Current Issues in Securitization

Adapted from a July 26, 2016
Educational Program by the

Committee on Structured Finance

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The New York City Bar Association
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CURRENT ISSUES IN SECURITIZATION

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of the
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Reporter: Mark Adelson

Structured Finance remains an efficient and effective financing technique. It has been used for more than four decades, first in the U.S. and then by many other countries around the globe. For roughly its first two decades, U.S. structured finance transactions were executed in a legal environment designed for traditional corporate offerings of equity and debt. Securitization lawyers had to extrapolate from laws and regulations developed for those areas. Eventually, however, the securitization area started to gets its own regulations. The first was Regulation AB from the SEC in 2005.[1] Many others have followed, creating both challenges and opportunities for companies that use securitization.

This report is based on the "Current Issues in Securitization" program held on July 26, 2016. The program was sponsored by the Committee on Structured Finance (the "Committee") of the New York City Bar Association (the "Association"). The program featured presentations on a mix of securitization related topics. The speakers at the event included Jason Kravitt (Mayer Brown LLP), Lewis Cohen (Hogan Lovells US LLP), Steve Levitan (Morgan Lewis & Bockius LLP), Melissa Hall (Morgan Lewis & Bockius LLP), Jeffrey Stern (Winston & Strawn LLP), Jeffrey Rotblat (Cadwalader Wickersham & Taft LLP) and Adam Singer (Cadwalader Wickersham & Taft LLP).

[1] Securities and Exchange Commission (SEC), *Asset-Backed Securities*, Release Nos. 33-8518, 34-50905, (70 Fed. Reg. 1506 (7 Jan 2005), available at http://www.gpo.gov/fdsys/pkg/FR-2005-01-07/pdf/05-53.pdf.

Patrick Dolan (Dechert LLP) was the moderator. The report is a summary of the panelists' remarks; it is not meant to be a full transcription. The views expressed are those of the individual panelists and not necessarily those of the Committee, the Association, or the firms with which the panelists are affiliated.

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Securitization in China

Jason Kravitt, Mayer Brown

China's economic output has passed that of Japan and Germany, making China the world's second largest economy, after the United States. China has achieved consistent double-digit economic growth in recent years. According to some views, China's economic output may eventually surpass that of the U.S.

China faces a number of key challenges affecting its ability to sustain economic growth in the future. These challenges include corruption, political domination of economic policy, pollution, and demographics.

Corruption: Corruption is a significant challenge in China. Chinese government officials wield tremendous power but receive very low pay. By contrast, public officials in Singapore are very highly compensated. Compared to their counterparts in China, officials in Singapore have less incentive for corruption. A major Chinese military figure was recently arrested for corruption. The problem with corruption is that it distorts policy decisions. Corruption is so bad in China that it may even taint the recent initiatives to reduce it; investigations and prosecutions may be motivated by contests for power rather than by the pursuit of justice.

Political Domination of Economic Policy: Economic decisions in China are driven primarily by political considerations. This distorts economic policy and means that the country's economic policy is unlikely to achieve optimal results. The country's huge investment in building roads and apartment buildings that remain mostly empty and unused may reflect the distortion of economic policy by political considerations.

Pollution: Environmental pollution in China is a ticking time bomb. Pollution creates two kinds of costs. The first is the cost of eventually cleaning it up. The clean-up cost will be huge. Even greater, however, is the related health care cost. That will be staggering. The effects of pollution in China may make it a political issue that ultimately will drive a huge demand for capital.

Demographics: A fourth challenge is demographics. Because of the one child policy, the age distribution of the population resembles a rectangle more than a pyramid. There are too few young Chinese for the number of older Chinese. This means that economic growth must eventually slow.

The four challenges mean that China will need capital from outside its borders. Despite having become the world's second largest economy, the country ranks 70th in the world by *per-capita* GDP. China's economy is now based primarily on exports. That cannot last indefinitely. A rising standard of living will eventually undercut the cost advantage that has helped fuel exports. Likewise, the country's heavy investment in infrastructure must eventually slow down. Ultimately, the Chinese economy will have to shift toward internal consumption and away from relying on exports and infrastructure. China wants to use securitization to help make the change.

By comparison, the U.S. has had the largest internal consumption market in the world for the past 150 years.

U.S. commercial banks supply only about 15% of credit in America. The capital markets supply much of the rest. China wants to follow that example. China wants to fund a real economy of production and consumption. Both domestic securitization and cross-border securitization can help supply the funding.

The volume of Chinese securitization now surpasses the volume of EU securitization. The great majority of Chinese securitization activity is domestic. Collateralized loan obligations ("CLOs") are the most common types of deals. Auto loan securitizations are the second most common. Chinese CLOs are used for funding assets rather than as arbitrage vehicles.

China has no legislated law on securitization. Instead there are three competing regulatory regimes that purportedly govern such transactions.[2] One is from the country's banking regulators: the Peoples Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC). The second is for insurance companies. The third is from the China Securities Regulatory Commission (CSRC).

There is no "true sale" law in China. Nevertheless, Chinese law firms frequently give true sale opinions in securitization transactions. China has a trust law and there is some law about true sales in the context of trusts. For rating a Chinese cross-border securitization, the rating agencies will require true sale opinions from an international law firm.

Moody's, S&P, and Fitch all rate Chinese securitizations and publish rating methodologies that cover Chinese securitizations.

Blockchain and Structured Finance

Lewis Cohen, Hogan Lovells US LLP

Blockchain technology is a topic that has attracted increasing attention in both the business and legal communities. While many of the claimed benefits relate to reducing transaction costs in the areas of clearance and settlement, some of the most exciting applications could be in the structured finance sector.

What Is Blockchain Technology? Blockchain is a software technology that enables the creation and operation of a shared, electronic ledger (or database) in which encrypted entries are *immutably linked* in *chronological order*. In plain English, a blockchain system records a "chain of title" of assets represented in electronic form. Proponents of blockchain technology assert that having a real-time chain of title helps to establish both the ownership and authenticity of each asset in a given blockchain system. Let's take a closer look:

Who Shares the Ledger? In the Bitcoin blockchain, the ledger is effectively public – anyone operating a node on the system can see the entries for every participant. However, there are other paradigms that provide for sharing an electronic ledger within a limited group.

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[2] *See generally*, Jinfei Zhang, *Chapter 25A: The Law of Securitization in China*, in SECURITIZATIONS: LEGAL AND REGULATORY ISSUES, (Patrick P. Dolan and C. VanLeer Davis III eds., 2015) available at http://www.sidley.com/~/media/publications/chapter-25a-securitizations.pdf.

What Gets Shared in the Ledger? In the Bitcoin blockchain, the shared items are tokens of value ("bitcoins"). For other blockchains, the shared items could be bonds, mortgage loans, or other receivables. The essential requirement is that the items be represented in electronic form.

What is immutably linked? Each entry in the ledger is cryptographically linked to the entry immediately preceding it. Changing an entry effectively means re-doing most or all of the existing ledger. This element is said to make the ledger "immutable." The immutability of the ledger is critical for preventing duplicate transfers of a given item. Once a transferor transfers an item to another party, the blockchain shows the transferee as the owner and the transferor cannot (fraudulently) transfer the asset to a second transferee.

Why Is Chronological Order Important? Chronological order is important because it prevents sharing multiple "copies" of an item. Only the first transfer is considered valid.

Blockchain technology is generating substantial interest in both the private and public sectors. The State of Delaware is trying to become the business "home" of blockchain activity. Vermont has also worked on blockchain-friendly legislation. The Governors of the Federal Reserve have met with representatives of blockchain technology providers to better understand the technology.[3] This dual endorsement from both government and business could be a key to rapid adoption. Other possible applications of blockchain technology range from facilitating the sale of electric power by small generators to linking real estate title records.

Bitcoin is an example of using blockchain technology primarily for the purpose of exchanging tokens of value. It eliminates the need for trusted third parties to mediate transactions. Bitcoin provides for non-reversible payments for non-reversible services.

Bitcoin uses "consensus validation" by the expenditure of real world computing power (known as "proof of work") to validate individual transactions. That is what eliminates the need for trusted third-party mediation. Bitcoin "miners" provide and maintain computers that validate transactions. The miners receive a reward – new

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[3] Chamber of Digital Commerce, *Chamber of Digital Commerce Gathers at Federal Reserve Annual Meeting to Discuss Blockchain Technology*, press release (6 Jun 2016) available at http://www.marketwired.com/press-release/chamber-digital-commerce-gathers-federal-reserve-annual-meeting-discuss-blockchain-technology-2131738.htm.

bitcoins – for doing so (*i.e.*, they "mine" bitcoins by expending computing power). When at least half of the nodes on the blockchain network validate the transaction it becomes "immutably" part of the shared ledger.

Ethereum is another blockchain network. It is similar to Bitcoin except that it permits computer programs to be included in the blockchain as data. Thus, Ethereum can include so-called "smart contracts," contracts expressed in the form of computer code. Smart-contract technology offers exciting possibilities, but a recent hacking incident on Ethereum showed that it may have vulnerabilities.[4]

So why should lawyers be excited about blockchain-friendly asset-backed securities ("B-FABS")? If the promise of B-FABS can be realized, underlying financial assets would be created in a blockchain-friendly format, with the payments due from individual obligors made automatically through smart-contract technology. Once a pool of these assets is created, it can be "audited" virtually instantaneously, as all payments and the very validity of the assets themselves will all be part of an immutable blockchain. Historical performance data on the assets would be available and completely reliable – it would be nearly impossible for a servicer to alter these records.

Moreover, an asset-backed security backed by blockchain-friendly assets could be issued in blockchain format, giving investors in B-FABS real-time access to the underlying payment history as the transaction progresses, allowing immediate and accurate valuation and near 100% transparency – one of the key goals of regulators in this area.

Of course, we have some ways to go before this vision becomes a reality. But the promise of a world in which B-FABS become the standard means of pooling and funding financial assets should be tantalizing enough to draw practitioners together to do the necessary legal work to put us on the road to a brave and exciting new world for securitization.

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[4] *The Bizarre Fallout of Ethereum's Epic Fail*, Fortune (4 Sep. 2016) available at http://fortune.com/2016/09/04/ethereum-fall-out/.

Mandatory Arbitration

Chris DiAngelo, Katten Muchin Rosenman

The Consumer Financial Protection Bureau ("CFPB") has proposed a rule[5] that would prohibit mandatory arbitration clauses in consumer financial contracts that would prevent a consumer from participating in a class action lawsuit. The proposal is based on the idea that consumer contracts are often contracts of adhesion. The proposal was open for comment until August 22, 2016 and any final rule would have delayed effectiveness.

The proposal would potentially dampen the volume of consumer receivable securitizations. One possible effect of the proposal could be a reduction in the volume of consumer receivables created. A second possible effect – and one that could significantly reduce securitization volumes – is the creation of new types of assignee liability.

Section 1028(a) of the Dodd-Frank Act[6] directs the CFPB to study arbitration. The CFPB has the discretion to promulgate regulations consistent with its arbitration study (§ 1028(b)). It must consider both costs and benefits and the effect of regulations on access to financial services.

The CFPB released its arbitration study in March 2015.[7] The study found that the current use of mandatory arbitration provisions does not create incentives for lenders to change business practices that might be illegal.[8] The study also found that mandatory

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[5] Bureau of Consumer Financial Protection, *Arbitration Agreements*, 81 Fed. Reg. 32830 (24 May 2016) available at https://www.gpo.gov/fdsys/pkg/FR-2016-05-24/pdf/2016-10961.pdf.

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028, Pub. Law No. 111-203, 124 Stat. 1376, 2003 (2010) available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[7] Consumer Financial Protection Bureau, *Arbitration Study – Report to Congress, pursuant to Dodd–Frank Wall Street Reform and Consumer Protection Act § 1028(a)*, (March 2015) available at http://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf.

[8] *See also* Richard Cordray, *Prepared Remarks of CFPB Director Richard Cordray at the American Constitution Society* (10 Feb 2016) available at http://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-american-constitution-society/ ("Class actions also create a mechanism to bring about much-needed changes in business practices. By inserting an arbitration

arbitration provisions somewhat deter consumers from pursuing potentially valid claims.

However, there are a number of arguments against the CFPB proposal. One key argument is that the proposed rule would increase lenders' compliance costs, which would, in turn, be passed along to consumers. Another argument against the proposal is that consumers do not care about whether a contract includes an arbitration provision. A third argument is that class actions are a procedural device that the CFPB is trying to use to change substantive law. A fourth argument is that class actions favor the plaintiffs' bar but do not really help consumers.

In the *Concepcion* case,[9] consumers sued AT&T over a $30 charge for taxes on a "free phone." The U.S. Supreme Court ruled that the Federal Arbitration Act[10] preempts state law that otherwise would have disallowed the arbitration clause at issue in the case. The case overruled a California Supreme Court decision that an arbitration provision could be nullified as unconscionable under state law despite the Federal Arbitration Act.[11]

In the *PHH* case,[12] PHH Corporation is challenging the constitutionality of the CFPB itself after the CFPB assessed a $109 million penalty against the company. The case is before the U.S. Court of Appeals for the D.C. Circuit and several judges on the court seem to accept the argument that the CFPB is unconstitutional because it is run by

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clause into their contracts, companies can sidestep the legal system, avoid big refunds, and continue to pursue profitable practices that may violate the law and harm consumers.").

[9] *AT&T Mobility v. Concepcion*, 563 U.S. 333, 131 S. Ct. 1740 (2011) available at https://www.supremecourt.gov/opinions/10pdf/09-893.pdf.

[10] 9 U.S.C. § 1 *et seq*. (2014) available at https://www.gpo.gov/fdsys/pkg/USCODE-2014-title9/pdf/USCODE-2014-title9-chap1.pdf.

[11] *Discover Bank v. Superior Court*, 30 Cal. Rptr. 3d 76, 36 Cal. 4th 148, 113 P.3d 1100 (2005) available at https://www.courtlistener.com/opinion/2570216/discover-bank-v-superior-court/.

[12] *PHH Corporation et al. v. CFPB*, No. 15-1177 (D.C. Cir., filed 19 Jun 2015) docket and filings available at http://www.plainsite.org/dockets/2ml5v5daw/court-of-appeals-for-the-dc-circuit/phh-corporation-et-al-v-cfpb/ (appeal from CFPB final order and decision in *In the matter of PHH Corporation et al.*, CFPB Admin. Proceeding, file no. 2014-CFBP-02 (4 Jun 2015) available at http://files.consumerfinance.gov/f/201506_cfpb_final_order_227.pdf (order) and http://files.consumerfinance.gov/f/201506_cfpb_decision-by-director-cordray-redacted-226.pdf (decision)).

a single person and is not accountable to a cabinet department. The CFPB is not funded by appropriations but, rather, by an allocation from the Federal Reserve.

The Democratic Party platform opposes any idea to change the structure of the CFPB into a commission similar to the SEC or to change its funding mechanism.[13] By contrast, the Republican Party platform is highly critical of the CFPB and calls for changing it.[14]

Marketplace Loans

Steve Levitan and Melissa Hall, Morgan Lewis

Marketplace lending, originally called peer-to-peer lending, was initially about matching borrowers with willing lenders. Today, the lending side is dominated by banks and hedge funds, but the borrowers are still mostly individuals and small businesses.

Madden Case

The *Madden* case[15] holds that a non-bank assignee of a national bank does not receive the benefit of federal preemption of state usury laws that made a loan legal when originated by the bank. The result is that the assignee can collect interest only up to the level permitted by applicable state usury laws.

Madden involved a bank-originated consumer debt that was charged-off and sold to a non-bank collection agency. The consumer was a resident of New York who opened a credit card account with a bank. The following year, the bank changed the account's terms with a "change of terms" document that included a Delaware choice-of-law provision. The account provided for an interest rate of 27%. That rate was legal under Delaware law but would be usurious under New York law. The borrower

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[13] Democratic Platform Committee, *2016 Democratic Party Platform*, at 11 (21 Jul 2016) available at https://www.demconvention.com/wp-content/uploads/2016/07/Democratic-Party-Platform-7.21.16-no-lines.pdf (paste link in browser).

[14] Republican National Committee, Platform Committee, *Republican Platform 2016*, at 3 (15 Jul 2016) available at https://prod-static-ngop-pbl.s3.amazonaws.com/media/documents/DRAFT_12_FINAL[1]-ben_1468872234.pdf (paste link in browser).

[15] *Madden v. Midland Funding*, 786 F.3d 246 (2d Cir. 2015) available at https://www.gpo.gov/fdsys/pkg/USCOURTS-ca2-14-02131/pdf/USCOURTS-ca2-14-02131-0.pdf.

defaulted on the debt while owing roughly $5,300. The bank later sold the debt to the collection agency.

The Court of Appeals for the Second Circuit reversed the lower court ruling and held that federal law preemption principles, which allowed the bank to originate the loan at an interest rate that was permissible in the bank's home state, did not apply to the non-bank collection agency. Therefore, the collection agency could not collect on the debt's 27% interest rate. The collection agency appealed to the U.S. Supreme Court, which denied certiorari.[16] The Supreme Court asked the Solicitor General to submit a brief on the petition for certiorari. The Solicitor General argued that *Madden* was wrongly decided by the Second Circuit and that contrary decisions in other judicial circuits were correct. However, those other cases involved sufficiently different circumstances such that there was not a clear conflict between the circuits. The Solicitor General ultimately recommended that the U.S. Supreme Court deny certiorari.[17]

The Court of Appeals remanded the case to the District Court to determine whether the maximum permissible interest rate should be determined under New York law or Delaware law, apart from the issue of federal preemption. Presumably, the district court will undertake a conflict of laws analysis, including the effect of the choice-of-law provision in the "change of terms" document.[18]

While *Madden* is the law in the Second Circuit, its reasoning so far has not spread to the other judicial circuits.

Triggering of Performance Covenants

In recent months, the credit performance of a few marketplace lending securitizations has violated the deals' performance covenants (triggers). The effect – at least temporarily – is to lock-out cashflows to equity holders and, in some cases, to

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[16] *Madden v. Midland Funding*, 786 F.3d 246 (2d Cir. 2015), *cert denied* No. 15-610 (U.S. 27 Jun 2016).

[17] Brief for the United States as Amicus Curiae, *Midland Funding et al. v. Madden*, *cert denied* No. 15-610 (U.S. 27 Jun 2016), available at https://www.justice.gov/sites/default/files/osg/briefs/2016/06/01/midland.invite.18.pdf.

[18] *See* TriBar Opinion Committee, *Supplemental Report: Opinions on Chosen-Law Provisions Under the Restatement of Conflict of Laws*, 68 BUS. LAW. 1161, n. 2 (August 2013) available at http://www.americanbar.org/content/dam/aba/publications/business_lawyer/2013/68_4/report-chosen-law-provisions-201308.authcheckdam.pdf.

holders of subordinate note tranches. The deals' performance covenants were designed very conservatively based on rating agency requirements. The newness of the sector, combined with limited historical performance data (especially for periods of economic stress), underlies the rating agencies' conservatism. The affected deals will remain in "turbo" mode until they meet their performance covenants, which would allow a return to the normal cash allocation mechanics.[19]

True Lender

The true lender issue is distinct from the "valid when made" issue that was the focus in *Madden*. The term "valid when made" refers to the idea that if the interest rate on a loan is non-usurious when the loan is made, then a later assignment of the loan should not make it usurious.[20]

The "true lender" issue focuses on the origination of the loan. A typical marketplace loan is originated by a bank that sells it to the sponsoring marketplace lender a few days after origination. Although the bank originates the loan, the marketplace lender is responsible for marketing the loans and is the customer-facing entity for the lending. These relationships raise questions about whether the bank or the marketplace lender is the "true lender." The issue is significant because if the bank is not the true lender then federal preemption of state usury laws would not apply.

The true lender issue is not unique to marketplace lending. It has arisen in the context of other lending products, such as payday loans. In *Sawyer v. Bill Me Later*,[21] the court found that federal preemption *should* apply because, among other reasons, Bill Me Later was subject to FDIC examination as a bank service provider. However, courts in other cases have reached the opposite conclusion. The Supreme Court of West Virginia has held that the true lender is determined based on the economic substance of the

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[19] *Troubled Loan Deals Draw Scrutiny*, Asset-Backed Alert, 22 Jul 2016, p. 2; Tracy Alloway and Matt Scully, *More Trouble in Bonds Backed by Peer-to-Peer Loans*, BLOOMBERG NEWS (14 Mar 2016) available at http://www.bloomberg.com/news/articles/2016-03-14/more-trouble-in-bonds-backed-by-peer-to-peer-loans (paste link in browser).

[20] *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103 (1833) ("a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction.").

[21] *Sawyer v. Bill Me Later Inc.*, 23 F.Supp.3d 1359 (D. Utah 2014) available at http://scholar.google.com/scholar_case?case=5607372065697101991&q=sawyer+v.+bill+me+later+inc&hl=en&as_sdt=6,31&as_vis=1.

relationship between the bank and the lender, and found that the payday lender was the "true lender" and subject to state licensing and usury laws.[22] And in the recently filed class action against Lending Club, the plaintiff alleges that Lending Club (as the "true lender") has violated state usury laws as well as the RICO anti-racketeering law.[23]

Concluding Thoughts

The marketplace lending industry should expect to be regulated eventually, although the states, the Department of Treasury, the CFPB, and other regulators have yet to formally issue regulations. Each new case has the potential to create additional restrictions for marketplace lenders, while at the same time often providing a little more clarity.

A marketplace lender that partners with a bank is subject to FDIC supervision as a bank services company.

A newly formed marketplace lending company would be well advised to get its consumer regulatory compliance matters squared away very early in the process. Investors and securitization underwriters are well aware of the usury and other consumer regulatory issues and will ask questions as part of their due diligence. Also, consumer lawsuits are almost inevitable and a company needs to prepare in advance for when they happen.

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[22] *CashCall, Inc. v. Morrisey*, No 12-1274 (W.Va., 30 May 2014) available at http://www.courtswv.gov/supreme-court/memo-decisions/spring2014/12-1274memo.pdf; *see also CFPB v. CashCall*, Inc., No. CV-15-7522-JFW (RAOx) (C.D.Ca, 31 Aug 2016) available at http://www.hudsoncook.com/alerts/alerts_09012016120955_379.pdf and https://www.mayerbrown.com/files/uploads/Documents/PDFs/2016/August/CFPB-v-CashCall-LRes.pdf.

[23] *Bethune v. Lendingclub Corporation*, No. 1:16-cv-02578 (S.D.N.Y., complaint filed 6 Apr 2016) (docket and materials available at http://www.plainsite.org/dockets/2yk1jpxbd/new-york-southern-district-court/bethune-v-lendingclub-corporation-et-al/).

Risk Retention Issues in CLOs[24]

Jeffrey Stern, Winston & Strawn

Why did the Dodd-Frank Act impose risk retention requirements?[25] The motivation appears to have been the pervasive "originate to distribute" business model in the mortgage industry. The fact that mortgage lenders did not retain the loans that they originated may have removed incentives to make loans prudently. The risk retention rule promulgated under the statute becomes effective, with respect to CLOs, on December 24, 2016.[26]

The Dodd-Frank Act imposed a risk retention requirement on "securitizers." Under the rule, a CLO manager is a "sponsor" (which is the rule's equivalent of a securitizer). The rule has already affected CLO issuance volumes. This year's CLO issuance volume is around half of last year's volume at the same point in the year.

The rule allows a sponsor to retain risk in different forms: vertical, horizontal, or a combination of the two. Vertical risk retention calls for retaining 5% of each class issued in a deal. Horizontal calls for holding the most subordinate 5% of a deal, measured by "fair value" (a GAAP concept).

Under the rule, a sponsor must hold the risk retention until the later of when the collateral backing a deal or the securities issued in the deal have amortized by two-thirds (but not less than two years from the closing of the CLO).

Under the rule, the risk retention obligation can be satisfied either by a securitization's sponsor or by a "majority owned affiliate" of the sponsor. The definition

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[24] *See generally* Jeffrey Stern, *H.R. 4166—Too Hot, Too Cold, or Just Right?*, J. STRUC. FIN., vol. 22, no. 2, pp. 31- 36 (Summer 2016); Craig Stein, *U.S. CLOs: Past and Present*, J. STRUC. FIN., vol. 22, no. 2, pp. 16- 23 (Summer 2016); Meredith Coffey, *LSTA and Risk Retention: Efforts on the Hill and in the Courts*, J. STRUC. FIN., vol. 22, no. 2, pp. 55-58 (Summer 2016).

[25] Dodd-Frank Wall Street Reform and Consumer Protection Act § 941, Pub. Law No. 111-203, 124 Stat. 1376, 1890 (2010) available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[26] *See, e.g.*, 12 C.F.R. Part 43 (2016), available at https://www.gpo.gov/fdsys/pkg/CFR-2016-title12-vol1/pdf/CFR-2016-title12-vol1-part43.pdf; OCC, Federal Reserve System, FDIC, Federal Housing Finance Agency (FHFA), SEC, and Dept. of Housing and Urban Development (HUD), *Credit Risk Retention*, 79 Fed. Reg. 77602 (24 Dec 2014) available at http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-29256.pdf.

of majority owned affiliate allows for a sponsor to have "majority control" of the affiliate either by having a majority of the voting equity or by having a "controlling financial interest" (another GAAP concept). The current view among the major accounting firms is that the sponsor must have at least 10% of the economics.

The rule is silent on the consequences of non-compliance. However, because the rules are under the Securities Exchange Act of 1934, a violation would be a violation under that law.

There is an argument that the statutory definition of the term "securitizer" should not include CLO managers. Under the statute, a "securitizer" is an issuer or an entity that organizes and initiates an asset-backed securities transaction by selling or transferring assets.[27] In a CLO, the manager does not sell or transfer assets.

A new bill, H.R. 4166,[28] would create a "qualified CLO" or "QCLO" designation, which would change the risk retention requirement to 5% of a CLO's equity rather than 5% of the whole CLO, as required under the current rule.

The current rule allows financing the retained risk piece, but only on a full recourse basis. Although the statute and rules do not address foreclosure directly, it is likely that a lender cannot foreclose on the retained piece without causing a violation of the rules. Also, a sponsor may need to retain voting rights on the retained interest, if it is holding such interest in a majority owned affiliate <u>and</u> is relying (for the majority control) on having a controlling financial interest in that interest.

If a "grandfathered" CLO is refinanced after the effective date of the risk retention rules, the refinancing will trigger the risk retention requirement.

Risk Retention Solutions: There are several potential risk retention solutions for CLO managers under the current rule. One is to capitalize an existing manager to a level at which it can afford to hold the required risk retention pieces of CLOs that it manages. This would require attracting third-party investors to provide debt or equity to the manager. A second potential solution is to capitalize a "new manager" with sufficient third-party equity and debt to cover the risk retention requirements. The new

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[27] 15 U.S.C. § 78o-11(a)(3) (2014) available at https://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-11.pdf.

[28] Expanding Proven Financing for American Employers Act, H.R. 4166, 114th Cong. (2015) available at https://www.gpo.gov/fdsys/pkg/BILLS-114hr4166ih/pdf/BILLS-114hr4166ih.pdf.

manager would subcontract much actual work to the existing manager. However, care must be taken to assure that the new manager will be recognized as an independent entity and that the new manager does not delegate so much of its management authority that the old manager is considered the "true manager" of the CLOs. A third potential solution is the use of a majority owned affiliate, but this entails a (small) measure of regulatory uncertainty. Also, a disadvantage of using a majority owned affiliate is that it may be more difficult to achieve dual-compliance with both the U.S. and E.U. risk retention requirements (the E.U. has had a risk retention requirement since 2011).[29]

Risk Retention Issues in CMBS

Jeffrey Rotblat & Adam Singer, Cadwalader

Some bank issuers of commercial mortgage-backed securities ("CMBS") are leaning toward vertical risk retention, provided that they can get advantageous capital treatment for the retained portion. One bank intends to force the issue by retaining a vertical slice and classifying it as a loan for risk-based capital purposes. The regulator will be forced to either accept or reject the bank's treatment.

Unlike other securitization asset classes, CMBS allows for compliance with the risk retention requirement by having outside third-parties hold a horizontal slice.[30] However, the sponsor retains the compliance obligation and must monitor the "B-piece buyers." There are tough potential issues around the exposure of an issuer to violations by a third-party B-piece buyer. In fact, the bankruptcy of the third-party B-piece buyer could result in a prohibited transfer of the retained risk piece. Another issue is whether

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[29] Commission Delegated Regulation (EU) No 625/2014, of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of Regulatory Technical Standards Specifying the Requirements for Investor, Sponsor, Original Lenders and Originator Institutions Relating to Exposures to Transferred Credit Risk, 2014 O.J. (L17416) http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOL_2014_174_R_0006&from=EN; *see also* E.U. Securitization Initiative (30 Sep 2015) available at http://ec.europa.eu/finance/securities/securitisation/index_en.htm.

[30] *See e.g.*, 12 C.F.R. §43.7(b) (2016) available at https://www.gpo.gov/fdsys/pkg/CFR-2016-title12-vol1/pdf/CFR-2016-title12-vol1-sec43-7.pdf.

or not all originators of loans included in a CMBS deal are "sponsors" subject to the risk retention requirement.[31]

The current rule provides for zero risk retention on "qualifying CRE loans."[32] However, the definition of qualifying CRE loan is very narrow,[33] which makes the exemption essentially useless.

CMBS issuance is about half of what it was last year, partly due to concern over risk retention. There is a substantial amount of CMBS coming up for refinancing this year and next year.[34] There will be pressure to execute new deals (to fund the refinancings) and the risk retention problem needs to be solved beforehand.

H.R. 4620 is a bill that would provide CMBS issuers with some relief from the risk retention requirement.[35] It would modify the B-piece option. The current rule allows up to two B-piece buyers, both of which must share the risk on a *pari passu* basis. The bill would allow for a senior tranche and a subordinate tranche within the B-piece. The bill would also provide an exemption from the risk retention requirement for single-asset CMBS. Additionally, the bill would revise the definition of "qualified commercial real estate loans," and would reduce or eliminate risk retention on such

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[31] *See* Cadwalader Wickersham & Taft, *Selected Risk Retention Questions and Answers for CMBS Securitizations* (16 Aug 2016) at http://www.cadwalader.com/resources/clients-friends-memos/selected-risk-retention-questions-and-answers-for-cmbs-securitizations.

[32] *See e.g.*, 12 C.F.R. §§ 43.15(a) (2016) available at https://www.gpo.gov/fdsys/pkg/CFR-2016-title12-vol1/pdf/CFR-2016-title12-vol1-sec43-15.pdf.

[33] *See e.g.*, 12 C.F.R. §§ 43.17 (2016) available at https://www.gpo.gov/fdsys/pkg/CFR-2016-title12-vol1/pdf/CFR-2016-title12-vol1-sec43-17.pdf.

[34] Daniel Balbi and Cathy Cunningham, *Be Afraid: $56B in Maturing Retail Loans Could Face Refinancing Troubles*, COMMERCIAL OBSERVER, (8 Jun 2016) available at https://commercialobserver.com/2016/06/be-afraid-56-million-in-maturing-retail-loans-could-face-refinancing-troubles/; Eric L. Pruit and Jamie DeRensis, C*MBS Maturity Wave – A Tsunami of Loans Is About to Wash Ashore*, COMMERCIAL INVESTMENT REAL ESTATE (Nov-Dec 2014) available at http://www.ccim.com/cire-magazine/articles/323684/2014/11/cmbs-maturity-wave/; Tad Phillipp, *Announcement: Moody's: US CMBS Refi Wave Approaching Crest; Most Loans Well Positioned to Pay Off*, Moody's press release (9 May 2016) available at https://www.moodys.com/research/Moodys-US-CMBS-refi-wave-approaching-crest-most-loans-well--PR_348623.

[35] Preserving Access to CRE Capital Act of 2016, H.R. 44620, 114th Cong. (2016) available at https://www.gpo.gov/fdsys/pkg/BILLS-114hr4620ih/pdf/BILLS-114hr4620ih.pdf.

loans. The bill would also (1) remove the exclusion of interest-only loans from the definition, (2) remove the requirement of an amortization schedule of 25 years or less, (3) remove the requirement that a qualifying CRE Loan have a minimum 10-year loan term and (4) remove the provision that requires that a qualifying CRE Loan originated based on an appraisal that used a "lower" capitalization rate be subject to a lower loan-to-value ratio.

— END —

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