reflect current market terms. Therefore, there may not be sufficient pools of loans satisfying the conditions to apply the exemptions to securitizations going forward.

Qualifying Commercial Loans

Underwriting Standards. Under the Final Rule, a **commercial loan** is a secured or unsecured loan to a company or an individual for business purposes, other than any (i) loan to purchase or refinance a one- to four-family residential property, or (ii) commercial real estate loan (as defined below in "Qualifying Commercial Real Estate Loans"). For a commercial loan to constitute a qualifying commercial loan under the Final Rule, the following underwriting criteria must be satisfied:

- prior to origination of the commercial loan, the originator must:
  - verify and document the financial condition of the borrower (i) as of the end of the borrower's two most recently completed fiscal years, and (ii) during the period, if any, since the end of its most recently completed fiscal year;
  - conduct an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections;
  - determine that, based on the previous two years' actual performance, the borrower has (i) a total liabilities ratio of 50 percent or less, (ii) a leverage ratio of 3.0 or less, and (iii) a debt service coverage (DSC) ratio of 1.5 or greater; and
  - determine that, based on the two years of projections, which include the new debt obligation, following the closing date of the loan, the borrower will have (i) a total liabilities ratio of 50 percent or less, (ii) a leverage ratio of 3.0 or less, and (iii) a DSC ratio of 1.5 or greater;
- prior to, upon or promptly following the inception of the loan, the originator must obtain (i) if the loan is originated on a secured basis, a perfected security interest (by filing, title notation or otherwise) or, in the case of real property, a recorded lien, on all of the property pledged to collateralize the loan, and (ii) if the loan documents indicate the purpose of the loan is to finance the purchase of tangible or intangible property, or to refinance such a loan, a first lien on the property;
- the loan documentation for the commercial loan must include covenants that:
  - require the borrower to provide the borrower's financial statements and supporting schedules to the servicer of the commercial loan on an ongoing basis (but not less frequently than quarterly);
  - prohibit the borrower from retaining or entering into a debt arrangement that permits payments-in-kind;
  - impose limits on the creation or existence of any other security interest or lien on the property that serves as collateral for the loan and on the transfer of any of the borrower's assets that serve as collateral for the loan; and
  - require the borrower and any other party that pledges collateral for the loan to take any action required to perfect or protect the security interest or first lien on the collateral and to maintain the collateral (including by paying taxes and other charges and by maintaining insurance that protects against loss on the collateral at least up to the amount of the commercial loan) and permit the originator or any subsequent holder of the loan, and the servicer of the loan, to inspect any collateral for the commercial loan and the books and records of the borrower;

- loan payments required under the loan agreement must be (i) based on level monthly payments of principal and interest (at the fully indexed rate) that fully amortize the debt over a term that does not exceed five years from the date of origination, and (ii) required to be made no less frequently than quarterly over a term that does not exceed five years;
- the primary source of repayment for the loan must be revenue from the business operations of the borrower;
- the loan must have been funded within the six months prior to the cutoff date of the securitization transaction; and
- at the cutoff date of the securitization transaction, all payments due on the loan must be contractually current.

The Agencies declined commenters' requests to adopt a capitalization ratio instead of an earnings-based leverage ratio, to allow for loans funded post-closing or to permit a reinvestment period.

Qualifying Commercial Real Estate Loans

Underwriting Standards. Under the Final Rule, a **commercial real estate loan** is a loan (1) secured by a property with five or more single-family units, or by nonfarm nonresidential real property, the primary source (50 percent or more) of repayment for which is expected to be (i) the proceeds of the sale, refinancing or permanent financing of the property, or (ii) rental income associated with the property; or (2) secured by improved land if the obligor owns the fee interest in the land and the land is leased to a third party who owns all improvements on the land, and the improvements are nonresidential or residential with five or more single-family units.[53] For a CRE loan to constitute a QCRE loan under the Final Rule, the following underwriting criteria must be satisfied:

- the CRE loan must be secured by:
  - an enforceable first lien on the commercial real estate and improvements;
  - an assignment of leases, rents, other occupancy agreements, franchise agreements, license agreements and concession agreements related to the commercial real estate or improvements or the operation thereof for which the borrower or an operating affiliate is a lessor, licensor, concession granter or similar party and all payments due to the borrower or due to any operating affiliate in connection with the operation of the property, and the right to enforce such agreements upon a breach by the borrower of any of the terms of, or the occurrence of any other event of default under, the applicable loan documents; and
  - a security interest (which must be perfected if it can be perfected by the filing of a financing statement, fixture filing or similar document) in all interests of the borrower and any applicable operating affiliate in all tangible and intangible personal property in or used in the operation of or in connection with any of the collateral;
- prior to origination of the CRE loan, the originator must:
  - verify and document the current financial condition of the borrower and each operating affiliate;

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[53] The Final Rule amends the definition of a commercial real estate loan to include a loan secured by improved land where the obligor owns the fee interest in the land but a lessor owns all the improvements on the land (and the improvements are nonresidential or residential with five or more single-family units). The definition excludes land development and construction loans (including one- to four-family residential or commercial construction loans), any other land loans and unsecured loans to a developer.

- obtain a written appraisal of the real property securing the loan that provides an "as is" opinion of the market value of the real property, which includes an income approach;[54]
- qualify the borrower for the CRE loan based on a monthly payment amount derived from level monthly payments consisting of both principal and interest (at the fully indexed rate) over the term of the loan, not exceeding 25 years, or 30 years for a qualifying multifamily property loan;[55]
- conduct an environmental risk assessment of the property securing the loan and take appropriate steps to mitigate any environmental liability determined to exist based on this assessment;
- conduct an analysis of the borrower's ability to service its overall debt obligations during the next two years, based on reasonable projections (including operating income projections for the property);
- determine that, based on the two years' actual performance immediately preceding the origination of the loan, the borrower would have had (i) a DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan,[56] net of any income derived from a tenant(s) who is not a qualified tenant(s),[57] (ii) a DSC ratio of 1.25 or greater, if the loan is a qualifying multifamily property loan, or (iii) a DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan, provided that if the borrower did not own the property for any part of the last two years prior to origination, the calculation of the DSC ratio shall include the property's operating income for any portion of the two-year period during which the borrower did not own the property;[58] and
- determine that, based on two years of projections, which include the new debt obligation, following the origination date of the loan, the borrower will have (i) a DSC ratio of 1.5 or greater, if the loan is a qualifying leased CRE loan, net of any income derived from a tenant(s) who is not a qualified tenant(s), (ii) a DSC ratio of 1.25 or greater, if the loan is a qualifying multifamily property loan, or (iii) a DSC ratio of 1.7 or greater, if the loan is any other type of CRE loan;

- the loan documentation for the CRE loan must include covenants that:
  - require the borrower to provide the borrower's financial statements and supporting schedules to the servicer on an ongoing basis (but not less frequently than quarterly), including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate;
  - impose prohibitions on the creation or existence of any other security interest with respect to the collateral for the CRE loan (except for purchase money security interests and junior liens as described below); and

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[54] The Final Rule allows for an appraisal which includes an income approach, which is broader than the Re-Proposed Rule that required the appraisal to use an income valuation approach using a discounted cash flow analysis. The appraisal must have an effective date of not more than six months prior to the origination date of the loan by a competent and appropriately state-certified or state-licensed appraiser and conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board and the appraisal requirements of the federal banking agencies.

[55] **Qualifying multifamily loan** means a CRE loan secured by any residential property (other than a hotel, motel, inn, hospital, nursing home or other similar facility where dwellings are not leased to residents) (i) that consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use, and (ii) where at least 75 percent of the net operating income is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs and dry cleaning), and not from other commercial uses.

[56] **Qualifying leased CRE loan** means a CRE loan secured by commercial nonfarm real property, other than a multifamily property or a hotel, inn or similar property (i) that is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one month, and (ii) where no more than 20 percent of the aggregate gross revenue of the property is payable from one or more tenants who (a) are subject to a lease that will terminate within six months following the date of origination, or (b) are not qualified tenants.

[57] **Qualified tenant** means (i) a tenant with a lease who has satisfied all obligations with respect to the property in a timely manner, or (ii) a tenant who originally had a lease that subsequently expired and currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to the date of origination, and has satisfied all obligations with respect to the property in a timely manner.

[58] Because newly formed SPVs are often used to acquire property, the Final Rule permits originators to use two years of historical data from the property, when the property has two years of operating history.

- require each borrower and each operating affiliate to take any action required to protect or perfect (to the extent that any security interest is required to be perfected) the security interest on the collateral and to maintain the collateral (including by (i) paying taxes and other charges, (ii) maintaining insurance that protects against loss on the collateral for an amount not less than the replacement cost of the property improvements,[59] (iii) complying with all environmental, zoning, building code, licensing and other laws and regulations applicable to the collateral, (iv) complying with leases, franchise agreements, condominium declarations and other documents and agreements relating to the operation of the collateral, and not modifying any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan, or the servicer, and (v) permitting the originator or any subsequent holder of the loan, and the servicer, to inspect any collateral for the CRE loan and the books and records of the borrower or any other party relating to any collateral for the CRE loan); and

- the loan documentation for the CRE loan must prohibit the borrower and each operating affiliate from obtaining a loan secured by a junior lien on the collateral, unless (i) the sum of the principal amount of such junior lien loan, plus the principal amount of all other loans secured by the collateral, does not exceed the applicable CLTV ratio,[60] based on the appraisal at origination of such junior lien loan, or (ii) such loan is a purchase money obligation that financed the acquisition of machinery or equipment and the borrower or operating affiliate (as applicable) pledges such machinery and equipment as additional collateral for the CRE loan;

- at origination, the applicable loan-to-value ratios for the loan must be (i) LTV[61] ratio less than or equal to 65 percent and CLTV ratio less than or equal to 70 percent, or (ii) LTV ratio less than or equal to 60 percent and CLTV ratio less than or equal to 65 percent, if the appraiser used a capitalization rate in the appraisal[62] and that rate is less than or equal to the sum of (a) the 10-year swap rate[63] as of the effective date of the appraisal, and (b) 300 basis points;

- all loan payments required to be made under the loan agreement must be (i) based on level monthly payments of principal and interest (at the fully indexed rate) to fully amortize the debt over a maximum term of 25 years, or 30 years for a qualifying multifamily loan, and (ii) required to be made no less frequently than monthly over a term of at least 10 years.

- under the terms of the loan agreement, (i) any maturity of the loan must occur no earlier than 10 years following the date of origination, (ii) the borrower must not be permitted to defer repayment of principal or payment of interest, and (iii) the interest rate on the loan must be (a) a fixed interest rate, (b) an adjustable interest rate and the borrower, prior to or at the time the CRE loan is originated, must obtain a derivative that results in a fixed interest rate, or (c) an adjustable rate, and the borrower, prior to or at the time the CRE loan is originated, obtains a derivative that establishes a cap on the interest rate for the term of the loan, and the loan meets the underwriting requirements using the maximum interest rate allowable under the interest rate cap;[64]

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[59] In the Re-Proposed Rule, insurance was required in an amount at least up to the amount of the CRE loan. The Agencies amended this provision in the Final Rule to require insurance in an amount not less than the replacement cost of the property improvements in keeping with customary market practice.

[60] **Combined loan-to-value (CLTV) ratio** means, at the time of origination, the sum of the principal balance of a first-lien mortgage loan on the property, plus the principal balance of any junior-lien mortgage loan that, to the creditor's knowledge, would exist at the closing of the transaction and that is secured by the same property, divided by (i) for acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on the required appraisal, or (ii) for refinancing, the estimated market value of the real property based on the required appraisal.

[61] **Loan-to-value (LTV) ratio** means, at the time of origination, the principal balance of a first-lien mortgage loan on the property divided by (i) for acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on the required appraisal, or (ii) for refinancing, the estimated market value of the real property based on the required appraisal.

[62] If the appraisal included a direct capitalization method using an overall capitalization rate, that rate must be disclosed to potential investors.

[63] As reported in the Federal Reserve Board's H.15 Report (or any successor report).

[64] The Final Rule expands the allowable derivatives to include interest rate caps provided the loan is underwritten using the maximum rate allowable under the cap. The Re-Proposed Rule only allowed for derivatives that fixed the interest rate.

- the originator must not establish an interest reserve at origination to fund all or part of a payment on the loan;
- at the closing of the securitization transaction, all payments due on the loan must be contractually current; and
- within two weeks of the closing of the CRE loan (or, if sooner, prior to the transfer of such CRE loan to the issuing entity), the originator must have obtained a Uniform Commercial Code lien search from the jurisdiction of organization of the borrower and each operating affiliate that does not report, as of the time that the security interest of the originator in the property was perfected, other higher priority liens of record (other than purchase money security interests).

The Agencies declined commenters' requests to allow for QCRE loans with less than a 10-year minimum maturity.

Qualifying Automobile Loans

Underwriting Standards. Under the Final Rule, an **automobile loan** is any loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck or similar light truck for personal, family or household use. The term does not include any (i) loan to finance fleet sales, (ii) personal cash loan secured by a previously purchased automobile, (iii) loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family or household purposes, (iv) lease financing, (v) loan to finance the purchase of a vehicle with a salvage title, or (vi) loan to finance the purchase of a vehicle intended to be used for scrap or parts. For an automobile loan to constitute a qualifying automobile loan under the Final Rule, the following underwriting criteria must be satisfied:

- prior to origination of the automobile loan, the originator must:
  - verify and document that within 30 days of the date of origination, (i) the borrower was not currently 30 days or more past due, in whole or in part, on any debt obligation; (ii) within the previous 24 months, the borrower has not been 60 days or more past due, in whole or in part, on any debt obligation; (iii) within the previous 36 months, the borrower has not (a) been a debtor in a proceeding commenced under Chapter 7 (Liquidation), Chapter 11 (Reorganization), Chapter 12 (Family Farmer or Family Fisherman plan), or Chapter 13 (Individual Debt Adjustment) of the U.S. Bankruptcy Code, or (b) been the subject of any federal or state judicial judgment for the collection of any unpaid debt; (iv) within the previous 36 months, no one- to four-family property owned by the borrower has been the subject of any foreclosure, deed in lieu of foreclosure or short sale; and (v) within the previous 36 months, the borrower has not had any personal property repossessed. An originator will be deemed to have met the foregoing verification requirements if, no more than 30 days before the closing of the loan, the originator obtains a credit report regarding the borrower that shows that the borrower meets all of these requirements (and no information in a credit report subsequently obtained by the originator before the closing of the loan contains contrary information);
  - determine and document that the borrower has at least 24 months of credit history; and
  - determine and document that, upon the origination of the loan, the borrower's debt to income (DTI) ratio is less than or equal to 36 percent. For the purpose of making this determination, the originator must (i) verify and document all income of the borrower that the originator includes in the borrower's effective monthly income (using payroll stubs, tax returns, profit and loss statements, or other similar documentation), and (ii) on or after the date of the borrower's written application and prior to origination, obtain a credit report regarding the borrower and verify that all outstanding debts reported in the borrower's credit report are incorporated into the calculation of the borrower's DTI ratio;

- at closing of the automobile loan, the borrower must make a down payment from the borrower's personal funds and trade-in allowance, if any, that is at least equal to the sum of: (i) the full cost of the vehicle title, tax and registration fees, (ii) any dealer-imposed fees, (iii) the full cost of any additional warranties, insurance or other products purchased in connection with the purchase of the vehicle, and (iv) 10 percent of the vehicle purchase price;
- the originator must record a first lien securing the loan on the purchased vehicle in accordance with state law;
- the terms of the loan agreement must provide a maturity date for the loan that does not exceed the lesser of (i) six years from the date of origination, or (ii) 10 years minus the difference between the current model year and the vehicle's model year;
- the terms of the loan agreement must (i) specify a fixed rate of interest for the life of the loan, (ii) provide for a level monthly payment amount that fully amortizes the amount financed over the loan term, (iii) not permit the borrower to defer repayment of principal or payment of interest, and (iv) require the borrower to make the first payment on the automobile loan within 45 days of the loan's contract date; and
- at the cutoff date of the securitization transaction, all payments due on the loan must be contractually current.

The Agencies declined commenters' requests to include motorcycle loans, fleet loans and automobile leases, to allow reliance on credit scores such as FICO, to use payment-to-income ratios rather than debt-to-income ratios in the underwriting criteria, to eliminate the down payment requirement or to otherwise relax the required underwriting criteria for the exemption. The Agencies did, however, amend the Final Rule to require evaluations of the loans' status as of the cutoff date rather than the closing date of the securitization.

Blended Pools of Qualifying and Non-Qualifying Loans

The Final Rule adopts as proposed the Re-Proposed Rule's provisions to allow for a reduction in the risk retention requirement for securitizers of "blended pools" of collateral comprised of qualified and nonqualified commercial loans, CRE loans and automobile loans, provided that all loans in the blended pool are from the same asset class (*i.e.*, a mixed pool of commercial and automobile loans would not qualify). The standard 5 percent risk retention requirement may be reduced by the ratio, measured as of the cutoff date, of the combined unpaid principal balance of qualified loans to the total unpaid principal balance of the loans in the pool, provided that regardless of the composition of the pool, the minimum required risk retention for blended pools is 2.5 percent.

Internal Controls and Cure or Buyback Requirement

For a qualifying commercial loan, qualifying commercial real estate loan or qualifying automobile loan to be eligible for a total or partial exemption from the risk retention requirements, the depositor of the ABS interests must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all of the qualified loans meet all of the underwriting standards described above and has concluded that its internal supervisory controls are effective. Such evaluation must occur within 60 days of the cutoff date or similar date for establishing the composition of the asset pool collateralizing the ABS interests. The sponsor must provide a copy of such certification to potential investors a reasonable period of time prior to the sale of the ABS interests, and upon request, to its appropriate federal banking agency, if any.

If a sponsor has relied on the exemption provided for qualifying commercial loans, qualifying commercial real estate loans or qualifying automobile loans and it is subsequently determined that a

loan did not then meet all of the underwriting requirements, the sponsor will not lose the benefit of such exemption with respect to the loan if the depositor complied with the certification requirement discussed in the preceding paragraph and:

- the failure of the loan to meet any of the applicable requirements is not material; or
- no later than 90 days after the determination that the loan does not meet one or more of the applicable requirements, the sponsor (i) effectuates cure and establishes conformity of the loan to the unmet requirements as of the date of the cure, or (ii) repurchases the loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) as of the date of repurchase.

If the sponsor cures or repurchases the loan, the sponsor must promptly notify the holders of the ABS interests of any loan included in the securitization transaction that is required to be cured or repurchased, including the principal amount of such loan and the cause for cure or repurchase.

QUALIFIED RESIDENTIAL MORTGAGES AND RELATED EXEMPTIONS

The Final Rule exempts a sponsor from the risk retention requirements with respect to any securitization transaction if (i) all of the assets that collateralize the ABS are qualified residential mortgages (QRMs) or servicing assets, (ii) none of the assets that collateralize the ABS interests are other ABS interests, and (iii) at closing, all of the QRMs are currently performing.[65] Additionally, to qualify for the QRM exemption, the depositor must certify that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the ABS are QRMs or servicing assets and has concluded that its internal supervisory controls are effective. This evaluation of internal supervisory controls must be performed within 60 days of the cutoff date or similar date for establishing the composition of the asset pool collateralizing the ABS, and the sponsor must provide a copy of the certification to potential investors a reasonable period of time prior to the sale of ABS in the issuing entity and, upon request, to the SEC and its appropriate federal banking agency, if any.

Definition of QRM

Under the Final Rule, a QRM is linked to the definition of "qualified mortgage" (QM) in Section 129C of the Truth in Lending Act and the regulations thereunder, as amended from time to time.[66] As a result, any change made by the Consumer Financial Protection Bureau to the definition of QM under the Truth in Lending Act will automatically modify the QRM definition unless the Agencies act to prevent such automatic modification.[67]

As described below, a QRM can be any loan that meets (i) the general criteria for a QM, (ii) the OM criteria established for loans insured, guaranteed or administered by HUD and by the Department of Veterans Affairs (VA), (iii) the special criteria under a temporary QM definition, or (iv) the QM criteria for small creditors. The definition includes any closed-end loan secured by any dwelling (*e.g.*, home purchase, refinances, home equity lines and second or vacation homes), and both first liens and subordinate liens. It does not include home-equity lines of credit, reverse mortgages, timeshares, temporary loans or "bridge" loans of 12 months or less and certain construction loans. It also does

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[65] Under the Final Rule, **currently performing** means the borrower in the mortgage transaction is not currently 30 days or more past due, in whole or in part, on the mortgage transaction.

[66] 15 U.S.C. § 1639c.

[67] When the Re-Proposed Rule was released, the Agencies invited comments on an alternative definition of QRM that was referred to as **QM-plus** and that would have been more restrictive than the definition that was eventually adopted in the Final Rule. The Agencies declined to adopt the QM-plus approach because of concerns that it would overly constrain mortgage credit and might have a disproportionate impact on low- and moderate-income, minority or first-time homebuyers.

not include loans that are exempt from the ability-to-repay requirements, such as loans made through state housing finance agency programs and certain community lending programs. However, the Final Rule includes a separate exemption from the risk requirements for community-focused residential mortgages.[68]

General QM Definition. The general definition of a QM requires that the loan meet the following criteria:

- regular periodic payments that are substantially equal (other than changes resulting from interest rate adjustments of an adjustable-rate or a step-rate mortgage);
- no negative amortization, interest only or balloon features;
- a maximum loan term of 30 years;
- total points and fees that do not exceed specified caps (for example, for loans greater than or equal to $100,000, the specified cap is 3 percent of the total loan amount);
- payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due;
- consideration and verification of the consumer's income and assets, including employment status if relied upon, current debt obligations, mortgage related obligations, alimony and child support; and
- total debt-to-income ratio that does not exceed 43 percent.

HUD and VA Loans. HUD and the VA (as well as the U.S. Department of Agriculture and Rural Housing Services) are each authorized to define QM for their own loans. Accordingly, based on rules adopted by HUD and by the VA, any loan insured, guaranteed or administered as a QM under the HUD or VA definitions qualifies as a QRM. Until the U.S. Department of Agriculture and Rural Housing Services pass regulations that define QM for their own loans, their loans may be exempt under the temporary QM definition described below.

Temporary QM Definition. Loans that are eligible for purchase, guarantee or insurance by an Enterprise (Fannie Mae or Freddie Mac), the Department of Agriculture or Rural Housing Services qualify if the loans meet the following criteria:

- regular periodic payments that are substantially equal (other than changes resulting from interest rate adjustments of an adjustable-rate or step-rate mortgage);
- no negative amortization, interest-only or balloon features;
- a maximum loan term of 30 years; and
- total points and fees that do not exceed specified caps (for example, for loans greater than or equal to $100,000, the specified cap is 3 percent of the total loan amount).

Loans that qualify for the temporary QM definition do not have to meet the other underwriting requirements of the general QM definition, such as the total debt-to-income ratio. The temporary definition expires for an Enterprise when it exits conservatorship, and will expire for each of the Department of Agriculture and Rural Housing Services when they issue their own QM rules, but, in any case, the temporary QM definition will expire no later than January 21, 2021.

Special QM Definitions for Small Creditors

Three additional QM definitions apply to small creditor portfolio loans. These are available only to small creditors that meet certain criteria including (i) the creditor originated 500 or fewer transactions secured

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[68] *See* "Community Focused Lending Exemption" below.

by a first lien, and (ii) the creditor had total assets of less than $2 billion. Because these loans must be held for at least three years to maintain QM status, they would be ineligible for QRM status for three years (as they could not be sold).

The first of these definitions allows these creditors to originate loans as QMs with greater underwriting flexibility, including without a quantitative debt-to-income threshold.[69] The second provides for a two-year transition period in which these creditors can originate balloon payment loans as QMs.[70] The last QM definition allows eligible small creditors that operate predominantly in rural or underserved areas to originate balloon-payment loans as QMs if they meet certain other criteria.[71]

Community-Focused Lending Exemption

Loans made through state housing finance programs and certain other community lenders that provide credit to low- and moderate-income, minority and first-time homebuyers use flexible underwriting standards and are exempt from the standard ability-to-repay rules. Consequently, they do not meet the QM definition. To maintain available credit for these types of loans on reasonable terms, the Agencies established a new risk retention exemption for community-focused lending securitizations in the Final Rule.

The loans that fall under the ability-to-repay exemption are provided through programs administered by a Housing Finance Agency,[72] a Community Development Financial Institution, a HUD-designated Down Payment Assistance through Secondary Financing Provider, a HUD-designated Community Housing Development Organization, and certain nonprofit organizations. Under the Final Rule, an exemption from the risk retention requirements is provided if the ABS interests are collateralized solely by community-focused residential mortgages and by servicing assets. Alternatively, if the community-focused residential mortgages are combined in a pool with other non-QRMs, the standard 5 percent risk retention requirement may be reduced by the ratio, measured as of the cutoff date, of the combined unpaid principal balance of community-focused loans to the total unpaid principal balance of the loans in the pool, provided that regardless of the composition of the pool, the minimum required risk retention for blended pools is 2.5 percent.

Exemption for Mortgage Loans Secured by Three- to Four-Unit Residential Properties

Mortgage loans that are secured by three- to four-unit residential properties do not meet the QM definition because they are deemed to be loans issued for business purposes. The Agencies were concerned that many low- and moderate-income areas contain a significant amount of such properties and provided an exemption in the Final Rule for mortgage loans secured by three- to four-unit residential properties that are owner-occupied and otherwise meet all the criteria for a QM. The Final Rule allows qualifying three- to four-unit residential loans to be combined with QRMs in a single pool, and securitizations of qualifying three- to four-unit residential loans are subject to the same certification and repurchase requirements as securitizations relying on the QRM exemption.

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[69] 12 C.F.R. § 1026.43(e)(5).

[70] 12 C.F.R. § 1026.43(e)(6).

[71] 12 C.F.R. § 1026.43(f).

[72] **Housing Finance Agency** is defined as any public body, agency or instrumentality created by a specific act of a state legislature or local municipality empowered to finance activities designed to provide housing and related facilities, through land acquisition, construction or rehabilitation.

Repurchase of Loans Subsequently Determined to Be Nonqualified After Closing

Under the Final Rule, a sponsor that has relied on the QRM exemption or the exemption for qualifying three- to four-unit residential mortgages for a securitization transaction will not lose its exemption for that transaction if, after closing, it is determined that one or more of the residential mortgage loans collateralizing the ABS interests does not meet all of the QRM or qualifying three- to four-unit residential mortgage criteria, provided that certain criteria are met. To maintain the exemption in such a case, (i) the depositor must have complied with the requirements relating to certification of internal supervisory controls, (ii) no later than 90 days after the determination that the loans do not meet the applicable criteria, the sponsor must repurchase the non-qualifying loans from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loans, and (iii) the sponsor must promptly notify the ABS holders of any loans included in the securitization transaction that are required to be repurchased, including the amount of the repurchased loans and the cause for the repurchase.

Periodic Review of QRM Definition and Other Exemptions

The Final Rule requires the Agencies to periodically review the definition of QRM and the risk retention requirements to consider, among other things, potential modifications to the definition of QRM that would result from proposed revisions by the Consumer Financial Protection Bureau to the QM definition and changes in market conditions and practices. It also requires the Agencies to review the exemption for community-focused residential mortgages and the exemption for mortgage loans secured by three- to four-unit residential properties. Reviews may be requested by any one of the Agencies at any time, but the Agencies are required to conduct reviews no later than four years after the Effective Date of the Final Rule with respect to securitizations of residential mortgages and then five years following the completion of such initial review and every five years thereafter.

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