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July 20, 2011

By Email: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, NE.
Washington, D.C. 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: Credit Risk Retention
(Rel. No. 34-64148; File No. S7-14-11)

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee and the Securitization and Structured Finance Committee (together, the "Committees") of the Business Law Section of the American Bar Association (the "ABA") in response to the Proposed Rules relating to Credit Risk Retention referenced above (the "Proposal") released jointly by the Office of the Comptroller of the Currency (Department of the Treasury), the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), the Federal Deposit Insurance Corporation (the "FDIC"), the U.S. Securities and Exchange Commission (the "Commission"), the Federal Housing Finance Agency and the Department of Housing and Urban Development (collectively, the "Agencies"), by reference both to the commentary on the Proposal (the "Commentary") and the text of the proposed common rules (the "Proposed Rules").

The Proposal seeks to give effect to the Agencies' mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") by promulgating rules for risk retention in transactions involving asset-backed securities ("ABS"). Terms that have been defined in the Proposal or the Dodd-Frank Act are used in this letter with the respective meanings as used in the Proposal or the Dodd-Frank Act, provided therein, unless we specify otherwise herein.

The comments expressed in this letter represent the views of the Committees only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law. This letter is addressed to the Commission, and not to the other Agencies, due to limitations on the Committees' authority within the Section of Business Law, but we will provide copies to the other Agencies.

Our Committees are composed of lawyers from private practice, corporate law departments, trade associations and other organizations. Collectively, we have substantial experience in the securitization markets, and in virtually all of the many asset classes that have been securitized.

The Committees thank the Commission for this opportunity to comment on the Proposal. We recognize that the Commission and the other Agencies have devoted a great deal of time and attention to the Proposal. The Proposal provides a number of risk retention options for securitizers, in contrast to the proposals made by the Commission in its proposal to amend Regulation AB and related laws (the "Reg AB II Proposal") and by the FDIC in the securitization rule the FDIC adopted on September 27, 2010 (the "FDIC Securitization Rule"). The Proposal also asks a number of thoughtful questions.

Risk retention rules, perhaps more than any other securitization reform initiative, have the potential to dramatically and adversely impact the future vitality of the securitization industry. For that reason alone, they deserve very careful scrutiny and detailed comment. We have sought to provide that level of scrutiny and comment in this letter; we hope that it is useful to the Agencies.

As this is a very lengthy comment letter, we include below a Table of Contents. We also point out that we have included as Appendix C for your assistance an Index of Defined Terms.

The Committees appreciate the opportunity to submit these comments. Members of the Committees are experienced in the securitization of various asset classes and structures; we would be happy to share our experience, not as industry representatives, but as experienced practitioners, in helping shape the Final Risk Retention Rules. We are available to meet and discuss these matters with the Commission and its staff and to respond to any questions.

Very truly yours,

/s/ Jeffrey W. Rubin
Jeffrey W. Rubin
Chair, Federal Regulation of Securities Committee

/s/ Vicki O. Tucker
Vicki O. Tucker
Chair, Securitization and Structured Finance Committee

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I. Introduction

Initially, we acknowledge the significant challenge posed by the Dodd-Frank Act's mandate to the Agencies to promulgate rules that relate to securitization transactions, especially considering that those rules relate to structural aspects of such transactions. The securitization market has developed many different structures and many different types of ABS. Multiple structures and types of ABS are necessary to accommodate investor preferences, the distinctive characteristics of each asset class, and the variety of legal regimes that can be applicable. These transactions differ in ways both large and small, but the differences are intentional, meaningful and necessary. A rule that is designed with one style of ABS transaction in mind often will not fit another style of transaction that has a different design.

We acknowledge that portions of the securitization market performed very poorly over the past few years, and that the financial crisis exposed substantial flaws in the processes of originating, packaging, rating, structuring and selling certain securities. From a credit risk perspective, the major problems that arose in the securitization market during this time were concentrated in securities backed by first mortgage loans, home equity loans and home equity lines of credit (which we will collectively refer to as "RMBS"); in entities that invested in RMBS, such as collateralized debt obligations ("CDOs") that largely consisted of subordinate RMBS (so-called "ABS CDOs"); and, to a much lesser degree, in commercial mortgage-backed securities ("CMBS").

Other securitization vehicles suffered from structures that were designed on the assumption that partial liquidity was sufficient to support a divergence between asset maturities and ABS maturities. ABS issued by structured investment vehicles ("SIVs") and auction rate securities fall within this category.

While ABS of all asset classes suffered mark-to-market losses due to a significant loss of liquidity (losses which occurred in all markets, not just in markets for ABS) during the worst part of the financial crisis, very few ABS in asset classes outside of RMBS and CMBS were expected to default.[1] The performance of the underlying assets in classes such as credit card, auto loans, and equipment loans worsened during the financial crisis, but the transaction structures were sufficiently robust to withstand these increased stresses and still repay investors in full.

Some sectors of the securitization market have returned to nearly the same issuance levels that were reached prior to the financial crisis. For example, issuance levels in auto ABS in the first half of 2011 are on pace to exceed annual issuance levels in 2006-07.[2] Other sectors of the securitization market that performed as expected at issuance have not returned to those levels for other reasons. One example is credit card ABS; reduced issuance in that sector seems largely attributable to the strong deposit bases of major banks and to the change in risk-based capital treatment resulting from the adoption of Statements of Financial Accounting Standards Nos. 166

[1] See Federal Reserve Board, *Report to Congress on Risk Retention* 49 (October 19, 2010) (the "FRS Report"), available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

[2] Source: *Asset Securitization Report statistics.*

and 167.[3] Student loan ABS issuance has been relatively active, notwithstanding significant structural changes in the industry.[4]

We recognize that the Dodd-Frank Act calls for risk retention rules to be applied to all ABS, not just to mortgage-backed securities. But we caution the Agencies not to assume either that the problems that existed in mortgage-backed securities also existed in other asset classes or that regulatory approaches that work for mortgage-backed securities will necessarily work for ABS of other asset classes. We believe that the Proposal too often makes these assumptions, and that the results are problematic. The differences among securitization transactions to which we allude in the first paragraph of this introduction cannot be ignored; the Proposed Rules must be revamped in significant ways in order to make them workable for the many forms of ABS that differ from mortgage-backed securities (as well as to make them workable for mortgage-backed securities).

As we have reviewed the Proposed Rules, we have borne in mind the motivations that led Congress to mandate the Agencies to write risk retention rules. We believe that the purpose of Section 941(b) of the Dodd-Frank Act, which added Section 15G to the Exchange Act,[5] was to address two significant problems Congress perceived to exist in the securitization markets.

The first problem with securitization identified in the portion of the Senate report on the Dodd-Frank Act that dealt with Section 941 was the divergence of the economic interests of securitizers in originate-to-distribute securitizations with those of the third party investors in such securitizations.[6] Congress sought to reform "the 'originate-to-distribute' model for securitization and [to realign] the interests in structured finance."[7] Concern exists that the originate-to-distribute model is susceptible to moral hazard or adverse selection because the company that originated the securitization asset, once it securitizes that asset, no longer has any capital at risk in that asset.

The entities that Congress intended to be subject to the retention of credit risk are the primary participants in an originate-to-distribute securitization. The legislative history of Section 941 of the Dodd-Frank Act, as well as, studies on risk retention released by various agencies mandated to do so under the Dodd-Frank Act, each concluded that the risk in originate-to-distribute models is that "originators receive significant compensation upfront without retaining a material ongoing economic interest in the performance of the loan. … [T]his reduces the

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[3] See, Karen Sibayan, *Dealogic: Marketed ABS Dip for Fifth Year*, High Yield Report, January 3, 2011, pg. 40, vol. 22, no. 1, available at: http://www.structuredfinancenews.com/news/-214560-1.html.

[4] Asset Securitization Report's database indicates that 19 offerings of student loan ABS totaling $10.01 billion were effected in the first six months of 2011.

[5] When used in this letter, references to "Section 15G" mean Section 15G of the Exchange Act, and references to "Section 941" mean Section 941 of the Dodd-Frank Act.

[6] See the Senate Report No. 111-176, at 128.

[7] Press Release, FDIC, Chairman Bair's Statement on Credit Risk Retention Notice of Proposed Rulesmaking (Mar. 29, 2011), available at http://www.fdic.gov/news/news/press/2011/statement03292011.html.

economic incentive of originators and securitizers to evaluate the credit quality of the underlying loans carefully."[8]

The second securitization problem that Congress sought to rectify was the complexity and opacity of securitization markets during the financial crisis that "created the conditions that allowed the financial shock from the subprime mortgage sector to spread into a global financial crisis."[9] Congress particularly noted the difficulty of understanding securitizations of securitizations, such as ABS CDOs and CDOs-squared.[10]

At the same time, Congress also recognized that a "one size fits all" solution would be impracticable. Congress noted the differences in securitization practices across asset classes, and indicated its desire that the Agencies tailor regulations to take these differences into account:

> The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required…. The Committee believes that regulators should have flexibility in setting risk retention levels, to encourage recovery of securitization markets and to accommodate future market developments and innovations, but that in all cases the amount of risk retained should be material, in order to create meaningful incentives for sound and sustainable securitization practices.11

Congress intended the risk retention requirements to restore investor confidence in securitizations and to assist in returning securitization markets to their role in providing credit to consumers and businesses.[12] Likewise, the Financial Stability Oversight Council ("FSOC"), formed and tasked by the Dodd-Frank Act, advised that "any framework [implemented by the Agencies] should serve to mitigate the misalignment of incentives, asymmetric information, and macroeconomic risks associated with securitization, and simultaneously promote a robust securitization market that can continue to provide credit to businesses, consumers and homeowners in the United States."[13]

We return in a number of locations in our comments to these underlying purposes of risk retention, because we believe that portions of the Proposed Rules do not fit with these purposes.

Our comments are largely organized into sections that correspond to the sections of the Proposed Rules. We begin our review of the Proposed Rules by addressing the general risk

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[8] See Financial Stability Oversight Council, *Macroeconomic Effects of Risk Retention Requirements* (Jan. 2011) (the "FSOC Risk Retention Study"), at 11.

[9] See the Senate Report No. 111-176, at 128 (available at: http://banking.senate.gov/public/_files/Comittee_Report_S_Rept_111_176.pdf.)

[10] Id.

[11] Senate Report No. 111-176, at 130.

[12] Id., at 128.

[13] See FSOC Risk Retention Study, at 18.

retention requirements in §§ _.3 through _.12 and the transfer of risk retention provisions in §§ _.13 and _.14, as these are the heart of the Proposal. We then provide comments on certain of the "general purpose" definitions in § _.2 and on some significant administrative law considerations. That commentary is followed by discussions of certain of the exemptions that were proposed (or those exemptions we think should have been proposed) in §§ _.15 through _.23.

In our discussions of these sections of the Proposed Rules, we illustrate in many locations the problems that arise for various asset classes and structures. We have also included specific sections on a variety of asset classes in Part VII of this letter; these sections are intended to provide background information on particular aspects of these asset classes and to note the risk retention issues that are particular to those asset classes. To assist the Agencies in understanding commonly used securitization structures, we have included Appendix A. In that appendix, we include descriptions of five common transaction structures used in securitizations.

II. General Risk Retention Requirements

A. Base risk retention requirement

1. Base 5 per cent risk retention (§ _.3)

We believe that the risk retention rules should not require more than 5% of the credit risk of the assets for any asset class, should better reflect existing forms of risk retention and should be tied more closely to retention of a portion of the credit risk of a securitization than to a percentage of the par or other value of the securities or assets.

Section 941 of the Dodd-Frank Act creates a dramatic change in the federal regulation of securities offerings by moving from regulation of the process of such offerings to regulation of their core economics. Those core economics differ not only across asset classes and transaction structures, but also as a result of the characteristics of the underlying assets themselves and the nature and role of the parties securitizing them, including the degree to which market participants have access to sufficient capital to support risk retention. The larger the financial requirement placed on sponsors, and the more costly that requirement becomes, the less viable securitization will be as a funding option. Provisions that would cause risk retention to become more costly, without advancing the primary goals discussed above, include those that do not recognize existing forms of risk retention, require existing forms to be modified in ways that are not consistent with larger transaction structuring needs, trap value in the securitization that would have been released through a direct sale of the underlying assets, or require sponsors to bear risk without receiving a market rate of return for that risk assumption. As the Proposal is currently drafted, we believe that all of these types of provisions appear within it, and we have tried to identify them and to offer alternative approaches.

There is a real cost to any risk retention, and the ability to bear that cost differs among asset classes. For asset classes where retention of substantial credit risk is the norm—and there are many of these—we would not expect a more formalized requirement to threaten the viability of the market, so long as existing forms of risk retention are appropriately recognized. For asset classes where substantial retention of credit risk will be new, or where existing forms of credit

risk retention are not credited against the requirement, or where the sponsor is not appropriately compensated for the risk of the position held, possible effects may include significant curtailment of issuance, exclusion of smaller market participants, higher costs of consumer loans, diminished availability of corporate credit, and greater challenges in capital formation. In other words, there is a lot at stake here. We believe that it is important that the Agencies neither require risk retention of more than 5% of the credit risk—whether through the proposed premium capture cash reserve account provisions, a higher baseline level or definitions that conflate credit risk and portfolio value—nor reject the forms in which risk retention is currently provided, without first having strong empirical evidence that (i) an amount greater than 5% of the credit risk would be necessary to achieve robust alignment of interests between sponsors and investors, (ii) the forms in which risk retention currently appears in certain asset classes are insufficient to create such an alignment of interests and (iii) a larger or different form of risk retention would not have material adverse effects on the securitization markets, the financial sector or the economy as a whole.

We believe that the statutory approach to risk retention reflects Congress' concern about the potential adverse effects of the requirement on the origination of loans. For example, Congress required the Agencies to provide the opportunity for market participants to avoid risk retention by originating and securitizing high quality assets. The provisions that require the Agencies to exempt securitizations of "qualifying residential mortgages" ("QRMs"), for instance, reflect an inherent Congressional assumption that mortgage originators will be willing to tighten significantly their underwriting criteria if doing so allows them to securitize assets for which they will not have to retain risk.[14] We believe the Agencies to some degree recognize that the financial incentive to originate QRM loans must be balanced against the costs of risk retention. The Proposal attempts to increase due diligence standards even for high quality loans in ways that would go markedly beyond current market practice and would also add provisions to these loans—in particular, the proposed servicing standards—that potentially diminish the value of those loans in the hands of their owners. Such changes, which directly increase the cost of originating and holding these loans, would only be justified from a business perspective if those costs are offset by sufficient savings through the avoidance of risk retention. But the proposals as a whole suggest insufficient understanding of the costs of the proposals, the economics of securitization, and the policies that drive the procedures for loan origination and the terms of those loans in various market segments.

Under the Proposed Rules, the costs of risk retention may well become an issue even for types of securitizations for which the sponsors customarily retain significant risk. The Agencies have recognized that a variety of existing forms of risk retention can appropriately align the interests of investors and sponsors, but the ways in which these forms have been articulated in the Proposed Rules often do not correspond to how these forms operate in practice. Indeed, the only generally applicable risk retention option that, in our view, does not require significant

[14] This aspect of the QRM exemption is undermined, however, by attempting to establish the criteria for QRMs in relation to the liquidity of the non-QRM portion of the market. As we discuss later, we have serious concerns that a smaller QRM pool will lead to anything other than a dearth of RMBS securitizations. To the extent that the QRM requirements were intended by Congress to function as a safety valve for those institutions that would not be able to bear the burden of retaining securitization risk, we believe an overly restrictive QRM definition would miss the mark.

revisions is the vertical option in § _.4. Each risk retention option in § _.5 through § _.10 and in § _.12 has significant problems as drafted. Here are just a few examples of these problems:

- The definition of "seller's interest" proposed by the Agencies does not work in credit card securitizations and auto floorplan deals as a technical matter. As we discuss later in this letter, we believe the seller's interest itself is properly structured to align interests and it is the regulatory definition that needs to be revised.

- It is far from clear whether the definition of "eligible horizontal residual interest" would permit inclusion of the net present value of excess spread or even recognize excess spread as a potential component of an eligible horizontal residual interest; as a result, sponsors of a number of types of securitizations have expressed concern that they would not be able to construct an eligible horizontal residual interest in transactions where excess spread provides critical first-loss protection.

- Although the Agencies have acknowledged that there may be value in combining forms of credit enhancement, with the proposed L-shaped option allowing an equal combination of a vertical slice and an eligible horizontal residual interest, they have taken a very limited and restrictive view of the degree to which forms of risk retention can be combined more broadly.[15]

- The status of ABS interests that constitute "second loss" protection when the securitizer holds the "first loss" ABS interest is, at best, unclear. One key example is retention of seller-retained subordinated notes, which may not qualify as "eligible horizontal residual interests" but which nonetheless provide substantial risk protection for third-party investors in the securitization.

In addition to our concerns about those risk retention options that were proposed, we believe that the Agencies have overlooked a number of other forms of retained interests or credit enhancement that currently exist in securitization structures. These forms have performed quite well during the financial crisis, but would seemingly get no credit under the rules as proposed. Examples include:

- Sales of 95% participation interests in assets by securitizers or receipt back by securitizers of 5% participation interests;

- Spread accounts in credit card and other securitizations that are funded from excess spread when performance begins to deteriorate and that release funds if performance metrics improve;

- Bank-issued letters of credit;

[15] It is, for instance, very common for a transaction to include both a seller-funded reserve account and a seller-retained residual interest, or for a revolving master trust securitization to include a combination of a seller's interest, excess spread, and subordinated notes, all of which are held by the seller. As we read the Proposed Rules, all of the mandatory risk retention in these structures must be held in a single form.

- Cash flow mechanisms that divert interest and principal collections away from sponsor-held subordinated interests to pay down senior tranches more quickly if certain performance or collateral-based tests fail; and

- Subordinated fees or incentive-based compensation.

We believe that all of these mechanisms create meaningful risk alignment between the securitizer and investors. In whatever combinations they appear in these transactions, these mechanisms, along with the Agencies' proposed options, should be included in the determination of whether the risk retention requirement has been satisfied. Although we recognize that the complexity of these structures makes valuing these interests more complicated, attempting to oversimplify the risk retention options in ways that excludes them, without understanding why they take the forms they do, why they appear in such combinations, or how they function within existing securitizations, would be a significant mistake. Particularly with respect to auto and credit card securitizations, we can point to decades'-old securitization programs in which no interest or principal payment has ever been missed or deferred, no investor has ever incurred a loss, no class or tranche of securities has ever suffered a downgrade and where the sponsor in fact has billions of dollars of investment at risk—and where arguably not one dollar of that at-risk investment would count under the rules as proposed. We cannot believe that either the Agencies or Congress intended such a result.

We have one further overarching concern about how the Agencies have interpreted the requirement to retain 5% of the credit risk of the assets. Although Section 15G(c)(1)(B)(i) requires that the regulations provide for retention of "not less than five percent of the *credit risk* for any asset... that" unless an exemption is available, the Proposed Rules instead require retention equal to 5% of the *par value of the ABS interests* (or 5% of the par value of the assets, in some cases). The effect of the Agencies' approach is a very real economic difference among the levels of credit risk that would be retained under various options, without a corresponding difference in the amount of capital required to be invested. The holder of a 5% vertical slice of a pool will bear 5% of the loss on any defaulted asset, for example, while the holder of a 5% eligible horizontal residual interest is likely to bear the entire loss on that asset and in many instances will hold an interest that far exceeds the projected losses on the pool.

We appreciate that, for rulemaking purposes, it is more difficult to relate horizontal and other interests to credit risk rather than to relate them to par values or face amounts, but we believe this difficulty is not a justification to ignore the distinctions - credit risk assessment is a familiar topic for many of the Agencies; for example, the capital requirements of our federal banking system are grounded on assessments of risk. Securitization structures are likewise deeply dependent on assessments of credit risk, with both credit ratings and credit enhancement levels determined by modeling transaction structures and asset pools using various stressed assumptions about pool performance, including rates of default and losses-given-default. We believe, therefore, that rules that in fact relate retained interests to the credit risk of the assets are feasible, whether that credit risk is determined through a third-party assessment, a rating agency model, an internal model approved by regulators or a formula-based approach.[16] Moreover, we

[16] We recognize that vertical risk retention does not leave room for incorrect anticipation of the credit risk in the way that horizontal risk retention would. Although, for the reasons stated in the prior paragraph, we would like

believe the law specifically requires the Agencies to craft regulations that relate to the retention of the credit risk of the assets rather than the par value or face amount. Especially for transactions where sponsors may have very limited access to capital, such as asset managers of CLOs if they are determined to be appropriately within the scope of the statute,[17] a horizontal option that requires a smaller capital investment may be essential, and may be equally or more effective in terms of risk alignment than a larger investment (by dollar amount) by an entity that does not have significant capital constraints. We therefore urge the Agencies to reevaluate their rule proposals relating to horizontal interests to allow these to be based on 5% of the credit risk of the assets, rather than requiring them to absorb the first 5% of aggregate losses on the asset pool.

In summary, we believe the Agencies need to adopt a more principles-based approach to risk retention. The variety of asset classes, structures and ABS interests that comprise the securitization market cannot be adequately comprehended in rules that are overly prescriptive. Rules that are largely tailored to mortgage-backed securities simply do not work in other contexts. Our suggestions in the remaining sections of this Part II seek to implement this view.

2. Holding of risk retention by depositors

One of the aspects of the Proposed Rules that we find most puzzling is the imposition of the risk retention requirement solely upon the sponsor at the inception of the securitization transaction. The Dodd-Frank Act calls for risk retention to be imposed upon the "securitizer," a term that includes both the sponsor and the entity commonly known as the "depositor." Based on little more than a passing observation that the sponsor is actively involved in the securitization,[18] the Agencies summarily dismiss the depositor as a party that is permitted initially to retain the required risk.

We find this decision to focus the retention requirement on the sponsor to be inappropriate for four reasons.

First, we see no suggestion in Section 941 that the Agencies should consider limiting the application of the risk retention requirement to just one branch of the securitizer definition. We acknowledge that Section 941 provides great latitude to the Agencies (and, indeed, we later encourage the Agencies to utilize more of this latitude),[19] but we see no imperative for the Agencies to have made this determination. Indeed, this limitation seems to us to be at odds with

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to see risk retention requirements maintained at the 5% level, we would not consider it unreasonable to require that horizontal risk retention be measured against stressed loss projections rather than base case projections. For instance, if a transaction had an expected loss-given-default of 2% of the face amount of its assets, and a stressed potential loss-given-default of 6% in extreme but plausible conditions, we would consider a horizontal risk retention of 0.30% of par (5% of the 6% calculation) to be reasonable, even though that would equate to 15% of the base case projected credit risk of the pool.

[17] As we discuss in Part VII.A(iii) of this letter, CLOs do not have a "securitizer" to which the risk retention requirements would apply.

[18] See Proposal, at 24099.

[19] See Part VI.C of this letter.

Congressional intent. Congress included both the depositor and the party "organizing and initiating" the transaction in the definition of securitizer; we do not think that evidences any sort of Congressional intent to exclude depositors from holding risk retention.

Second, we think the Agencies have failed to provide a meaningful justification for this limitation. The sole justification offered – that the sponsor is actively engaged in the selection of assets – is little more than a rehashing of the definition of sponsor. As we describe in our fourth point, we think there could a significant adverse impact upon principles of legal isolation resulting from this limitation. It seems to us that the Agencies have dramatically limited the flexibility of the Proposed Rules without providing a compelling justification.

Third, we believe that the distinction the Agencies have drawn is largely eroded by the transfer provisions in § _.14(a) of the Proposed Rules. That section permits transfer of a retained interest to an entity that is and remains a consolidated affiliate of the retaining sponsor. In virtually all instances, a depositor is such an affiliate, which means that the Proposed Rules would permit the transfer of the retained risk to it. We believe that the depositor should be permitted to retain that interest initially, rather than acquiring it by subsequent transfer. For the reasons that we illuminate in our fourth point, this is a distinction with a difference from a legal perspective.

Fourth, and critically to us as lawyers and practitioners, this limitation raises difficult issues with respect to the legal isolation of the assets in a securitization from the insolvency risk of the transferor. Legal isolation is one of the foundational elements of securitization. Securitization investors rely on the ability to invest solely in a pool of assets without taking on the credit risks of the transferor of those assets. Although there may be some incidental risk with respect to the transferor, such as the risk that the transferor will not be able to honor its obligations with respect to breaches of representations and warranties, investors expect the issuing entity to own the pool assets, without the risk that an insolvent transferor will assert that the assets were merely pledged to support a secured loan to the issuing entity. Such an assertion would result in the assets (and the collections thereon) becoming subject to the automatic stay in bankruptcy in the event of the transferor's insolvency. To achieve separation of the assets from the seller's estate in bankruptcy and from the automatic stay with respect to the collection of the relevant receivables, transfers are structured as "true sales" for purposes of state law and relevant insolvency law, and where the transferor is an insured depository institution, transfers may be structured to satisfy the FDIC Securitization Rule. Legal isolation of the pool of assets from the insolvency risk of the seller is a basic objective of the structuring of any securitization transaction and an important protection for investors. It is also a necessary element for sale accounting treatment[20] and credit ratings that are not linked to the seller.[21]

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[20] Statement of Financial Accounting Standards No, 166, Paragraph 9a.

[21] For instance, Standard & Poor's "Legal Criteria For U.S. Structured Finance Transactions (2006)" says "to avoid the risk that a court, in the event of the bankruptcy of any |Bankruptcy| Code transferor, would deem any of the assets transferred in the chain of transfers to the intermediate SPE to be part of the transferor's bankruptcy estate (and thus subject to the automatic stay), Standard & Poor's generally considers whether each transfer of assets from any |Bankruptcy| Code transferor (through all intermediaries that are |Bankruptcy| Code transferors) to an intermediate SPE is a true sale (or qualifies for an exception to the automatic stay under

The single most important element in a true sale analysis is the degree to which the risk of loss on the pool of assets has been transferred by the seller to the purchaser.[22] If an entity sells financial assets but agrees to protect the buyer from the credit risk of the obligor on those assets, the transfer begins to look less like a true sale and more like a loan secured by the assets purported to have been transferred. For entities not relying on the FDIC Securitization Rule, it is therefore generally considered necessary that the assets be sold in a transaction that does not include credit recourse. In these types of transactions, the sponsor generally sells the assets in a true sale to an affiliate, often a wholly owned subsidiary. Alternatively, the sponsor may make a capital contribution of some or all of the assets to a subsidiary, with the sponsor receiving an equity interest in exchange. The affiliate transferee, which will have been structured to be a bankruptcy-remote special purpose vehicle, may then transfer the assets to a separate trust or other vehicle, and may retain credit risk with respect to the assets. These "two-step" structures thus employ a true sale or true contribution at the first step, transferring ownership to a separate entity, and at the second step rely on an entity whose only corporate or organizational functions are related to the securitization (and which is thus unlikely to have separate creditors that could force the entity into bankruptcy). The transfer will typically also include "separateness covenants" which are designed to ensure that the transferee and transferor would not be substantively consolidated in a bankruptcy of the transferor such that their assets and liabilities would be considered joint assets and joint obligations. Separateness covenants generally require the transferor and transferee to deal with each other on an arm's length basis.

The proposal to forbid the depositor from holding the risk retention at the outset potentially puts pressure on both the true sale and substantive consolidation analyses. To the extent the rules require risk to be held by the sponsor rather than the bankruptcy-remote depositor, they raise the concern that the retention constitutes recourse that would undermine the true sale nature of the transfer of assets. Moreover, if the sponsor is required to fund an interest in the securitization for which the sponsor is not adequately compensated, such as the proposed premium capture cash reserve account, there might be questions as to whether the transfers were appropriately made on arm's length terms and whether the entities are truly separate. The more risk that is required to be retained, and the more that it is required to be retained by the seller rather than the issuer or depositor, the greater the potential issues will be for the overall legal structure of the securitization. It would be counterproductive to impose risk retention requirements that had the effect of burdening investors with significant legal structural risk. The burdens could outweigh the benefits if any transaction that was intended to be structured as a sale were recharacterized as a secured financing as a result of risk retention.

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the Bankruptcy Code), as further described below.... To obtain legal comfort that each transfer of assets through the chain of transfers from any [Bankruptcy] Code transferor through the first-tier transfer to an intermediate SPE constitutes a true sale, Standard & Poor's will, as a general matter, request a "true sale opinion" on each transfer. The true sale opinion should state that the assets being transferred and the proceeds thereof will not be property of the transferor's estate under Section 541 of the Bankruptcy Code or be subject to the automatic stay under Section 362(a) in the event of the bankruptcy of the transferor."

[22] Other significant factors include: the degree to which the benefits of ownership (the "upside") has been transferred by the seller to the purchaser; the degree of control over transferred assets retained by the seller; the accounting treatment of the transfer on the seller's books; and the intent of the parties as to the characterization of the transaction as set forth in the documentation.

De minimis levels of risk may be retained by the sponsor without invalidating the true sale, but as levels increase so does the possibility that the lawyers structuring the transaction will be unable to reach an opinion level of certainty with respect to the true sale. In most cases, this would mean that the transaction simply could not be done. This concern could be alleviated if the final rules were to permit the risk retention to be held at all times by the depositor rather than the sponsor in a multi-step structure. The risk of loss would then be borne by the purchaser in the "true sale" transfer rather than by the seller.

The premium capture cash reserve account provisions, which would increase risk retention above the 5% level and require at least a portion of it to be held in a first-loss position, present an additional challenge to achieving a legal true sale, and structuring around those provisions by embedding retained interests in less obvious forms may not alleviate those issues.

Although we have tried to identify a number of the places where compliance with the risk retention provisions may undermine the true sale of the financial assets, we caution that there are degrees of risk retention that are fundamentally incompatible with true sale, and where the Agencies' rules specify an amount, form or party holding the risk that prevents a true sale determination, those rules may significantly curtail the availability of securitization and increase financing costs to the seller and its customers.

For the foregoing reasons, we believe that the Agencies should revisit this aspect of the Proposed Rules and permit the depositor, as well as the sponsor, to retain the required risk position in a securitization. In light of our belief, we will generally use the term "securitizer" rather than "sponsor" throughout this letter when referencing the holder of risk retention (other than when we are quoting the Proposal's use of "sponsor").

3. Third party purchasers of horizontal interests

Section _.10 of the Proposed Rules would allow a securitizer in a CMBS transaction to satisfy its retention obligation through the third-party purchaser retention option. That option provides flexibility to CMBS securitizers, though we have several comments on that rule that we express in Part II.B.7 of this letter.

We believe that the Agencies should make the third-party purchaser retention option available for asset classes beyond CMBS. There are other asset classes in which individual assets may be significant enough in size to merit the individual review required of a purchaser, such as jumbo residential mortgages, commercial loans, resecuritizations, aircraft and other large-ticket equipment items. If a third-party purchaser is willing to undertake that level of review, we believe that the securitizer should be entitled to rely on that third party for the risk retention option.

4. Multiple sponsors

We believe that, in transactions with multiple sponsors, the Agencies should allow the securitizers to divide the risk retention among themselves in their discretion, and should not impose obligations on any securitizer to monitor other securitizers' compliance after initial issuance.

Section _.3(b) of the Proposed Rules provides:

> *Multiple sponsors.* If there is more than one sponsor of a securitization transaction, it shall be the responsibility of each sponsor to ensure that at least one of the sponsors of the securitization transaction retains an economic interest in the credit risk of the securitized assets in accordance with any one of § _.4 through § _.11 of this part.

We understand this language to mean that (1) one securitizer must take on the entire 5% interest, though other securitizers could retain interests in addition to that, and (2) the sponsors not holding the interest must monitor risk retention by the sponsor to whom the risk has been allocated. We do not believe either of these requirements would be appropriate.

When there are multiple securitizers in a securitization, we believe the sponsors should be permitted to share the risk retention among themselves as they determine appropriate, so long as in the aggregate they retain the minimum required amount of risk retention. There are a number of reasons to take this approach. First, it is common for a securitization with multiple sponsors to be very large, in which case it may be difficult or impossible for any one sponsor to assume the entire retained risk independently.[23] Second, dividing the risk retention among multiple sponsors may cause each of them to provide important cross checks on asset quality and due diligence. Third, the Agencies have already acknowledged that there are circumstances in which it is appropriate for other parties to take on a portion of the risk, as reflected for example in its proposals to allow risk retention by originators. We believe that allowing division of the risk retention among sponsors, even though it will mean that no one sponsor will hold 5% of the credit risk, is entirely consistent with that approach.

We also do not believe that one sponsor can reasonably be expected to monitor the risk retention of another sponsor beyond the initial closing. We agree that all sponsors should have the responsibility to ensure that at the time of issuance of the securities, the entire amount of required risk retention has been assumed among the sponsor group. We also support the inclusion in transaction documents of covenants to the effect that each such sponsor will hold the risk retention in accordance with the Agencies' rules for the period required by such Agencies. As a practical matter, however, we believe it would be impossible for any sponsor to ensure that another sponsor had complied with the restrictions on hedging or pledging of the retained interests, and we do not believe such a requirement is appropriate. We ask that the Agencies' final risk retention rules (the "Final Risk Retention Rules") allow reliance on a covenant with no obligation for further monitoring.

Consistent with our position in the preceding section of this letter, we also believe the § _.3(b) shall be reformulated to acknowledge that the risk retention obligation is imposed on securitizers rather than just sponsors.

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[23] We note that, although the risk retention rule proposals and Section 941 of the Dodd-Frank Act each focus on the retention of a *percentage* of the risk retained, we believe the actual dollar amount of such retention also has relevance, particularly in larger transactions. In other words, we do not believe that a sponsor will give less weight to a $25 million investment if it is made as 5% of a $500 million transaction or as 2.5% of a $1 billion transaction.

5. Holding a partial interest in a qualifying form of risk retention

A securitizer seeking to satisfy the risk retention requirements may wish to hold a portion, but not all, of an interest that satisfies one of the permitted forms of risk retention. For example, a securitizer might retain a 50% undivided interest in an eligible horizontal residual interest, with an unaffiliated third party holding the other 50% interest.

We are not certain that ownership of a portion of a permitted form is permissible. For example, § _.5 requires that "the sponsor retains *an* eligible horizontal residual interest . . ." (emphasis added). The use of "an" could be read to mean that the sponsor must hold the entire interest. If a 50% interest in an eligible horizontal residual interest is sufficient to satisfy the base 5% requirement, we believe that partial ownership should be satisfactory.[24]

The goal of the Proposal is to ensure that the securitizer hold a sufficient amount of risk retention; it is not to require that the securitizer hold all of the risk. We ask that the Agencies clarify that ownership of an undivided interest in any permissible form of risk retention is acceptable and that it counts on a ratable basis toward the securitizer's risk retention obligation.

6. Compounding effects of risk retention

A sponsor that originates a pool of $100 million of mortgage loans and securitizes them—without retaining any risk of or investment in the pool—would ordinarily expect to receive approximately $100 million in securitization proceeds to support new loan originations. A sponsor that securitizes the same loan pool but retains a 5% vertical interest in the securitization will only receive $95 million in securitization proceeds to originate new loans. If the sponsor that retains risk repeats the lend-and-securitize process with this $95 million, and again retains 5% risk, that sponsor will have just over $90 million to relend, and will be holding nearly $10 million in retained risk. Each successive securitization will further exacerbate this problem, leading to ever diminishing amounts available for lending. We acknowledge that the sponsor will receive distributions over time on its retained interests, but these distributions will occur over an extended period of time.

A lender must maintain capital against its assets and cannot hold incremental risk retention while continuing to originate loans at the rate at which it originates when risk retention is not required. If a lender has sufficient capital to originate and hold on its books $100 million of loans, and in fact originates $100 million of 30-year mortgage loans, it must either sell those mortgage loans, raise additional capital (and increase its liquidity), or wait until a combination of monthly payments and prepayments on its loan portfolio provides it with the capacity to make new loans.

For many decades, our housing markets have depended on the existence of a liquid market for mortgage loans that makes the first option readily available to mortgage originators. Supporting such a liquid market has been a longstanding government policy. But risk retention in securitizations inherently limits the amount of liquidity banks can obtain through this funding

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[24] See Part II.B.2(b)(i)(I) of this letter.

source. Moreover, it will constrain liquidity at the same time that the government seeks to reduce dependence on Fannie Mae and Freddie Mac as liquidity sources. A mortgage loan originator that relied on securitizations and sales to GSEs to support its origination of $500 million in loans a year, but that could only hold $100 million in mortgage-related assets on its balance sheet at any one time, would find itself unable to originate new loans if it is holding $100 million worth of risk retention interests and if the GSEs have been unwound. These conditions may also reduce the return on capital, making it more difficult to raise capital either to support loan origination or to satisfy higher regulatory capital requirements.

For this reason, many of the approaches the Agencies propose to take with respect to risk retention raise significant concerns. The QRM definition, which could have been drafted in a way to encourage prudent underwriting but still allow many Americans to qualify for QRM loans, has been made too narrow to allow meaningful relief from the risk retention requirement and thus will not provide a critical safety net from the adverse effects of risk retention. The failure of the Agencies to propose workable definitions of the other types of qualifying loans they have addressed will have the same effect, as will establishing options for risk retention by reference to the principal amount of the assets rather than by more narrowly requiring only credit risk retention. The premium capture cash reserve account provisions would exacerbate these issues. The decision not to provide a graduated scale of risk retention for assets with an intermediate range of risk attributes may further contribute to a contraction of loan availability for creditworthy borrowers who do not have the pristine credit histories necessary for QRM status. The failure to provide an end date on risk retention, when a transaction has reached the point where such retention is no longer meaningful, will continue to restrict lending capacity without advancing any of the goals of the statutory provision. And the resistance to the use of unfunded risk retention, such as letters of credit, would eliminate an option that could provide robust alignment of interests while minimizing the impact on available funding.

In other words, we believe that the approach the Agencies have taken to risk retention reflects too narrow a focus on ensuring that sponsors cannot evade the requirements, and too minor a focus on the macroeconomic effects of the requirement. Risk retention is not an unqualified good, and the requirements must be implemented in a way that reflects an appropriate concern about the unintended consequences of a system that may well be too inflexible. We ask that the Agencies revisit all of these issues from a broader perspective.

B. Permissible Forms of Risk Retention

1. Vertical risk retention (§ _.4)

In the Proposal, the Agencies propose to permit a sponsor to satisfy its risk retention requirements with respect to a securitization transaction by requiring a sponsor to retain at least 5% of each class of ABS interests issued as part of the transaction.[25] A sponsor using this approach must retain at least 5% of the par value (if any), fair value and number of shares or units of each class of ABS interest, regardless of whether the class has a par value, was issued in certificated form, or was sold to unaffiliated investors. The Agencies note in the Proposal that,

[25] See Proposal § _.4, at 24158.

under the vertical risk retention option, by holding a 5% vertical slice in an ABS issuance, a sponsor is exposed to five percent of the credit risk that each class of investors has to the underlying collateral or, stated differently, the entire structure of the securitization transaction.[26]

We agree that the vertical risk option is an acceptable method of risk retention and should be included in the Final Risk Retention Rules. We note, in particular, that this was the one form of risk retention selected by both the Commission, in its Reg AB II Proposal[27], and the FDIC, in its FDIC Securitization Rule.[28] A securitizer's holding of a vertical slice of each class of securities serves to align the interests of the sponsor with the interests of all other investors, regardless of the priority of payments of principal and interest allocated to any particular class. In addition, it appears more likely that securitizers that retain a 5% vertical slice (including a securitizer that is a servicer or an affiliate of the servicer) will be able to obtain sale accounting treatment for loans sold into the securitization. Subject to our comments below and elsewhere in this letter, the vertical risk slice is easy to calculate, thereby facilitating transparency to investors and review and monitoring by the Agencies. The vertical risk option may, however, need to be tweaked in order to be a viable alternative for some asset classes. For example, as we discuss in more detail in Part VII.B., this option could be used by securitizers of credit card securitizations using a master trust structure only if § _.4 is revised to clarify that the rule applies only to classes of ABS interests issued by the master trust after the effective date of the Final Risk Retention Rules.

We also suggest that the Agencies consider permitting securitizers (and originators) to meet the risk retention requirement by retaining a 5% participation interest in each *asset* backing an issuance of ABS rather than 5% of each *ABS interest* issued in an ABS transaction. The 95% portion of the asset held by the issuing entity and the securitizer's 5% retained interest would share equally, on a pro rata basis, in all principal and interest payments on the asset as well as any servicing expenses and other expenses of the issuing entity and all losses on the assets. Servicing of the asset would be conducted by the servicer under the related servicing agreement, so there would be no difference in how the participation interest held by the securitizer would be serviced.

This alternative method of vertical risk retention could be easily implemented and would be particularly useful for asset pools consisting of a relatively small number of higher balance assets. Moreover, there will be no question that the retained participation interests are exactly representative of, and perform exactly the same as, the securitized assets. We do not believe that the retention of participation interests, as opposed to a portion of each ABS interest issued, would be more difficult for the Agencies to monitor because the participation interests would be appropriately documented in the transaction documents and would be disclosed in the offering documents for the transaction.

One way in which this form of risk retention could be structured would be for the securitizer to sell a 95% participation interest to the issuing entity and retain a 5% participation

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[26] Proposal, at 24101.

[27] See Reg AB II Proposal, at 23338-23341.

[28] See 12 C.F.R. § 360.6(b)(5)(i)(A).

interest. This approach may have advantages in terms of supporting both a legal true sale and sale accounting for the transferred interests. A variation on this approach would be for the securitizer to sell 100% of the asset to the issuing entity and receive a 5% participation interest from the issuing entity. The latter approach may minimize questions as to what entity "owns" of the asset is in connection with the enforcement of remedies following default by the obligor, and it would also eliminate any issue of whether a 95% participation interest sold to the issuing entity is a separate "security" that must itself be registered under federal securities laws. In any event, we believe that the utility of the Final Risk Retention Rules would be enhanced by expanding § _.4 to permit the securitizer to retain a 5% participation interest in each asset through either of these structures (i.e., whether the securitizer conveyed a 95% participation interest to the issuing entity and retained a 5% participation interest or the securitizer conveyed 100% of the asset to the issuing entity and received a 5% participation interest from the issuing entity).

2. Horizontal risk retention (§ _.5)

We are pleased that the Agencies have included a horizontal risk retention option in the Proposal. Many securitizers hold significant residual interests in their securitization transactions and receive meaningful returns on these interests, indicating that they have "skin in the game." Below we discuss some general matters relating to the horizontal risk retention option, including more closely correlating that option with the first loss risk retention option adopted by the European Union, certain requests for comment in the Proposal and, finally, some specific concerns that we have identified relating to the eligible horizontal residual interest and horizontal cash reserve account provisions of the Proposed Rules.

(a) Generally

(i) European Union risk retention requirements

In 2009, the European Union adopted Article 122a[29] of its Capital Requirements Directive[30], which requires certain participants in the securitization market to retain specified levels of interests in securitizations. Article 122a permits risk retention in several forms, including a first loss tranche of the applicable securitization.

Although Article 122a describes, in broad terms, permissible forms of risk retention, those requirements are more fully described in Guidelines to Article 122a of the Capital Requirements Directive published on 31 December 2010 by the Committee of European Banking Supervisors[31] (the "CEBS Guidelines"). The CEBS Guidelines appear to recognize that the horizontal or first loss risk retention requirement can be satisfied in a number of ways in addition to residual interests, subordinated notes and funded reserve accounts, including: (1)

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[29] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009.

[30] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006.

[31] Available at: http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

synthetically; for example by the sponsor entering into a total return swap with the ABS issuer (Paragraph 45 of the CEBS Guidelines); (2) by a deferred purchase price mechanism (Paragraph 55 of the CEBS Guidelines); (3) by overcollateralization[32] or similar structures (Paragraph 56 of the CEBS Guidelines, which appears not to require the overcollateralization to be on the sponsor's balance sheet); and (4) by letters of credit or guarantees (Paragraph 57 of the CEBS Guidelines).

We believe that a first loss tranche referred to in Article 122a and in the CEBS Guidelines is comparable to the eligible horizontal residual interest option in the Proposal and also believe that the Agencies should make efforts to harmonize the Proposal's eligible horizontal residual interest option and the European Union's first loss tranche option. Such harmonization would, among other things, (1) permit European Union regulated institutions (including their U.S. affiliates) to invest in U.S. securitizations that rely upon the eligible horizontal residual interest option and (2) not disadvantage U.S. entities subject to the Dodd-Frank Act risk retention requirements by limiting choices available to those U.S. entities.

(ii) Requests for comment

The Agencies have requested comment on several questions regarding the eligible horizontal residual interest in the Proposed Rules. We provide below our views on several of those questions below.

First, the Agencies have asked, in request for comment 33, whether a sponsor should be prohibited from utilizing the horizontal risk retention option if the sponsor (or an affiliate) acts as servicer for the securitized assets.

Although the Agencies do not discuss why they requested comment on this point, we assume the question reflects a concern as to whether such servicers will have conflicts of interest that cause them to manage servicing for the benefit of the holder of the horizontal risk retention rather than for investors as a whole (a concern reflected in the CMBS proposals as well.) This possible conflict relates to the timing of recognition of losses. Timing of loss recognition may be managed for least two reasons: (1) it may be part of a reasonable servicing plan to minimize losses by pacing the times at which foreclosed or repossessed property is offered for sale or lease and (2) it may be part of a plan by the servicer to delay the effects of cashflow allocations based upon delinquency, loss or other portfolio performance metrics, thereby allowing the holders of certain subordinated securities to receive distributions that they would not be entitled to receive had the portfolio performance metrics caused the allocation of collections differently. We view the first reason as a wholly legitimate servicing technique that is designed to secure the best outcome for investors. The second reason could be inappropriate manipulation. Indeed, we are aware that there have been allegations in connection with certain RMBS transactions of the use

[32] "Overcollateralization" is a term often used in descriptions of securitizations to depict a form of credit enhancement in which the principal balance of the ABS interests is less than the principal balance of the securitized assets. Overcollateralization may exist at the closing of the securitization or it may be created following the closing of the transaction by the application of excess spread (as we discuss in Part II.B.2(b)(i)(2)) to pay principal on some or all of the more senior ABS interests, thereby reducing the principal balance of the senior ABS interests relative to the principal balance of the securitized assets.

of this second methodology to allow cash to be paid to the most subordinated securities, the holders of which were the servicer or affiliates of the servicer, at times when, if the losses had been reported sooner, one or more of the portfolio performance triggers would have required the allocation of cash from the most subordinated securities to the most senior securities.

As to any questions about the timing of loss recognition, we have four observations. First, we note that a servicer is typically subject to a written agreement that provides a stated servicing standard that the servicer must meet. Second, many transactions provide specific instructions to the servicer regarding actions it must take at specified times; for example, the servicer may be required to begin enforcement against a delinquent borrower at a certain number of days of delinquency, including repossession of the financed asset. Third, if a servicer fails to perform its duties, it is typically subject to replacement and may be liable for damages. We believe that these types of provisions provide effective safeguards against servicer conflicts of interest and, further, that such potential conflicts of interest do not outweigh the benefits of having the transaction serviced by the sponsor or an affiliate, given the heightened familiarity that the sponsor has with the assets and its strong interest in ensuring the overall success of the transaction. Fourth, we note that there are many asset classes where the servicer's employees do not know whether a particular asset has been securitized, which means that their decisions cannot be influenced by such considerations. Retail auto, equipment loan and lease and student loan ABS are all examples. This area is one of those where we caution the Agencies not to assume that RMBS issues exist in all asset classes.

If this request for comment is elicited in connection with attempting to establish national servicing standards through the risk retention requirements, we do not believe that the risk retention requirements are a proper place for the creation of national servicing standards. Instead, we believe that such a goal, if desired, is properly addressed in the Agencies' project to address national servicing standards. In addition, we note that servicing standards are unique to each asset class.

The Agencies have also asked, in requests for comment 36a and 36b, whether the eligible horizontal residual interest be required to be structured as a "Z bond" such that it pays no interest while principal is being paid down on more senior interests.

Many non-mortgage securitizations currently include a first loss tranche that is retained by the sponsor or an affiliate. It is not typical that those first loss tranches are structured as Z bonds or that they receive no interest until the more senior interests have been repaid. The markets, including investors, have accepted these structures and appear to continue to accept them. We believe that requiring that an eligible horizontal residual interest be structured as a Z bond or otherwise requiring that no interest be paid on the eligible horizontal residual interest until the more senior interests have been paid would effect a fundamental change in many securitization structures and to the relationship of sponsors and investors without benefit to any party.

(b) Eligible horizontal residual interest and horizontal cash reserve account

Below we discuss several specific concerns that we believe exist with the Proposed Rules' eligible horizontal residual interest and horizontal cash reserve account. In addition, we refer the Agencies to the discussions of the applicability of the eligible horizontal residual interest to residual interests for securitizations of credit card receivables, retail auto loans, dealer floorplan loans and equipment leases found, respectively, in Parts B, C, E and F of Part VII.

(i) Eligible horizontal residual interest

(1) Single interest

Although not stated expressly, the definition reads in all respects as though the eligible horizontal residual interest is required to be a single ABS interest. Such a concept, if that in fact is what the Agencies intended, is unnecessarily restrictive. We believe that the combination of several ABS interests (and other structural elements, as described in paragraph (2) below), in an aggregate amount equal to the required amount of risk retention, should be permitted as long as those interests are allocated all of the losses, on either a collective or a sequential basis. This change would preserve flexibility in structuring securitizations while still meeting the requirements of the definition of eligible horizontal residual interest.

One area where this flexibility currently exists is revolving asset master trusts that issue multiple series or tranches of ABS interests. These master trusts typically have multiple residual or subordinated interests. As discussed in the considerations relevant to dealer floorplan loans in Part VII.E., each series of dealer floorplan ABS issued will have its own residual interest, which provides credit enhancement just to that series. Similarly, credit card securitizations that use "de-linked" structures, as described in Part VII.B., will also have multiple residual interests.

(2) "All losses" requirement

Clause (1) of the definition of eligible horizontal residual interest requires that this interest be "allocated all losses on the securitized loans." We note that securitization structures (for example, RMBS transactions) may include overcollateralization which the relevant documents require to be reduced by the allocation of losses, but which either is not represented by an ABS interest or is represented by an ABS interest with no principal balance. We believe that, where overcollateralization exists, whether or not it is represented by an ABS interest (with or without a principal balance) it should be recognized as an eligible horizontal residual interest.

In addition, securitization structures may also include excess spread[33] that is used to absorb losses. In such structures, the excess spread may not be represented by an ABS interest or may be represented by an ABS interest with no principal balance. We believe that, where

[33] "Excess spread," which we discuss in more detail in Part IV.A.5 of this letter, is a term often used in descriptions of securitizations to depict a form of credit enhancement in which the underlying assets generate interest income, or spread, at a rate that is expected to exceed the interest expense, servicing fees and other carrying costs incurred by the issuing entity.

losses are absorbed by excess spread, whether or not it is represented by an ABS interest (with or without a principal balance), it should be recognized as an eligible horizontal residual interest.

Likewise, many securitization structures include a combination of overcollateralization and excess spread, in which losses are first absorbed by excess spread and, if losses are greater than the excess spread, then reduce the overcollateralization. There are situations in which neither the overcollateralization nor the excess spread is represented by an ABS interest or by an ABS interest with no principal balance. In those transactions, contractual provisions that require that collections be directed to repay the principal amount of one or more senior securities such that the principal amount of the senior securities is maintained as a fixed percentage of the principal amount or value of the securitized assets. These contractual provisions are designed to maintain a specified amount of overcollateralization that protects the senior securities, yet there is no explicit allocation of losses in these transactions. We believe that, where a structure includes both overcollateralization and excess spread and losses are absorbed by the excess spread and reduce the overcollateralization (whether by maintaining the senior securities as a fixed percentage of the securitized assets or by formal allocation of losses), such a structure should be recognized as an eligible horizontal residual interest.

In addition, in our experience, there are at least two distinct methods used for allocations of cash received in securitizations. The first method does not distinguish between principal and interest collections on the underlying asset (indeed, in securitizations of leases, there is no "principal" ever received on the underlying asset). The second method distinguishes principal collections from interest collections. In the first situation, all collections are paid using a single priority of payments or "waterfall," whereas in the second situation principal collections and interest collections are separated and applied to two or more payment priorities or waterfalls, with excess amounts remaining after the application of those separate waterfalls applied to cover shortfalls in the other waterfall, made available to the holder of the equity interests in the issuer or reinvested in new assets. If the second method is used, we are not sure how losses could be allocated solely to the eligible horizontal residual interest first, because, for example, any interest collections remaining following allocation and payment under the interest collections waterfall would be used to cover shortfalls in the principal collections waterfall, thus absorbing losses to the extent of those remaining interest collections. We believe that such a structure should be recognized as an eligible horizontal residual interest.

Although we have used "overcollateralization" and "excess spread" in this section as though they are well understood, we caution that these terms are general concepts employed for broad-brush descriptive purposes. They simply do not have universally-agreed meanings that can be applied equally across a broad range of transactions. Indeed, a great many transactions that are considered to benefit from either or both of overcollateralization and excess spread do not use those terms in the transaction documents. Further, the concepts cannot be clearly demarcated from each other. For example, in transactions in which the assets either have no principal balance (such as leases) or have a principal balance that is not reflective of value (such as subvened auto loans), the distinction between the two forms of credit enhancement virtually disappears. While we use these terms to highlight our concerns, we believe it would be counterproductive to try to enshrine them in the Final Risk Retention Rules.

A feature of securitizations of equipment leases that highlights the many forms of credit enhancement and their varied roles in absorbing losses from the securitized assets is the treatment of the residual value of the leased equipment. The residual value represents the fair market resale or re-lease value of a piece of equipment at expiration or earlier termination of the lease contract. It is generally the case that investors and rating agencies in equipment lease securitizations do not give explicit credit to this residual value when sizing credit enhancement for a transaction, and upon termination of the lease in accordance with its terms the equipment typically would be released from the lien of the indenture and become the property of the equipment owner.

Nonetheless, this residual value is at risk in the securitization. If an event of default occurs under the related lease, then the servicer has the right to foreclose on the equipment as well as on the lease and the rentals payable thereunder. The proceeds of any sale or re-lease in such circumstances would be applied to repay the ABS interests and would not benefit the securitizer until the more senior ABS interests were paid in full. Further, if an event of default occurs under the transaction, then the holders of the senior ABS interests would typically have the right to retain all proceeds of equipment upon lease termination, whether or not the individual lease had defaulted, for application to cover amounts due on the senior ABS interests.

In a normal equipment lease securitization, some defaults will occur on individual leases, and the residual values of the equipment subject to the defaulted leases will be used to cover losses. But, absent an event of default, the residual values of the equipment subject to other leases will not be applied to cover losses. Neither investors nor rating agencies have demanded such a feature, because they believe the structure to be sufficiently robust. However, the result would be that this form of credit enhancement would not qualify under the "all losses" standard of clause (1).

We believe that is the wrong result. The entirety of the equipment residual values is subject to the claims of senior investors when an event of default occurs in the equipment lease securitization. Accordingly, we believe that this interest constitutes a valid retention of risk by the securitizer. and the aggregate present value, at closing of the transaction, of the residual values should be recognized as an acceptable form of risk retention. We believe that such a structure should be recognized as an eligible horizontal residual interest.

(3) "Most subordinate" requirement

Clause (2) of the definition of eligible horizontal residual interest requires that this interest be "the most subordinated claim to payments of both principal and interest." For some securitization structures, subordination provisions require the payment of interest to all interest-bearing classes of ABS interests, in descending order of priority and then, after payment of interest to the most subordinate interest-bearing ABS interest, provide for the payment of principal to all classes of ABS interests (other than classes with notional balances), again, in descending order of priority. We believe that this arrangement would satisfy clause (2) and request that this understanding be confirmed in the final rules.

In addition, we note, as described above, that securitizations may or may not separate interest and principal collections and may or may not use a single waterfall for the allocation of

those collections. Where principal and interest collections are separated and applied to more than a single waterfall, we are not sure how the "most subordinate" requirement would be applied. For example, the interest collections waterfall would typically pay interest to all interest-bearing ABS interests in a descending order of priority, and any remaining interest collections might be made available to pay shortfalls in the principal collections waterfall. The reverse could also occur. In such a situation, we believe the correct interpretation of this clause is that, so long as the payments allocated to the eligible horizontal residual interest, whether for interest or principal, are the most subordinate in their respective waterfalls, the "most subordinate" requirement would be satisfied. We ask that this interpretation be clarified in the Final Risk Retention Rules.

(4) "Scheduled payments" requirement

Clause (3) of the definition of eligible horizontal residual interest requires that, prior to the repayment of all senior interests, the eligible horizontal residual interest should receive principal payments only from "scheduled payments of principal received." The commentary included in the Proposal describes this requirement as preventing the payment to the holder of an eligible horizontal residual interest of any prepayments of principal (which we understand would include not only full or partial prepayments by borrowers, but also all other unscheduled payments, including insurance, condemnation and liquidation proceeds, to the extent applicable to the asset class).

We believe that this restriction, which seems to us to be written with RMBS transactions in mind, is unnecessary to further the Proposal's intent of requiring that a minimum amount of risk be retained by the sponsor. We believe that this restriction would have the effect of increasing the percentage of the eligible horizontal residual interest above 5% as the related portfolio of assets is reduced. We suggest that all prepayments be treated in the same fashion as scheduled payments and that principal payments on the ABS interests should be allowed to be made on a proportionate basis (i.e., that the holder of the eligible horizontal residual interest may receive such interest's proportionate share of all prepayments of principal received).

Preventing payments of principal to the eligible horizontal residual interest based upon receipt of prepayments would also be impractical or unworkable for many asset classes. Some asset classes, such as credit cards and dealer floorplan loans, do not have scheduled payments of principal; obligors in these asset classes make principal payments based upon minimum required amounts or at their whim (as in credit cards) or based upon sales of inventory (as in dealer floorplan loans). Other asset classes such as auto leases and equipment leases do not have principal payments at all; obligors in these asset classes must make lease payments rather than payments of principal and interest. As a result, this restriction would be impossible to implement for those asset classes. In addition, servicers for other asset classes such as retail auto loans and equipment loans and leases do not distinguish the amount of scheduled principal payments from the amount of prepayments. Regarding retail auto loans, even if a retail auto loan servicer were to track the differences, the format of most auto loans as simple interest receivables would frustrate the effort (because the amount of principal in a simple interest loan varies according to the day on which payment is actually made).

(5) Application to revolving asset master trusts

We believe that securitizers of revolving asset master trusts should be entitled to use the eligible horizontal residual interest as a method of risk retention. However, § _.5(a) and the definition of eligible horizontal residual interest, as drafted, do not seem to contemplate application to revolving asset master trusts. There are a number of problems with trying to apply these concepts to such securitizations. We discuss these problems in Parts VII.B and VII.E of this letter, which are the sections describing asset class considerations for, respectively, credit card loans and dealer floorplan loans (each of which are traditionally securitized in revolving asset master trusts).

(ii) Horizontal cash reserve account

In lieu of retaining an eligible horizontal residual interest, the Proposal permits a sponsor to establish and fund, in cash, at the closing of a securitization transaction, a horizontal cash reserve account in the same amount as the eligible horizontal residual interest, subject to certain conditions. We appreciate the flexibility this alternative provides to sponsors and believe that some sponsors will find it useful. However, we point out below two ways in which we believe that this provision should be improved.

(1) Clause (2)(ii)

Clause (2)(ii) of the description of horizontal cash reserve account permits funds in such an account to be invested in bank accounts "that are fully insured by federal deposit insurance." We are not sure what this clause means, given the existing limits on federal deposit insurance, which limits would generally be far lower than the amount held in a horizontal cash reserve account after the temporary unlimited coverage for transactional accounts expires. Permitting only investments in such small amounts would generally be exceedingly inefficient. We encourage the Agencies, instead, to use a formulation that is often used in securitizations, which is to permit such investments with depository institutions whose deposits are insured by the FDIC, but without reference to the individual account being fully insured.

More generally, we believe that the permitted investments in cash reserve accounts are far too circumscribed. There are widely accepted standards for investments of reserve and spread accounts in transactions that permit a range of extremely safe investments.[34] We believe that the Agencies should permit investments of these types. However, we understand that the Agencies cannot write rules that apply credit rating levels, and we do not suggest that the Agencies specify with precision the types of permitted investments. Accordingly, we suggest that the Agencies

[34] A typical formulation would include, for example, (i) obligations of (or guaranteed by) the United States, (ii) senior debt obligations of Fannie Mae or Freddie Mac or any other U.S.-sponsored agency rated in the highest long-term rating by a rating agency, (iii) FDIC-insured deposits and other unsecured short-term obligations of a U.S. supervised banking or depository institution maturing within 360 days, which obligations have the highest short-term credit rating from a rating agency, (iv) commercial paper maturing within 270 days and having the highest short-term credit rating, (v) money market funds having the highest short-term credit rating, (vi) repurchase obligations secured by assets described in clauses (i) or (ii) above with the highest short-term credit rating, and (vii) any negotiable instruments, securities or other investments with the highest short-term credit rating.

could formulate a rule that would permit high quality, short term investments articulated in a manner that is consistent with the Commission's ongoing efforts to remove credit ratings from its rules while still maintaining appropriate standards of creditworthiness. For example, the Commission is considering a new standard for use in Section 3(a)(41) of the Exchange Act, which is the definition of "mortgage related security," tied to whether the security has "a minimal amount of credit risk."[35] We believe that the Agencies could specify in § _.5(b)(2) that the investments in the reserve account would need to be in investments which the parties have determined to have a minimal amount of credit risk.[36]

(2) Clause (3)(ii)(A)

Clause (3)(ii)(A) of the description of horizontal cash reserve account permits amounts to be released from this account to the sponsor or another person only in respect of interest received and due to the receipt of scheduled payments of principal on the securitized assets. The Commentary describes this requirement as preventing the release of funds due to the receipt of any prepayment of principal. We believe that this restriction is improper because it would have the effect of fixing the amount of the horizontal cash reserve account while the related portfolio of assets is reduced, the result of which is an increase in the percentage that the amount in the horizontal cash reserve account represents of the overall amount of ABS interests issued by the issuing entity. We believe that amounts should be permitted to be released from the horizontal cash reserve account in the same way that releases are made based upon receipt of scheduled payments.

3. L-Shaped risk retention (§ _.6)

As noted in the proposal, the L-shaped risk retention option under § _.6 would allow a securitizer to use a combination of vertical risk retention and horizontal risk retention as a means of satisfying the base risk retention requirement of § _.3.

We commend the Agencies for having proposed L-shaped risk retention as an option to satisfy the base requirement. Nevertheless, we find § _.6 unduly restrictive on several counts. As a general matter, we believe that by permitting securitizers to comply with § _.3 by choosing from a menu of risk retention alternatives, the Agencies have implicitly made the determination that, for the purpose of aligning incentives, no particular single risk retention option is, in all cases, materially more or less suitable than any other. By extension, then, there is no compelling reason to believe that any combination of permitted options that results in retention of 5% of a transaction's credit risk should be less effective at aligning incentives than any one option by itself. As we discuss in Part III.A., securitizers and investors might well agree on the appropriateness of a variety of possible combinations. § _.6 as proposed does not contemplate any combination other than vertical and horizontal interests and does not even permit a combination that includes the seller's interest as a vertical component. We believe that

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[35] See Commission, Release No. 34-64352, Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, 76 Fed. Reg. 26550 (2011).

[36] We note, though, that while the Agencies may not mandate credit ratings standards, we believe that securitizers and investors could continue to utilize such standards in their securitization documents, if they so chose.

expanding the proposal to include additional combinations would make it substantially more useful.

The practical utility of the proposed rule is also minimized by its limitation to combinations of two equally sized interests. The Proposal explains that the purpose of requiring the equal vertical and horizontal components is to help ensure that each component is large enough to affect the sponsor's incentives and to help align the incentives of the sponsor and investors. In addition, requiring that each component represent 50 percent of the total minimum risk retention requirement should assist investors and the Agencies with monitoring compliance with the proposed rules. [37]

The two purported justifications are unpersuasive. With respect to the first, requiring a minimum investment in any type of retained interest is inconsistent with several other aspects of the Proposal, including those relating to allocations to originators. As noted in Part IV.A. of this letter, a securitizer satisfying its base risk retention obligation under either proposed § _.4 or § _.5 would be permitted to allocate a portion of the risk retention requirement contractually to certain substantial originators, subject to the constraints set forth in § _.13. As a consequence of these allocations, each such originator might ultimately hold as little as 1% of the interest in the pool, and the sponsor itself might end up retaining little or no interest.[38] Nevertheless, the aggregate retained interest is not reduced by the allocations – nor should it be – and the Agencies would seem to have concluded that the incentive alignment resulting from the various conceivable allocation scenarios would not be materially more or less effective than retention either solely by the sponsor or by virtue of any particular allocation.

It is similarly not obvious why, under § _.6, permitting any deviation from an equal division between a vertical interest and a horizontal interest should operate to diminish the sponsor's incentives. We believe that the precise allocation between retained vertical and horizontal interests is best left to those parties, absent convincing evidence that a 50-50 division is, in all cases, ideal for both the sponsor and the investors.

Just as it is likely that certain sponsors will, in time, settle on a particular retention-risk option that they deem appropriate for themselves and their asset classes – whether vertical slice, horizontal slice, representative sample, or otherwise – there is reason to believe that sponsors that select the L-shaped risk retention option will eventually settle on particular combinations that are similarly appropriate for their purposes and that tend not to vary considerably from transaction to transaction. Therefore, we also believe that concerns about monitoring compliance are largely unwarranted. In any event, the possible mix of combinations under § _.6 will certainly be no more complex than the universe of possible sponsor-originator allocations under § _.13.

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[37] Proposal, at 24104.

[38] For example, in a securitization transaction with three 25% originators and one 20% originator, with proportional allocations of a 5% vertical interest that would otherwise be held by the sponsor, the three 25% originators could each be allocated 1.25%, the 20% originator could be allocated 1%, and the sponsor would retain the remainder (i.e., 0.25%).

Below, we have set forth a proposed modification of § _.6, which we have renamed "Combination risk retention" to reflect the enhanced set of options. Our proposal would permit the base risk retention requirement § _.3 to be satisfied by retention, in appropriate circumstances, of a combination of a vertical interest, a horizontal interest, a seller's interest, a representative sample and a third-party purchaser interest. As we have noted elsewhere in this letter,[39] we believe that the various risk retention options should properly be options of the securitizer rather than of the sponsor, and our proposed modification of § _.6 reflects that belief. In Appendix B, we have reproduced the proposed modification with annotations that explain certain terms and that suggest an additional possible modification to accommodate more sophisticated options.

§ _.6 Combination risk retention.

(a) General requirement. At the closing of the securitization transaction, a combination of two or more of the following interests is retained by the persons referenced below:

(1) The securitizer retains a percentage (the "Vertical Percentage") of each class of ABS interests in the issuing entity issued as part of the securitization transaction;
(2) The securitizer (i) retains an eligible horizontal residual interest in the issuing entity, (ii) establishes and funds in cash a horizontal cash reserve account that meets all of the requirements of § __.5(b) of this part, or (iii) satisfies both clauses (i) and (ii), in an amount (which, in the case of clause (iii), will be an aggregate amount) that in any of the three foregoing cases is equal to a percentage (the "Horizontal Percentage") of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than any portion of such ABS interests that the securitizer retains pursuant to paragraph (1) of this section;
(3) Until all ABS interests in the issuing entity are paid in full, the securitizer retains a seller's interest equal to a percentage (the "Seller's Interest Percentage") of the unpaid principal balance of all the assets owned or held by the issuing entity;
(4) The securitizer retains ownership, as a representative sample, of a percentage (the "Representative Sample Percentage") of the unpaid principal balance of all the securitized assets in the securitization transaction; and
(5) A third party purchases an eligible horizontal residual interest in the issuing entity in an amount that is equal to a percentage (the "Third Party Percentage") of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than any portion of such ABS interests that the securitizer retains pursuant to paragraph (1) of this section;

provided that

(A) the sum of (i) the Vertical Percentage, (ii) the Horizontal Percentage, (iii) the Seller's Interest Percentage, (iv) the Third Party Percentage and (v) the product of (x) 0.95 and (y) the Representative Sample Percentage minus

[39] See, for example, Part II.A.2 of this letter.

(B) the percentage-equivalent of the product of (i) the Vertical Percentage and (ii) the sum of the Horizontal Percentage and the Third Party Percentage

is not less than five percent.

(b) Additional requirements. A securitizer using paragraph (a)(1), (a)(2), (a)(3), (a)(4) or (a)(5) of this section shall comply with all of the applicable requirements respectively set forth in § _.4, § _.5, § _.7, § _.8 and § _.10 of this part, other than:

(1) In the case of paragraphs (a)(1), (a)(2) or (a)(3) of this section, the five percent requirement of § _.4(a), § _.5(a) or § _.7(a), respectively, of this part;
(2) In the case of paragraph (a)(4) of this section, the 5.264 percent requirement of § _.8(a)(1) of this part and the 5 percent requirement of § _.8(b)(2)(ii) of this part; and
(3) In the case of paragraph (a)(5) of this section, the five percent requirement implicit in the reference (in § _.10(a) of this part) to § _.5(a) of this part.

(c) Calculations. Each of the Vertical Percentage, the Horizontal Percentage, the Seller's Interest Percentage, the Representative Sample Percentage and the Third Party Percentage, as well as the product and the percentage-equivalent in the proviso to paragraph (a) of this section, shall be expressed (or, in the case of the product and the percentage-equivalent in the proviso, rounded) to not more than three decimal places.

4. Revolving asset master trusts (seller's interest) (§ _.7)

(a) Generally

The Proposal provides that retention of a "seller's interest" of not less than 5% of the unpaid principal balance of all of the assets owned or held by a revolving asset master trust will be a permissible form of risk retention. A seller's interest in a revolving asset master trust is generally a fractional undivided interest in the asset pool which entitles its holder to be allocated collections and losses on the loans or other extensions of credit at a priority that is equivalent or subordinate to the allocation to each series of ABS issued by the master trust. Given the characteristics of a seller's interest in a revolving asset master trust, it is appropriate for a securitizer to be able to satisfy its base risk retention requirement by retaining the seller's interest.

The Commentary provides that the seller's interest option was included "in light of and to accommodate" revolving asset master trust transactions, such as credit card receivable and floorplan loan securitizations, and continues that "The definition of a seller's interest and a revolving asset master trust are intended to be consistent with market practices"[40] Although we generally agree with the approach taken in the Proposal to include the seller's interest as a permitted form of risk retention, the seller's interest alternative will need to be refined in order to accommodate existing revolving asset master trust transactions. As proposed, the seller's interest definition and the requirements for the exemption set forth is §_.7 of the Proposal are not

[40] Proposal, at 24104.

consistent with the features of a seller's interest in outstanding securitization transactions. Our comments regarding § _.7 and the related definitions are intended to provide clarifications and drafting suggestions to help the Final Risk Retention Rules achieve the Agencies' objectives in crafting this risk retention option.

(b) Definition of seller's interest

"Seller's interest" is defined in § _.2 of the Proposal as "an ABS interest (1) in all of the assets that: (i) Are owned or held by the issuing entity; and (ii) Do not collateralize any other ABS interests issued by the issuing entity; (2) That is pari passu with all other ABS interests issued by the issuing entity with respect to the allocation of all payments and losses prior to an early amortization event (as defined in the transaction documents); and (3) That adjusts for fluctuations in the outstanding principal balances of the securitized assets." With respect to clause (1), we note that typically the seller's interest represents a percentage interest in the receivables in a revolving trust but does not represent a percentage interest in certain assets that are specifically allocated to investors, such as pre-funding accounts, reserve accounts or interest rate swaps or caps. As defined in the Proposal, "asset" means a self-liquidating financial asset (including but not limited to a loan, lease, mortgage, or receivable)." If, in the context of the seller's interest definition, "assets" refers only to the receivables, loans or other extensions of credit that arise under the applicable revolving accounts, then the use of such term in clause (1) is not problematic. However, if it is intended to encompass other trust property, such as cash equivalent investments of funds in trust bank accounts, such term would be inconsistent with market practice related to the allocation of trust property to a seller's interest.

Clause (2) of the definition of "seller's interest" also is inconsistent with the terms of seller's interests in the current market in that it requires the seller's interest to be pari passu with all other ABS interests "prior to an early amortization event." A seller's interest is generally allocated whereby collections and losses equal 100% minus the amount allocated to investors. For series or tranches of investor securities in a revolving period, the allocation is generally pro rata based upon the outstanding invested amount of the series or tranche over the total amount of principal receivables in the issuing entity. During an amortization or accumulation period, which could be a scheduled amortization or accumulation period or an early amortization or accumulation period, a series or tranche of investor securities is allocated principal collections, and in some cases finance charge collections, on a fixed/floating allocation basis, using the invested amount of the relevant investor securities at the end of the revolving period as the numerator and the aggregate principal receivables in the issuing entity as the denominator. Because revolving asset master trusts may have many series and tranches outstanding at any given time, some investor securities will be allocated collections and losses on a pro rata, floating allocation basis while others will be allocated collections and losses on a fixed/floating basis. Therefore, when any other ABS interest is not in its revolving period, the seller's interest will not be pari passu with respect to the allocation of all payments, and this situation will occur regularly as the other ABS interests are repaid. This inconsistency with current market practice could be addressed if the phrase "that is pari passu with" is revised to read "that is pari passu with or subordinate to."

In addition, during a revolving period the principal collections allocated to a series or tranche will not be paid to the holders of investor securities of that series or tranche. Instead,

such collections will either be used to pay down outstanding securities of another series or tranche or be paid to the holder of the seller's interest in consideration for the continued transfer of new principal receivables and maintenance at its then current level of the invested amount of the series or tranche to which the collections were initially allocated.

Finally, with respect to the requirement that the allocation to the seller's interest should be pari passu with the allocation to all other ABS interests, we note that the discussions above generally describe the allocation to a series or tranche of investor securities. However, once that allocation takes place, payments are made to different classes of securities based on their seniority in the capital structure of the series. There will likely be senior, mezzanine and junior securities in a particular series. These securities will not be pari passu with each other and, to the extent that they are each viewed as a separate ABS interest under the rules, they will not individually be pari passu with the seller's interest. The focus of § _.7 should be on the allocation of collections and losses to the seller's interest as compared with the allocation of collections and losses to the asset-backed securities issued by the master trust in each series viewed collectively rather than individually by class.

For these reasons, to reflect current structures better, we suggest revising clause (2) of the definition of "seller's interest" to read *"That is allocated collections on the loans or other extensions of credit on a basis that is pari passu with or subordinate to the allocations to each series of asset-backed securities issued by the issuing entity."*

Clause (3) correctly reflects the current market practice of adjusting a seller's interest generally for fluctuations in the outstanding principal balance of the loans or other extensions of credit that arise under revolving accounts. However, this fundamental characteristic of a seller's interest creates problems for disclosure of the amount of the seller's interest in future periods, as we discuss in Part II.4(d)(ii) below.

For ease of reference, taking into consideration all of the changes we recommend above, the definition of "seller's interest" in the Final Risk Retention Rules would read as follows:

> *<u>Seller's interest</u> means an ABS interest or interests:*
>
> *(1) In all of the loans or other extensions of credit that arise under the revolving accounts and other assets as may be specified in the transaction documents that:*
>
> > *(i) Are owned by or transferred to the issuing entity; and*
> >
> > *(ii) Are not allocated to any other ABS interest issued by the issuing entity;*
>
> *(2) That is allocated collections on the loans or other extensions of credit on a basis that is pari passu with or subordinate to the allocations to each series of asset-backed securities issued by the issuing entity; and*
>
> *(3) That adjusts for fluctuations in the outstanding principal balance of the securitized assets.*

(c) Definition of revolving asset master trust

We also believe that the definition of "revolving asset master trust" in § _.2 raises some concerns. The definition of "revolving asset master trust" provides that the trust must be "established to issue more than one series of asset-backed securities." In recent years most large issuers of credit card ABS have used a de-linked issuance trust structure under which multiple tranches of notes of a single series are issued from time to time. Issuances are made periodically, and notes of different classes are issued with scheduled repayment dates and then repaid when they reach their repayment date while other notes issued over time remain outstanding. Although issuance trust documentation usually provides flexibility to issue more than one series, an issuance trust may be established with the intent just to issue notes over time from a single series.

It would therefore be consistent with market practices to modify clause (2) of the definition of "revolving asset master trust" to provide as follows: "Established to issue, on multiple issuance dates, one or more series or tranches of asset-backed securities…"

Clause (2) of the definition of "revolving asset master trust" also provides that all of the asset-backed securities issued by the master trust must be "collateralized by a single pool of revolving securitized assets that are expected to change in composition over time." This requirement is inconsistent with structures used to securitize revolving assets from multiple legacy pools. Over the past 25 years, credit card program structures evolved from common law stand-alone trusts to common law master trusts and then to the use of statutory trusts that issue securities in the form of notes. Many credit card ABS programs include a legacy master trust that holds receivables and issues a collateral certificate to a statutory trust that then issues the notes that are sold to investors. In some cases the dollar amount of the collateral certificate is increased at the time of each issuance by the note issuance trust to match the amount of notes outstanding, and in other cases the collateral certificate may be held by the note issuance trust in an amount at least equal to, but often in excess of, the principal amount of notes outstanding. In some cases receivables are held at the statutory trust level as well as the master trust level. A statutory trust in such a structure may hold both collateral certificates representing interests in one or more master trusts and a pool of receivables. A sponsor may have acquired credit card portfolios with receivables securitized through pre-existing master trusts and therefore have multiple legacy master trusts that issue collateral certificates to a single statutory trust.[41]

Because an issuance trust may hold collateral certificates representing interests in more than one underlying master trust and may also directly hold receivables, we recommend that this portion of clause (2) of the revolving master trust definition be revised to delete the words *"a single pool of."*

Based on all the changes discussed above, we recommend that the definition of "revolving asset master trust" included in the Final Risk Retention Rules read as follows:

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[41] As discussed in Part V.A.4, we recommend that in a structure involving multiple trusts with respect to which certain conditions are satisfied, those multiple trusts should be treated as a single "issuing entity" for purposes of the rules.

Revolving asset master trust means an issuing entity that is:

(1) A master trust; and

(2) Established to issue on multiple issuance dates one or more series or tranche of asset-backed securities all of which are collateralized primarily by revolving securitized assets that are expected to change in composition over time.

(d) Seller's interest retention alternative

(i) Retention requirement

The risk retention alternative for revolving asset master trusts set forth in § _.7 of the Proposal begins by requiring that "At the closing of the securitization transaction and until all ABS interests in the issuing entity are paid in full, the sponsor retains a seller's interest of not less than five percent of the unpaid principal balance of all the assets owned or held by the issuing entity." As an initial matter we note that a primary characteristic of a revolving asset master trust is that it will issue multiple series or tranches of securities over time. The phrase "at the closing of the securitization transaction" appears to assume a single closing. Although this may not have been the Agencies' intent, it is important here and throughout the Proposal that consideration be given to this fundamental characteristic of revolving asset master trusts.[42]

To address this issue we suggest that the initial point of reference should be to "the closing of each issuance of securities by the issuing entity. . ."

Unlike the vertical risk retention and horizontal risk retention requirements, the seller's interest risk retention requirement for revolving asset master trusts is ongoing and must be met "until all ABS interests in the issuing entity are paid in full." We note that a revolving account may be closed at any time in the future and that for regulatory, competitive, financial or other reasons an originator might close all of the accounts that are designated to have their receivables included in an asset pool. If all of the accounts designated to have their receivables transferred to an asset pool are closed, the revolving asset master trust would become equivalent to an amortizing trust with a fixed pool of loans. As that pool liquidates, dilution – which includes reversed charges related to rebates, refunds, adjustments, returned goods and fraud — would continue to be allocated to and absorbed by the seller's interest. In these circumstances, the seller's interest, while performing its function in the structure, could be reduced to a level below the 5% requirement. Consideration should be given to allowing a seller's interest to continue to be an accepted form of risk retention after a revolving pool becomes a fixed pool and when the seller's interest, like an eligible horizontal residual interest, may be reduced to a level below the 5% requirement while other ABS interests remain outstanding.

Section _.7 requires the risk retention to be held by the sponsor. Many revolving asset master trust transactions are structured as multi-step transactions with an intermediate special purpose depositor between the sponsor and the master trust. If the depositor is not also the

[42] See, for example, the discussion in Part VII.B with respect to issues that result in attempting to use the vertical or horizontal risk retention options for existing revolving asset master trusts such as a credit card master trust.

sponsor, then the sponsor will not be the holder of the seller's interest. In a multi-step transaction the sponsor transfers receivables to the depositor in exchange for cash and other consideration and the depositor transfers the receivables to the master trust in exchange for the seller's interest or, after the initial transfer, an increase in the outstanding amount of the seller's interest. The increase in the size of the seller's interest is a form of consideration to the depositor for the transfer of the additional receivables. The Commentary notes that the Dodd-Frank Act applies the risk retention requirement to a "securitizer" defined in the Dodd-Frank Act to include an issuer of asset-backed securities which the Commentary notes would mean, for several purposes under the federal securities laws, the depositor.[43] In the context of a revolving asset master trust, it is appropriate and necessary for the seller's interest to be held by the depositor and the language of § _.7 should be modified to allow this. As with other asset classes, a multi-step structure is generally used in revolving asset classes to allow for a transfer of assets from an originator to a special purpose entity in a transaction that will qualify as a true sale for legal property rights purposes. As discussed in Part II.A.2 of this letter, requiring the seller's interest to be held by the sponsor could jeopardize the ability to obtain a legal true sale opinion; this could happen if the seller's interest were viewed as embodying too much of the risk of loss on the asset pool through the right of the holder of the seller's interest to receive excess spread or otherwise. As with other potential changes to existing master trust structures, it could be difficult or impossible to amend an existing multi-step revolving asset master trust transaction to remove the separate depositor from the structure or move the seller's interest to the sponsor.

Section _7(a) requires the retention of "a seller's interest of not less than five percent of the unpaid principal balance of *all the assets* owned or held by the issuing entity" (emphasis added). Some revolving asset master trust transactions include a seller's interest requirement based upon the amount of investor securities that are outstanding rather than based upon the unpaid principal balance of the receivables. In other programs, the required seller's interest is based on a percentage of the aggregate amount of principal receivables outstanding in the trust, but it would not include the balance of all trust property owned or held by the issuing entity, that is dedicated to a specific series or tranche, such as pre-funding accounts, reserve accounts or interest rate swaps or caps.[44]

To accommodate such variations in current master trust structures, we suggest that this portion of § _.7 be revised to read: "the sponsor or depositor retain a seller's interest of not less than five percent of the aggregate outstanding principal amount of investor interests."

The Proposal also requires that all of the securitized assets must be "loans or other extensions of credit that arise under revolving accounts." As noted above, the assets of a typical master trust will include trust bank accounts that provide collateral or enhancement for some series or tranches of notes, such as pre-funding accounts and reserve accounts, and derivatives such as interest rate swaps or caps and currency swaps. If "securitized assets" is limited, through the inclusion of the definition of "assets" as discussed above, to the receivables, loans or other extensions of credit that are self-liquidating financial assets, then this language would generally work. However, if any other assets of the trust, such as investments of funds in trust bank

[43] Proposal, at 24099.

[44] If "assets" as used in § 7(a) refers solely to receivables, then this issue has less relevance.

accounts, were considered "securitized assets" for purposes of clause (a)(2) of § _.7, then current transactions would not satisfy this standard.[45]

Therefore, we recommend that this portion of §__.7 be revised to read: "The assets of the master trust consist primarily of loans or other extensions of credit that arise under revolving accounts."

In sum, we recommend that § _.7(a) be revised as follows:

> *§ .7 Revolving asset master trusts.*
>
> *(a) General requirement. At the closing of the securitization transaction and until all ABS interests in the issuing entity are paid in full, the securitizer retains a seller's interest of not less than five percent of the aggregate outstanding principal amount of investor interests provided that:*
>
> > *(1) The issuing entity is a revolving asset master trust; and*
> >
> > *(2) The assets of the master trust consist primarily of loans or other extensions of credit that arise under revolving accounts.*

(ii) Disclosure requirement

The disclosure requirements for the seller's interest risk retention alternative should be revised to be consistent with existing structures and any changes made in response to the comments above. Under the Proposal, a sponsor is required to disclose, prior to closing, the amount of the seller's interest which will be retained at closing. If the amount of the seller's interest required to be retained with respect to any securitization transaction is tied to the amount of the investor interest to be issued, as discussed above, then it would be possible for the securitizer to disclose the amount of the seller's interest required to be retained for the issuance of that tranche or series and the aggregate amount required to be retained on the closing date. If, however, the amount of the seller's interest that is required to be retained is based on the unpaid principal balance of all the assets owned or held by the issuing entity as set forth in the Proposal, then it will not be possible to determine prior to closing the amount required to be retained at closing, and it will not be possible to disclose the dollar amount that is required to be retained thereafter because the pool will continually fluctuate.

The requirement to disclose the material assumptions and methodology used in determining the aggregate dollar amount of ABS interests issued by the issuing entity does not appear to have relevance to the seller's interest risk retention alternative. As proposed, the required risk retention is 5% of the unpaid principal balance of all of the assets owned or held by the issuing entity. Disclosure of the aggregate dollar amount of ABS interests issued by the issuing entity should not be required, because, as proposed, the dollar amount of ABS interests issued by the issuing entity is not used in calculating the required retention. Even if, as we

[45] For example, amounts deposited in a premium capture cash reserve accounts that are invested in U.S. treasury securities could be viewed as self-liquidating financial assets that could constitute "assets."

suggest, the seller's interest requirement is revised to be calculated on the outstanding principal amount of the ABS interests, the disclosure requirement in paragraph (3) would still not be relevant; therefore, we recommend that paragraph (3) be removed from § _.7.

(iii) Transition issues

Most revolving asset master trusts that will need to comply with the risk retention rules exist currently and are governed by documentation that has been negotiated with the parties thereto and investors over time. If changes are not made to the definition of "seller's interest" and the § _.7 requirements for revolving asset master trusts, as described above, existing master trusts would need to be restructured to comply with the risk retention requirement. In our experience, the seller's interest as defined in § _.7 is more favorable to its holder than the outstanding seller's interests in existing revolving asset master trusts because the allocations to existing seller's interests are more subordinated than is permitted under the Proposed Rules. A securitizer wishing to avail itself of the proposed seller's interest risk retention alternative must amend its existing documentation in a manner that would be adverse to the interest of holders of outstanding investor securities, making investor consents difficult or impossible to obtain. Therefore, it is important for the Agencies to achieve a workable seller's interest risk retention option that is consistent with market practices and, accordingly, will accommodate existing programs and structures.

5. Representative sample (§ _.8)

The Proposed Rules also permit a sponsor of a securitization transaction to meet the risk retention requirements by retaining a randomly selected representative sample of assets that is equivalent, in all material respects, to the assets that are transferred to the issuing entity and securitized, subject to specified conditions. The Agencies posit that, by retaining a randomly selected representative sample of assets, the sponsor retains exposure to substantially the same credit risk as the ABS investors, thereby providing the sponsor with incentives to originate high quality assets and helping align the sponsor's and investors' interests in the ABS.[46] Although we appreciate the Agencies' attempt to include a form of risk retention that is being used in the securitization market,[47] the Proposal, as currently written, does not, in our view, provide a workable alternative risk retention method for many types of assets and transactions.

The Proposal starts with a relatively straight-forward random selection of 5% of the unpaid principal balance of the assets in the pool to be securitized, but the other requirements proposed to ensure that the sample selected is truly representative are inconsistent with random selection techniques in general and are extremely difficult (if not impossible) to achieve for many types of assets and transactions (including, for example, RMBS transactions). Some aspects of the representative sample approach are particularly troublesome, including the limitation on the minimum size of the pool of assets from which the representative sample must

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[46] Proposal, at 24105.

[47] The Agencies note that this form of risk retention has been used in securitizations of automobile loans where the loans are not originated purely for securitization but are securitized as part of the sponsor's overall funding strategy. Proposal, at 24105.

be drawn, which effectively precludes its use for smaller issuers and issuers of ABS backed by pools with a relatively small number of higher balance assets such as commercial mortgage loans or jumbo prime residential mortgage loans, and the requirements relating to the servicing of the assets and the disclosures to investors concerning the sample. For example, the restriction against the servicer's servicing personnel being able to know the identity of the owner of the retained (versus the securitized) assets could be problematic for certain asset classes. This requirement would not be problematic in any of the auto asset classes, because owner consent is never required for servicing decisions and it is in fact the case that the parties "in the field" that are making servicing decisions do not know what entity owns the loans. On the other hand, the restriction could hamper a servicer's ability to service commercial or residential mortgage loans in situations in which the servicing personnel have limited authority with respect to loss mitigation activities and would need to obtain the consent or approval of the owner for such actions as a short sale of a delinquent mortgage loan, a modification of the mortgage loan or, in the case of a commercial mortgage loan, a partial release of collateral. At the very least, those servicers would be obligated to separate their actual servicing operations from those relating to the remittance and reporting with respect to the assets, while it would be impossible for the servicer to obtain input from the owner of the retained assets for approval of servicing decisions that the servicer did not have the contractual authority to make independently.

Notwithstanding our concerns, § _.8 may work well for some asset classes or securitization structures and we believe it should be included in the menu of risk retention options available to sponsors in the Final Risk Retention Rules. We recognize that the requirements of § _.8 are designed to ensure that the representative sample retained will be truly representative of the securitized assets. As we discuss in more detail in Part III.B.1. of this letter regarding vertical risk retention, a practical additional alternative to the representative sample approach would be to permit a securitizer (either directly or through the related originator of the assets) to meet the 5% risk retention requirement by retaining a 5% pro rata participation in each asset included in the securitized pool.

6. Asset-backed commercial paper conduits (§ _.9)

Asset-backed commercial paper ("ABCP") programs[48] provide many U.S. and international businesses with efficient access to low-cost financing through the capital markets, and we appreciate the Agencies' special attention to ABCP's unique features in drafting the Proposed Rules.[49] Prior to implementation of the Proposed Rules, ABCP program sponsors already retained significant exposure to the assets funded by these programs, as did the originators of those assets (either directly or through affiliates). ABCP programs fund a broad

[48] This Part II.B.6 and our proposals set forth herein apply to traditional multi-seller conduits described in Part 4 of Appendix A. "ABCP," as used in this Part II.B.6, does not include commercial paper that may be issued by structured investment vehicles, market value CDOs and similar issuers, which is supported primarily by the market value of the securitized assets rather than by credit enhancement and liquidity support commitments from sponsoring banks or financial institutions.

[49] See Part C of the American Securitization Forum's June 10, 2011 comment letter to the Agencies regarding the Proposed Rules (the "ASF Letter"), which provides an excellent summary of ABCP's importance to U.S. and global businesses as well as compelling policy arguments for excluding ABCP from the proposed risk retention requirements altogether.

range of financial assets, including trade receivables from mainstream manufacturing, retail and service companies; health care receivables; credit card receivables or credit card backed notes or certificates; equipment loan or lease receivables; and a variety of other assets. To accommodate these assets and their originator-sellers, ABCP programs must offer varied and flexible financing structures. As with other aspects of the Proposed Rules, the proposals for ABCP are too rigid to permit many of the current uses of these programs, even where such programs include robust risk retention by both the originator or transferor of the assets and the sponsor of the ABCP conduit. If the Proposed Rules were adopted in their current form, the adverse effects of such a limited approach would likely be felt most strongly by mainstream U.S. businesses that would lose a much-needed, cost-effective funding source.

Moreover, as discussed in Part II.B.6(a) of this letter, our analysis of the Dodd-Frank Act and the Exchange Act leaves substantial doubt as to whether the Agencies have the statutory authority to subject most ABCP to any of the risk retention requirements set forth in the Proposed Rules. If, notwithstanding that analysis, the Agencies impose risk retention requirements on all ABCP programs, the substantial changes to the Proposed Rules described in Parts II.B.6(b) through (d) below will be necessary to avoid severely disrupting (or eliminating altogether) the U.S. ABCP market and the efficient financing this market provides to businesses across the globe and, particularly, in the U.S.

(a) The Agencies may lack statutory authority to impose risk retention requirements with respect to certain ABCP and its sponsors

ABCP fundamentally differs from many other securities covered by the Proposed Rules in many ways, including the following: (i) ABCP sponsors retain a substantial portion (equal to or very near 100%) of the credit risk associated with the ABCP by providing both liquidity and credit enhancement commitments;[50] (ii) ABCP-funded transactions are privately negotiated and structured to provide flexible and efficient funding for many middle-market and small businesses that would otherwise lack access to the capital markets;[51] (iii) ABCP is issued with short initial maturities not exceeding 397 days and, more often, less than 270 days;[52] (iv) ABCP's maturity is rarely matched to the maturity of the issuer's underlying financial assets;[53] and (v) due to their substantial "skin in the game," ABCP sponsors already perform robust due diligence and structuring to ensure the safety of ABCP-funded transactions.[54] For these reasons, in our view, there is no need for the Agencies to impose potentially burdensome risk retention regulations on ABCP conduits and their sponsors, and we do not believe that the Dodd-Frank Act directs the Agencies to do so.

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[50] See Part II.B.6(c)(iii) below.

[51] See Part II.B.6(b)(i) below.

[52] See Part II.B.6(d)(ii) below.

[53] See Part II.B.6(a)(i) below.

[54] See Part II.B.6(b)(i) below.

In our analysis of the Dodd-Frank Act and its amendments to the Exchange Act, we were unable to locate any clear statutory authority for the Proposed Rules' imposition of risk retention requirements with respect to certain ABCP and its sponsoring financial institutions. Section 15G(b) requires the Agencies to prescribe risk retention requirements applicable to "securitizers" (as defined in Section 15G(a)(3)) of "asset-backed securities" (as defined in Section 3(a)(77) of the Exchange Act). By imposing specific risk retention obligations on all ABCP conduits and their financial institution sponsors, the Proposal appears to assume that all ABCP notes constitute asset-backed securities and that all ABCP sponsors constitute securitizers within the meaning of the Exchange Act. However, we believe that these assumptions deserve further consideration in light of our analysis below, which concludes that (i) many ABCP notes (perhaps the vast majority) are not "asset-backed securities" within the meaning of Section 3(a)(77) of the Exchange Act and (ii) most financial institutions sponsoring ABCP programs are not "securitizers" within the meaning of Section 15G(a)(3). We therefore urge the Agencies to expressly exclude from the Proposed Rules' risk retention requirements any ABCP transaction for which Section 15G(b) does not provide statutory authority.

(i) ABCP with an initial maturity of nine months or less does not constitute an "asset-backed security" because it is excluded from the Exchange Act's definition of "security"

Section 15G(b) provides the Agencies with statutory authority to impose risk retention rules with respect to "asset-backed securities" as defined in Section 3(a)(77) of the Exchange Act. Although the Proposal purports to impose risk retention obligations with respect to the broad universe of ABCP, most ABCP does not appear to constitute an asset-backed security within the meaning of the authorizing legislation.

Section 3(a)(77) of the Exchange Act defines "asset-backed security," which in turn references "security," a term separately defined in Section 3(a)(10) of the Exchange Act. By operation of those definitions, if an ABCP note is not a "security" under Section 3(a)(10), it is not an "asset-backed security" under Section 3(a)(77). Section 3(a)(10) excludes from the definition of "security" "any *note*, draft, bill of exchange, or banker's acceptance *which has a maturity at the time of issuance of not exceeding nine months*, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited" (emphasis added). Although a comprehensive review of the Exchange Act's definition of security is beyond the scope of this letter, we note that there appears to be no authority that limits the broad exclusion of commercial paper and other short-term notes from the definition of security. There have been a number of court decisions that limit the types of commercial paper that fall within the exclusion, but all of those cases relate to alleged fraud under the Federal securities laws,[55] and the Proposed Rules'

[55] To avoid the antifraud provisions of the Federal securities laws, commercial paper must have a maturity of less than nine months and must also be (1) prime quality negotiable commercial paper, (2) of a type not ordinarily purchased by the general public, that is (3) paper issued to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve Banks. See, e.g., *Securities and Exchange Commission v. American Board of Trade, Inc.*, 751 F.2d 529 (Second Cir. 1984). Because ABCP issued by traditional multi-seller conduits typically meets these requirements, it would not be considered a security under Section 3(a)(10) of the Exchange Act even in the application of the antifraud provisions of the Exchange Act.

risk retention requirements are not designed or intended to function as antifraud provisions. ABCP notes are most often issued with maturities of less than 270 days (or nine months), and Section 3(a)(10) of the Exchange Act excludes such ABCP notes from its definition of "security." Therefore, such ABCP does not constitute an "asset-backed security" under Section 3(a)(77) of the Exchange Act and should be excluded from the Proposed Rules' risk retention requirements.[56]

In addition, strong policy reasons support the exclusion of short-term ABCP from the Exchange Act's definitions of "security" and "asset-backed security" as well as from the Proposed Rules' risk retention requirements. ABCP is not primarily dependent upon cash flows from the issuers' self-liquidating financial assets. Rather, because the maturity of ABCP is rarely matched to the maturity of the issuers' underlying assets, ABCP investors rely primarily on the liquidity support and credit enhancement that ABCP sponsors provide to their conduits, which is available to pay the ABCP in full at maturity.[57] Even absent the Proposed Rules' risk retention requirements, the "skin-in-the-game" retained by ABCP sponsors through their liquidity and credit enhancement commitments ensures that ABCP sponsors have strong incentives to structure safe transactions with adequate reserves and risk retained by the relevant originator-sellers. Little if any purpose seems to be served by imposing the Proposed Rules' stringent risk retention and disclosure requirements on ABCP conduit sponsors that already bear the brunt of the risk associated with their ABCP conduit programs.

(ii) Most financial institutions sponsoring ABCP conduits are not "securitizers" under the definition provided in Section 15G(a)(3)

Section 15G(b) provides the Agencies with statutory authority to impose risk retention rules with respect to "securitizers" of asset-backed securities, but Section 15G(b) does not appear to authorize imposing risk retention obligations on the many financial institutions sponsoring ABCP programs that are not securitizers. Section 15G(a)(3) defines a "securitizer" as "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." We do not believe Section 15G(b) authorizes the imposition of risk retention rules on any person or entity that falls outside such Section's definition of securitizer.

As described in the Proposal, the financial institutions providing liquidity and credit support to most ABCP conduits do not issue the ABCP notes and rarely sell or transfer assets

[56] We note that the Proposal's definition of "ABCP" is limited to asset-backed commercial paper that "has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited," which mirrors the language in Section 3(a)(10)'s exclusion from the definition of "security." Therefore, all notes meeting the current definition of "ABCP" in the Proposal should be exempt from the Proposal's risk retention requirements.

[57] See Part II.B.6(b)(i) below.

(directly or indirectly or through affiliates) to their sponsored conduits.[58] Rather, most ABCP conduits acquire all of their assets from third-party originator-sellers (or their intermediate SPVs) not affiliated with the conduits or their sponsoring financial institutions. Because such financial institutions neither issue ABCP nor sell or transfer assets to their sponsored ABCP issuers, they do not constitute securitizers within the meaning of Section 15G(b). Nevertheless, the Proposal purports to impose risk retention obligations on all "sponsors" of ABCP conduits, regardless of whether such sponsors constitute securitizers.[59]

Imposing the Proposed Rules' risk retention requirements on ABCP conduit sponsors is, we believe, contrary to both the text and the spirit of Section 15G(b), which imposes risk retention requirements on originators of financial assets which might otherwise be incentivized to loosen underwriting and credit standards in connection with originate-to-distribute securitizations. Sponsoring an ABCP program does not, in our view, raise the originate-to-distribute issues attributed to certain other securitization programs because (i) ABCP sponsors do not originate the assets being "distributed" and (ii) due to the substantial risk retained by ABCP sponsors through their liquidity and credit enhancement commitments, ABCP sponsors are highly incentivized to ensure that originator-sellers retain sufficient residual interests in their ABCP-funded transactions. We therefore believe that ABCP sponsors, which neither issue asset-backed securities nor sell or transfer assets to their sponsored ABCP issuers, are excluded from Section 15G(b)'s definition of "securitizer" and should be excluded from the Proposed Rules' risk retention requirements.

For the foregoing reasons, we encourage the Agencies to expressly exclude from the Proposed Rules' risk retention requirements any ABCP sponsor that does not meet the specific criteria for "securitizers" provided in Section 15G(a)(3).

(b) Comments to the special risk retention rules for eligible ABCP conduits set forth in § _.9 of the Proposed Rules

We appreciate the Agencies' efforts to provide special risk retention rules for eligible ABCP conduits and their sponsors in § _.9 of the Proposed Rules, and if risk retention requirements are ultimately applied to ABCP programs, the specialized rules envisioned by § _.9 will likely be of great importance to ABCP issuers and sponsors. However, the traditional multi-seller ABCP conduits apparently targeted by the definition of, and rules applicable to, "eligible ABCP conduits" do not easily fit within the rigid requirements set forth in the Proposed Rules. Indeed, we doubt that many (if any) such traditional multi-seller ABCP conduits would be willing or able to utilize § _.9's risk retention option as currently drafted. To make this

[58] We note that this analysis is particularly relevant to the majority of multi seller ABCP conduits, but may not apply to certain single-seller ABCP conduits, which may acquire all or a substantial portion of their assets from originator-sellers or intermediary SPVs affiliated with their sponsors.

[59] See footnote 82 of the Commentary and our discussion of the Proposed Rules' definition of "sponsor" in Part II.B.6(b)(i) below. We recognize that the Proposal's definition of "sponsor" essentially mirrors the definition of "securitizer" in Section 15G(a)(3) of the Exchange Act, but the Proposal and the Commentary indicate that the Agencies intend to impose risk retention obligations on the financial institutions providing liquidity and credit support to ABCP Conduits as "sponsors" thereof.

important option accessible to § _.9's intended beneficiaries, this Part II.B.6(b) identifies a number of needed adjustments to the Proposed Rules.

(i) Requiring disclosure of the identities of ABCP conduits' customers is likely to have a chilling effect on the ABCP market without providing material beneficial information to investors

For ABCP conduit sponsors taking advantage of the Proposed Rules' special risk retention guidelines for eligible ABCP conduits, § _.9(b) would require sponsors to disclose to prospective ABCP investors and, upon request, to the Commission and its applicable Federal banking agency, the names of the relevant originator-sellers, together with a description of the form, amount and nature of the risk interest retained by each originator-seller. The Proposed Rules would also require ABCP sponsors to monitor each originator-seller's compliance with its risk retention obligations and to disclose to ABCP investors any originator-seller's failure to comply. These disclosure requirements would represent a dramatic change in the current practices of virtually all multi-seller ABCP conduits, which have typically never disclosed the names of their customers to ABCP investors. We believe that these changes would have a significant chilling effect on the ABCP market while failing to provide investors or regulators with additional material information.

Today, ABCP conduits do not typically share with investors specific information regarding their individual transactions that identify specific originators/servicers. In fact, the confidentiality agreements between ABCP conduits and their customers often prohibit such disclosure. Rather, ABCP conduits usually provide investors with (i) private offering documents that focus on disclosing the identity of the sponsor, where copies of the sponsor's most recent financial statements can be obtained, the liquidity support and credit enhancement provided by the sponsor, priorities of payment, the conduit's general investment strategy, the general types of financial assets in which the conduit invests, terms of the ABCP notes, relevant transfer restrictions and the role of the placement agents and other parties to the conduit's program documents and (ii) monthly reports that provide investors with information about each transaction without identifying originators/servicers by name. Because the short tenors of ABCP are not typically matched to the longer tenors of the issuer's various transactions or the underlying financial assets, investors rely primarily on such issuer's ability to "roll" or refinance its ABCP or to draw upon the issuer's liquidity and credit support facilities. ABCP investors also rely on the related sponsor's ability to identify creditworthy customers and to structure sound transactions. Therefore, rather than requiring detailed information regarding an ABCP issuer's transactions, investors have a much greater interest in the structural protections underlying such issuer's ABCP program (including liquidity and credit support features), such issuer's demonstrated ability to "roll" ABCP and the related sponsor's structuring capabilities. Given the broad liquidity and credit support provided by sponsors, and therefore, such sponsors' significant risk retention or "skin in the game," ABCP investors are generally far more concerned with the sponsor's creditworthiness, financial condition and demonstrated ability to structure sound transactions for well-chosen customers, rather than information regarding the ABCP conduit's specific underlying transactions, the identity of each originator-seller or the percentage of risk held by each originator-seller in up to hundreds of individual and unrelated transactions. In addition, any such detailed information reported by an ABCP conduit regarding

its underlying transactions and originator-sellers may quickly become stale or misleading because conduits' transaction portfolios, commitments, outstanding investments, originator-sellers, overcollateralization and outstanding subordinated interests change rapidly and materially, often on a daily basis. In light of the unique features of ABCP conduit programs, the ABCP Investor Subcommittee and the ABCP Conduit Subforum of the American Securitization Forum jointly proposed uniform reporting standards for ABCP conduits in the American Securitization Forum's August 22, 2010 comment letter with respect to the proposed changes to Regulation AB.[60] Those reporting standards, developed by ABCP investors and sponsors, would not require the disclosure of originator-seller identities. Based on the foregoing, additional information regarding the identity of, and risk positions maintained by, specific originator-sellers is quite unlikely to be material to ABCP investors.

The proposed disclosure requirements would impose substantial burdens on ABCP originator-sellers. ABCP-funded deals are typically structured as private transactions, and we suspect that many originator-sellers would strenuously object to the disclosure of their identities, risk positions and compliance or non-compliance with risk retention rules. In addition, for ABCP sponsors, the Proposed Rules would require disclosing their customer bases and other deal-level information traditionally viewed by the ABCP market as confidential and proprietary, which could put U.S. ABCP sponsors at a significant competitive disadvantage. If such disclosures were required under the Proposed Rules, we believe that such a requirement would likely have a significant chilling effect on the market for ABCP funding.

Moreover, the required disclosures would not materially advance the Agencies' stated policy goal of providing an efficient mechanism to monitor compliance with the Proposed Rules' risk retention requirements.[61] As discussed above and in Part II.B.6(c)(iii) of this letter, ABCP sponsors retain, through their liquidity and credit enhancement commitments, all or nearly all the credit risk associated with their conduits' transactions, and ABCP sponsors are, therefore, highly incentivized to ensure that originator-sellers hold ample "skin in the game." In practice, ABCP sponsors carefully structure their ABCP-funded transactions to contain adequate reserves and structural protections and receive detailed periodic reporting of asset performance and composition. Further, as discussed above, ABCP investors already demand and receive the information they deem necessary to ensure that ABCP sponsors themselves retain sufficient "skin in the game" through liquidity and credit enhancement commitments. Because the interested parties in the ABCP market (both sponsors and investors) are highly motivated to ensure adequate risk retention at each tier of an ABCP transaction and already receive the relevant information, the ABCP market already provides efficient mechanisms to monitor risk retention. Contrary to the Proposal's intent, requiring detailed disclosure regarding originator-sellers is likely to introduce unnecessary inefficiency to this process.

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[60] Available at: <http://www.americansecuritization.com/uploadedFiles/ASFRegABIIABCPCommentLetter8.2.10.pdf>.

[61] Section I.B of the Commentary states in relevant part: "Further, the disclosures are also integral to the rule because they would provide investors and the Agencies with an efficient mechanism to monitor compliance with the risk retention requirements of the proposed rules."

For the foregoing reasons, we believe that ABCP sponsors should not be required to disclose the identities of their originator-sellers.[62]

(ii) Subsection (1) of § _.9(c) of the Proposed Rules is unnecessary and should be deleted

Under § _.9(c) of the Proposed Rules, ABCP sponsors are required to monitor originator-sellers' compliance with the special risk retention requirements for eligible ABCP conduits. Clause (1) of § _.9(c) provides that ABCP sponsors are responsible for originator-sellers' compliance with the risk retention rules for eligible ABCP conduits, and clause (2) of § _.9(c) requires ABCP sponsors to maintain and adhere to policies and procedures to monitor originator-sellers' compliance with the risk retention rules for eligible ABCP conduits and to report non-compliance. We generally agree that ABCP sponsors are in the best position to fulfill the monitoring role but, in our view, clause (1) of § _.9(c) should be deleted, as it is not only unnecessary, but would also be impossible to satisfy. For example, no ABCP sponsor could prevent or even know whether an originator-seller has violated the hedging prohibition. With respect to clause (2) of § _.9(c), we propose that the Final Risk Retention Rules permit ABCP sponsors that rely on originator-seller risk retention to satisfy their compliance monitoring requirements if the transaction documents contain representations and warranties and covenants obligating the originator-seller to comply with risk retention requirements and to report any non-compliance to the ABCP sponsor.

(iii) The special rules for eligible ABCP conduits should not limit risk retention options to the "horizontal slice" method and should permit the use of otherwise available exemptions

In order for an ABCP sponsor to satisfy its risk retention requirement using the special rules for eligible ABCP conduits, § _.9(a) of the Proposed Rules requires that the originator-seller for each ABCP transaction maintain a specified eligible horizontal residual interest in accordance with § _.5 of the Proposed Rules. Section _.9 does not, however, permit originator-sellers to utilize any of the other risk retention options specified in the rules (including vertical, L-shaped and representative sample risk retention and the special risk retention option for revolving asset master trusts set forth in § _.7 of the Proposed Rules). This limitation would severely limit the assets and originator-sellers eligible to receive funding from "eligible ABCP conduits." For example, many ABCP conduits purchase notes or similar instruments issued by credit card master trusts in privately negotiated transactions separate and distinct from the master

[62] We note that a potential alternative would be to require disclosure of an originator-seller's identity only if such originator-seller constitutes a "Ten Percent Obligor" within the meaning of Rule 2a-7 under the Investment Company Act of 1940, the definition of which is set forth in paragraph (c)(4)(ii)(D) of Rule 2a-7. Most (perhaps all) eligible ABCP conduits actively monitor their originator seller exposures in consideration of Rule 2a-7 because money market funds subject to the rule constitute a substantial portion of the ABCP investor base.

In addition, if the Agencies determine that disclosure of originator-seller identities is necessary, we would support the American Securitization Forum's proposed disclosure of such information on a confidential basis to the relevant regulator upon its request, rather than requiring blanket disclosure to investors. See Part C(iii) of the ASF Letter.

trusts' other issuances. Such master trusts, as "originator-sellers," would likely need to use the special risk retention option set forth in § _.7 of the Proposed Rules rather than retaining horizontal residual interests. As drafted, the Proposed Rules would effectively prohibit an "eligible ABCP conduit" from funding such master trusts, and we see no policy justification for that result, particularly given the Agencies' attempt to accommodate revolving asset master trust structures under § _.7 of the Proposed Rules.[63] Similarly, the Proposed Rules should not impose risk retention requirements with respect to otherwise exempted securities (e.g., qualified residential mortgages and qualifying commercial loans, commercial mortgages and auto loans) simply because such securities are being funded by an ABCP conduit. To maintain the flexibility necessary to accommodate the myriad of existing and potential structures for ABCP-funded transactions, we suggest modifying § _.9 of the Proposed Rules to allow for ABCP originator-sellers to use any of the risk retention methods or exemptions available to sponsors.

(iv) The special rules for eligible ABCP conduits should credit the retention of risk by intermediate SPVs and other affiliates of the originator-sellers

Section _.9(a) of the Proposed Rules requires residual interests to be held by the relevant originator-seller. For true sale purposes, residual interests in ABCP transactions are most commonly retained in the intermediate SPV, rather than being transferred back to (or retained by) the related originator-seller, and the originator-sellers or their affiliates typically hold the equity in the intermediate SPV (a different "interest" than that issued to the ABCP conduit).[64] In addition, in many ABCP transactions, particularly those with multiple affiliated originator-sellers,[65] the residual interest or equity in the intermediate SPV may be held by one or more affiliates of the originator-seller(s), rather than by each originator-seller itself.[66] Such equity interest can be viewed as more valuable than subordinated debt from a risk retention perspective because it generally arises from capital contributions of cash or financial assets by the originator-seller or one of its affiliates, rather than from goodwill or excess spread. In order to provide a workable solution to this issue, and consistent with our recommendation in Part II.A.2 of this letter with respect to securitizers, we suggest allowing any of the intermediate SPV, its originator-sellers or any entity affiliated with all of the foregoing to hold the retained risk under § _.9(a) of the Proposed Rules so long as such entities are in the same consolidated group.

(v) The special rules for eligible ABCP conduits should permit common ABCP transaction structures with multiple affiliated originator-sellers

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[63] See also the Agencies' discussion of revolving asset master trusts in Section III.B.4 of the Commentary.

[64] We discuss the true sale considerations in Part II.A.2 of this letter in the context of sponsors and depositors. The considerations are the same for originator-sellers and their intermediate SPVs.

[65] See our discussion of such transactions involving multiple affiliated originator-sellers in Part II.B.6(b)(v) below.

[66] The affiliate holding the residual interest is often the ultimate parent company of the originator-seller(s) or, for accounting reasons, may be an intermediate SPV placed between the originator-seller and the SPV issuing interests to the ABCP conduit.

Clause (2) of the Proposed Rules' definition of "eligible ABCP conduit" requires all interests issued by each intermediate SPV to be supported solely by the assets of a single originator-seller. However, many ABCP conduit transactions involve assets of multiple, usually affiliated, originator-sellers. The Agencies appear to have included this single originator-seller requirement to differentiate traditional multi-seller ABCP conduits from CDOs, SIVs and arbitrage conduits.[67] However, the rule as drafted is so narrow as to disqualify many, if not a substantial majority, of ABCP conduits and transactions. In order to resolve this issue while still addressing the purpose of the rule, we suggest permitting each intermediate SPV to be supported by the assets of one or more affiliated originator-sellers.

(vi) The special rules for eligible ABCP conduits should permit the funding of assets that were originated by parties other than the originator-sellers

Clause (2) of the Proposed Rules' definition of "eligible ABCP conduit" requires all assets held by an intermediate SPV to have been "originated by" a related originator-seller, which precludes funding assets that an originator-seller acquires from a third party. However, ABCP conduit facilities are often provided in connection with M&A transactions and portfolio acquisitions pursuant to which the acquired assets are financed under the ABCP facility. In addition, many ABCP transactions are structured in multiple tiers such that one or more affiliated originator-sellers transfer assets to another affiliated originator-seller or intermediate SPV, which then aggregates the assets before transferring them on to the SPV that issues interests to the ABCP conduit. As currently drafted, such assets acquired by an originator-seller, whether from a third party or from the originator-seller's affiliates, would not satisfy the ABCP retention rule because the assets were not originated by the originator-seller. We therefore suggest removing the requirement that all assets held by an intermediate SPV be "originated" by a related originator-seller and substituting a requirement that all assets held by an intermediate SPV be "transferred to the intermediate SPV" by a related originator-seller or by another affiliated intermediate SPV in the same consolidated group.

(vii) The special rules for eligible ABCP conduits should contemplate "club deals" and other transaction structures with non-ABCP conduit participants

Clause (3) of the Proposed Rules' definition of "eligible ABCP conduit" requires that all interests issued by an intermediate SPV be transferred to one or more ABCP conduits or retained by the related originator-seller. However, many ABCP transactions are structured as multi-lender or "club" deals in which some of the lenders/purchasers are ABCP conduits and some are banks or other financial institutions.[68] In addition, while certainly less common than before the

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[67] See the Agencies' request for comment No. 63 in Section II.B.6 of the Commentary.

[68] In many ABCP conduit transactions, the conduits' sponsoring banks are also parties to the securitization documents as committed lenders/purchasers in order to provide alternative funding in the event that ABCP funding is not available. We note however, that lenders/purchasers that are parties to ABCP conduit transactions are not always sponsors of participating ABCP conduits. This is often the case when a bank that does not sponsor an ABCP conduit desires to participate in a structured credit facility or when a borrower desires to diversify the funding sources under a structured revolving line of credit. Even in single-

credit crisis, some ABCP transactions may benefit from insurance policies or hedging arrangements, the providers of which could be deemed to hold "interests" issued by an intermediate SPV. Finally, an originator-seller's retained interest, if any, may be held through its or its affiliate's ownership of the equity in the intermediate-SPV, rather than directly. We see no policy basis for excluding ABCP-funded transactions with the foregoing features, and doing so would limit the utility of § _.9 for traditional multi-seller ABCP conduits. We therefore suggest substantially revising clause (3) of the definition of "eligible ABCP conduit" to provide greater flexibility to contemplate the universe of common ABCP structures.

(c) Comments regarding ABCP sponsors' utilization of non-ABCP-specific risk retention options

Although many ABCP sponsors may avail themselves of the special rules set forth in § _.9 of the Proposed Rules, certain sponsors will prefer to satisfy the risk retention requirements by utilizing the other risk retention methods specified in the Proposed Rules for asset-backed securities generally. The following discussion sets forth adjustments necessary for ABCP sponsors to comply with the Proposed Rules' general risk retention methods in light of the unique structures of ABCP conduit programs.

(i) § _.9 of the Proposed Rules should clearly indicate that sponsors of eligible ABCP conduits may comply with the risk retention rules other than by using the special rules set forth in § _.9

Section _.9(a) of the Proposed Rules provides with reasonable clarity that an ABCP sponsor will be deemed to have met its risk retention obligations if it complies with the special criteria applicable to eligible ABCP conduits. However, we anticipate that some sponsors of eligible ABCP conduits may instead choose to satisfy the risk retention requirements by using one of the other methods set forth in §§ _.4, _.5, _.6 and _.8 of the Proposed Rules. We request a clear statement in the Proposed Rules permitting an ABCP sponsor to satisfy the risk retention requirements for a sponsored "ABCP conduit" by using one of the methods set forth in §§ _.4, _.5, _.6 and _.8, rather than being limited to the special risk retention option set forth in § _.9. We believe such a statement would provide sponsors with substantially greater certainty regarding their obligations under the Proposed Rules, while the risk retained directly by ABCP sponsors would satisfy the Agencies' goal of incentivizing sponsors to structure and select transactions for their sponsored conduits carefully and safely.

(ii) § _.9 of the Proposed Rules should clearly indicate that if a sponsor of an eligible ABCP conduit itself retains the required risk position, originator-sellers will not be required to meet the Proposed Rules' risk retention requirements

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lender/purchaser transactions funded by a single ABCP conduit, the conduit's program support provider often serves as an alternate lender or purchaser allowing the program support provider to fund the deal directly, rather than through liquidity, if necessary.

Under § _.9 of the Proposed Rules, an ABCP sponsor can fulfill its risk retention obligations by requiring originator-sellers to maintain the specified 5% residual interest. If, on the other hand, a sponsor itself retains the required risk position as discussed in Part II.B.6(c)(i) of this letter, we believe that the related originator-sellers should be deemed to have satisfied their risk retention obligations if the Proposed Rules apply to such originator-sellers directly as sponsors of an ABS interest issued to the related ABCP conduit. We believe this is particularly important in light of the key role that ABCP programs play in providing capital markets funding to start-up and middle-market businesses. Such businesses often rely on ABCP conduits for efficient financing because such businesses lack the sophistication or resources to participate in the broader capital markets, particularly given the substantial cost of complying with the myriad of regulatory requirements applicable to asset-backed securities. Rather, ABCP-funding allows such businesses to obtain financing at attractive rates through negotiated transactions flexibly structured to meet the unique operational capabilities and limitations of such businesses. In this way, ABCP conduits function more like specialized banks than term ABS issuers. However, many ABCP-funded transactions are necessarily structured in a manner that would bring them within the Proposed Rules' definition of "ABS interest," and this raises the prospect of many less sophisticated originator-sellers being deemed "sponsors" subject to the Proposed Rules. We believe that many originator-seller customers of ABCP conduits would be unwilling or unable to comply with the relatively inflexible risk retention and disclosure requirements set forth in the Proposed Rules. Furthermore, requiring these originator-sellers to retain the specific forms and amounts of risk specified in the Proposed Rules seems to serve little if any purpose given the substantial incentives ABCP-sponsors have to structure their ABCP-funded transactions carefully with adequate reserves and structural protections (including originator-seller provided "skin in the game"). In order to preserve ABCP as an important financing source for these businesses, we propose adjusting the Proposed Rules to exclude ABCP-funded transactions from the definition of "ABS interest" so long as the related ABCP sponsor itself retains the required risk position with respect to its ABCP conduit by using the methods set forth in §§ _.4, _.5, __.6 and _.8 of the Proposed Rules.

(iii) ABCP conduit sponsors should be permitted to satisfy the risk retention requirements through existing credit enhancement and liquidity commitments

Rather than taking advantage of the special risk retention options available for eligible ABCP conduits under § _.9 of the Proposed Rules, sponsors of some ABCP conduits may choose to utilize the other risk retention options available for non-ABCP securities. Financial institutions that sponsor ABCP conduits currently retain a substantial degree of risk or "skin in the game" with respect to their conduits' underlying assets by providing significant liquidity support for their conduits' ABCP (often 102% of par in order to cover both initial principal and accrued interest and discount to maturity) as well as program-wide credit enhancement in the form of letters of credit or similar instruments. Such liquidity and credit enhancement commitments have long been standard practice in the ABCP market. Indeed, the Agencies have required a 100% liquidity commitment from a sponsoring bank as a condition to reliance on § _.9. The Agencies have not, however, treated any form of unfunded risk retention (other than guarantees from Fannie Mae or Freddie Mac while they remain in conservatorship), including a

letter of credit issued by a regulated financial institution, as being effective risk retention for ABCP programs or otherwise.[69] We believe such an approach confuses alignment of interests and risk retention, both of which are amply provided in this circumstance, with an actual cash infusion. Notwithstanding the approach taken by the Agencies in recognizing vertical risk retention, permitting only funded risk retention could be viewed as regulating the quality of credit enhancement, rather than requiring ABCP sponsors to retain credit risk exposure. Section 15G(b)(1) instructs the Agencies to "prescribe regulations to require any securitizer to retain an ***economic interest in a portion of the credit risk*** for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party" (emphasis added). There can be no doubt that, whether or not funded, ABCP conduit sponsors' credit enhancement and liquidity commitments constitute substantial "economic interests" in their programs' credit risk.

ABCP investors, which to our knowledge are virtually all sophisticated institutional investors, have relied on the commitments of conduit sponsors to such a degree that they largely (perhaps entirely) rely on the credit quality and reputation of the sponsoring financial institution, rather than the character or quality of the conduit's underlying assets.[70] Given the risk typically retained by an ABCP conduit sponsor through its liquidity and credit enhancement commitments, we believe that the Proposed Rules should be adjusted to permit such commitments to satisfy a sponsor's risk retention obligations as qualifying horizontal risk retained under § _.5.

(1) Credit enhancement commitments should be permitted to satisfy ABCP sponsors' risk retention obligations

The majority of ABCP sponsors provide program-wide or transaction-specific credit enhancement commitments to their sponsored ABCP conduits. Sponsors provide such credit enhancement commitments in the form of letters of credit or similar instruments, which require the sponsors to fund drawing requests unconditionally, without regard to the quality or performance of the underlying assets or the solvency of the ABCP conduit. Although such credit enhancement commitments are not typically funded or "cash collateralized," these commitments must typically be provided by a sponsor carrying credit ratings equivalent to or higher than the conduit's ABCP (e.g., "A-1" / "P-1" in most cases). Such credit enhancement providers are extremely unlikely to default on their funding commitments. In fact, we are not aware of a single multi-seller ABCP conduit sponsor that has ever defaulted on its credit enhancement commitment (or its liquidity commitment), even during the credit crisis.

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[69] We appreciate the Agencies' decision not to count obligations with respect to representations and warranties as a form of risk retention, given the potential difficulties in enforcing those obligations. However, such a position cannot reasonably be extended to bank-issued letters of credit, similar bank-provided credit enhancement or bank-provided "wrapped" liquidity commitments.

[70] At the same time, ABCP is in fact supported by a high quality pool of financial assets acquired pursuant to program guidelines that require significant risk retention by the originators or sellers of those assets and generally also stringent performance-based triggers that will cut off new transfers from such originator-sellers if performance declines. In many instances, however, the proposed ABCP rules do not provide credit for either of these forms of risk retention.

In the recently adopted European risk retention rules, the Committee of European Banking Supervisors expressly permit unfunded credit enhancement commitments to satisfy ABCP sponsors' risk retention obligations.[71] We encourage the Agencies to emulate the European risk retention rules with respect to ABCP credit enhancement commitments. Failure to adopt similar measures would unfairly ignore the substantial credit support currently provided by U.S. ABCP conduit sponsors and would impose substantial additional costs on U.S. ABCP conduits and their sponsors – likely placing U.S. ABCP and domestic businesses funded by U.S. ABCP at an additional significant competitive disadvantage.[72]

(2) The Proposed Rules should credit ABCP sponsors' substantial liquidity commitments

In addition to credit enhancement, ABCP sponsors also retain significant risk by providing liquidity support for their conduits' ABCP (often 102% of par in order to cover both initial principal and accrued interest and discount to maturity). These liquidity commitments typically take the form of agreements to purchase the conduit's underlying assets (or participating interests therein) in the event that collections on the assets are not sufficient to repay maturing ABCP and such maturing ABCP cannot be "rolled" or refinanced with new ABCP. Many ABCP sponsors provide "wrapped" liquidity for all or a portion of their ABCP conduits' transactions. Such "wrapped" liquidity commitments require the sponsor to fund without regard to the credit quality of the underlying assets. The sole condition precedent to a wrapped liquidity provider's funding obligation is a requirement that the ABCP conduit not be bankrupt, which is an exceedingly unlikely event given the bankruptcy-remote structuring of these conduits.[73] Such bankruptcy conditions do not (and are not intended to) materially reduce the credit risk borne by the sponsor. Effectively, an ABCP sponsor that provides wrapped liquidity retains 100% of the credit risk on the underlying assets. Therefore, we encourage the Agencies to permit ABCP sponsors to satisfy their risk retention obligations by providing "wrapped" liquidity commitments, where the only condition to funding is that the ABCP conduit not be bankrupt.

(3) The Proposed Rules should exclude *de minimis* first-loss positions in determining risk retention

Through their credit enhancement and liquidity commitments, many ABCP sponsors bear the first-loss risk associated with their conduits' assets but, for accounting or similar reasons, a *de minimis* portion of the first-loss risk is sometimes transferred to a non-affiliated third party through the conduit's issuance of a subordinated note or a similar interest, often referred to as a "first-loss note" or "expected loss note." The principal amount of and, therefore, the maximum

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[71] CEBS Guidelines, at paragraph 57.

[72] We would also support the American Securitization Forum's proposal to include, as permissible horizontal risk retention for ABCP conduits, "Program Support Facilities" sponsored by program support providers meeting the American Securitization Forum's proposed definition of "eligible program support provider" as described in Part C.ii of the ASF Letter.

[73] Note that, even after the recent credit crisis, we are not aware of a single traditional multi-seller ABCP conduit subject to a voluntary or involuntary bankruptcy proceeding.

risk borne by, such first-loss notes rarely exceeds 20 basis points (0.20%) of a conduit's outstanding ABCP. Even with such a subordinated note in place, the conduit sponsor continues to bear a substantial and, in our view, more than sufficient portion of the ABCP program's real credit risk. Therefore, we encourage the Agencies to exclude *de minimis* first-loss positions held by third parties in determining whether an ABCP sponsor has fulfilled its risk retention obligations.[74]

It has been suggested that, in ABCP conduit programs, the overcollateralization and other reserves supporting each of the various transactions funded by the ABCP conduit, rather than such conduit's credit enhancement and liquidity facilities, constitute the first-loss risk position. This argument is advanced in support of excluding liquidity and credit enhancement commitments from eligible risk retention for ABCP conduit sponsors. Such an argument is analogous to suggesting that, in a typical auto loan securitization, the vehicle owners' equity in their cars, rather than the most deeply subordinated class of notes or equity certificates, constitutes the first loss position. For both ABCP and our hypothetical auto loan securitization, such a view is inconsistent with the widely accepted concept of "first-loss" and mischaracterizes the substance of these transactions. A central goal of the Proposed Rules' risk retention requirements is to ensure that sponsors of asset-backed securities are properly incentivized to carefully structure sound securities. In our hypothetical auto loan securitization, the sponsor could meet such requirements by, among other methods, holding the prescribed horizontal or vertical slice of the relevant securities, thereby aligning the sponsor's incentives with those of other investors. Ignoring such a sponsor's horizontal or vertical slice based on an argument that the real "first loss" is the vehicle owners' equity in their cars would neither advance the purposes of the Proposed Rules nor comport with accepted market practices. Similarly, an ABCP sponsor that provides liquidity and credit enhancement commitments that support repayment of its conduit's ABCP has aligned its incentives with those of ABCP investors. These commitments encourage ABCP sponsors to carefully structure sound transactions on behalf of their ABCP conduits and to ensure the proper administration of their conduits' ABCP programs. As with our hypothetical auto loan securitization, ignoring an ABCP sponsor's liquidity and credit enhancement commitments based on an argument that the real "first loss" is the overcollateralization and other reserves supporting each of the various transactions funded by the ABCP conduit would neither advance the purposes of the Proposed Rules nor comport with accepted market practices.[75] Therefore, we strongly encourage the Agencies to reject any argument that ABCP sponsors' liquidity and credit enhancement commitments do not represent the first-loss positions in ABCP programs.

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[74] We suggest that any such subordinated first-loss positions not greater than 1.00% of an ABCP issuer's outstanding ABCP should qualify as "*de minimis*," consistent with the American Securitization Forum's proposal described in footnote 74 in Part VII.C.ii of the ASF Letter.

[75] We acknowledge that vis-à-vis any particular transaction funded by an ABCP conduit, the overcollateralization and other reserves represented by the residual interest retained by an originator-seller represent a first-loss position solely with respect to that specific transaction in precisely the same way that a vehicle owner's equity in a car represents the first-loss position in a securitized auto loan. However, from the perspective of an ABCP investor, an ABCP issuer or an ABCP sponsor, there is no doubt that the first-loss position (as such concept is commonly understood) is held by the bank or financial institution providing the supporting liquidity and credit enhancement commitments. Similarly, no investor, issuer or sponsor of an auto loan securitization would view the underlying vehicle owners as holding the first-loss position in the securitization.

(4) Appropriate consideration of credit enhancement and liquidity commitments is critical to maintaining the ABCP market's vitality

Due to the credit enhancement and liquidity commitments made by ABCP sponsors, ABCP is fundamentally different from all other categories of asset-backed securities covered by the Proposed Rules. Today (even prior to enactment of the Proposed Rules), a typical ABCP conduit sponsor bears, in substance, 100% or very near 100% of the credit risk associated with its sponsored conduit's ABCP, and even during the worst U.S. credit crisis since the Great Depression, ABCP sponsors continued to honor their credit enhancement and liquidity commitments.[76] ABCP clearly does not raise the originate-to distribute concerns found with respect to other asset-backed securities for which the Proposed Rules require only 5% risk retention. Failing to credit ABCP sponsors for the substantial risk they retain through credit enhancement and liquidity commitments will impose new and onerous costs on ABCP programs – possibly pricing such programs out of the credit markets. Such a result seems to run contrary to the Dodd-Frank Act's intent, which seems to encourage securitizations like ABCP programs in which sponsors retain all or nearly all the credit risk associated with the underlying assets. For the reasons expressed above, we firmly believe that ABCP sponsors should be permitted to apply their credit enhancement and liquidity commitments to satisfy the risk retention requirements, and we would be happy to work with the Agencies in drafting the necessary revisions to the Proposed Rules.

(iv) Section _.5(b) of the Proposed Rules should permit ABCP sponsors that are not FDIC-insured U.S. banks to satisfy the horizontal cash reserve account requirements with deposits in any regulated liquidity provider

As drafted, § _.5(b) of the Proposed Rules requires that amounts in horizontal cash reserve accounts be invested in short maturity U.S. Treasury securities or deposits in FDIC-insured depositary institutions. However, many ABCP sponsors that meet the Proposed Rules' definition of "regulated liquidity provider" are non-U.S. banks that are not FDIC-insured depositary institutions. In order to permit such sponsors to satisfy their risk retention obligations through the horizontal cash reserve account option, we suggest amending § _.5(b)(2)(ii) of the Proposed Rules to permit the use of deposits in any regulated liquidity provider.[77]

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[76] See Part VII.C.ii of the ASF Letter, which contrasts ABCP sponsors' consistent performance of their unconditional credit enhancement commitments with disputable payment obligations supporting certain different categories of asset-backed securities.

[77] We support the American Securitization Forum's proposal in this regard, which appears in Part VII.C.iii of the ASF Letter.

(d) Comments generally applicable to ABCP

Whether ABCP conduit sponsors fulfill their risk retention obligations under § _.9 of the Proposed Rules or in a manner generally applicable to all asset-backed securities, the following adjustments to the Proposed Rules should be made in order to adequately address the unique characteristics of ABCP programs.

(i) The definition of "sponsor" must be revised if it is intended to include financial institutions that provide liquidity and credit support to ABCP conduits

The Proposed Rules' definition of "sponsor" currently only includes "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." Financial institutions that provide liquidity and credit support to ABCP conduits do not often fall within that definition because such institutions rarely, if ever, transfer assets to their ABCP conduits. On that basis, these ABCP programs arguably do not have a sponsor that should bear the related risks. However, we acknowledge that the Proposed Rules and the Proposal's associated commentary clearly indicate the Agencies' intent to treat these financial institutions as the "sponsors" of their related ABCP conduits. To the extent that the Agencies conclude, notwithstanding our positions to the contrary, that (i) the regulation of ABCP programs is within the authorization given to them under the Dodd-Frank Act, and (ii) the bank sponsor of a conduit is appropriately the "securitizer" for purposes of the statutory requirement, we recommend clarifying the definition of "sponsor" to match that intent.

(ii) The definition of "ABCP" should be revised to include asset-backed commercial paper with an initial maturity of up to 397 days

A significant percentage of ABCP investors are money market funds subject to Rule 2a-7 under the Investment Company Act of 1940, and the commercial paper market generally accepts commercial paper notes with initial maturities up to 397 days in keeping with Rule 2a-7's general prohibition against money market funds acquiring securities with longer maturities. The Proposed Rules' definition of "ABCP," which limits "ABCP" to notes with initial maturities not exceeding nine months, is therefore inconsistent with existing commercial paper market practices and could be viewed as inconsistent with Rule 2a-7's treatment of money market instruments. This discrepancy would prohibit money market instruments with maturities between nine months and 397 days, which are commonly viewed in the market as asset-backed commercial paper, from utilizing the risk retention option for eligible ABCP conduits in § _.9 of the Proposed Rules. To avoid inadvertently excluding these ABCP conduits, § _.9 should be expanded to include conduits issuing ABCP with initial maturities not exceeding 397 days.[78]

[78] We note that in our view, as discussed in Part II.B.6(a)(i) above, ABCP with an initial maturity of nine months or less should be exempt from the Proposal's risk retention rules because it does not constitute an "asset-backed security" under the Exchange Act.

(iii) The Proposed Rules' various risk retention alternatives should be available on a transaction-by-transaction basis

As drafted, the special risk retention option for eligible ABCP conduits set forth in § _.9 of the Proposed Rules is only available with respect to a particular ABCP conduit on an all-or-nothing basis (*i.e.*, the sponsor will only be deemed to have complied if each of the conduit's transactions provides for eligible risk retention by the applicable originator-seller). We see no policy reason why an ABCP conduit's sponsor should be prohibited from utilizing the § _.9 option with respect to some of the conduit's underlying transactions while retaining risk directly in accordance with the Proposed Rules' generally applicable risk retention options (such as those set forth in §§ _.4, _.5 and _.6) with respect to the conduit's remaining transactions. We urge the Agencies to permit risk retention on a transaction-by-transaction basis, which would both serve the purposes of the Proposed Rules and provide ABCP conduit sponsors with additional needed flexibility.

(iv) The Proposed Rules should provide compliance deadlines permitting the amendment or restructuring of existing ABCP-funded deals

Even after the Proposed Rules are adjusted as we have suggested, many existing ABCP-funded transactions will need to be amended or restructured in order to comply with the special risk retention option set forth in § _.9 of the Proposed Rules. ABCP conduits commonly enter into ABCP-funded transactions with commitment periods up to five years and perhaps longer in certain cases. Conduits and their sponsors will therefore not have an opportunity to compel the amendment or restructuring of such transactions until they terminate in accordance with their terms or are renewed. In order to permit sponsors of existing eligible ABCP conduits to utilize § _.9's risk retention option, we recommend that the Agencies only apply the new risk retention requirements with respect to ABCP-funded transactions entered into or renewed after the effective date of the Final Risk Retention Rules. We note that such an approach would be consistent with risk retention rules recently adopted by the Committee of European Banking Supervisors.[79]

7. Commercial mortgage-backed securities (§ _.10)

Proposal § _.10(a) provides that for CMBS transactions a sponsor may satisfy the risk retention requirements "if a third party purchaser purchases an eligible horizontal interest in the same form, amount, and manner as would be required of the sponsor" under the risk retention rules and certain conditions are satisfied.

(a) Commercial real estate loan definition

One of the conditions to be satisfied is that "at least 95% of the total unpaid principal balance of the securitized assets in the securitization are commercial real estate loans." Proposal

[79] See Committee of European Banking Supervisors, *31 December 2010 Guidelines to Article 122a of the Capital Requirement Directive*, paragraphs 8 and 131.

§ _.16 defines "commercial real estate loan" and specifically excludes from such definition land loans and loans to real estate investment trusts ("REITs").

(i) Land loans

The term "land loan" is not defined in the Proposed Rules. We request that the Agencies define land loan to mean a loan secured entirely by unimproved land. It is common for commercial mortgage loans to be made to a borrower that owns the fee interest in the property that secures the mortgage but ground leases the land to an unrelated third-party ground-lease tenant that owns and operates the improvements on the land. The funds available to pay the borrower's commercial mortgage loan are the lease payments made by the tenant under the ground lease. In order to provide more certainty that such a commercial mortgage loan would not be considered a "land loan," we request the Agencies to make it clear that a land loan means a loan secured entirely by unimproved land. This change would make it clear that the exclusion applies only to loans secured entirely by unimproved raw land, which is what we believe the provision is intended to capture.

(ii) REITs

It is common for commercial mortgage loans (i.e., mortgage loans secured by real estate, as opposed to unsecured loans) to be made to subsidiaries of REITs or, in some cases, to REITs themselves. There is no discussion in the Proposal of the rationale for excluding loans to REITs from the definition of commercial real estate loan or what constitute loans to REITs. Some participants on the Committees believe that exclusion of loans to REITs is intended to cover loans to REITs that are not secured by commercial or multifamily property. This interpretation seems a reasonable one, inasmuch as we cannot formulate a policy reason to treat traditional commercial mortgage loans differently under the Proposed Rules based on whether the borrower is or is not a REIT. As such, we request that the Agencies make it clear that loans to REITs means unsecured loans made to REITs and would not cover commercial mortgage loans made to REITs or subsidiaries of REITs that otherwise satisfy the requirements of the definition of commercial real estate loan.

(b) Source of funds

A second condition that must be satisfied in order to use the third-party purchaser retention alternative is that the third-party purchaser "does not obtain financing, directly or indirectly, for the purchase of such interest from any other person that is a party to the securitization transaction. . . . " The language of this provision is quite broad and could be interpreted to prohibit the third-party purchaser from having any general corporate finance facilities with other parties in a securitization, such as sponsors and trustees. We request that the Agencies make it clear that this condition is to be limited to financing obtained for the specific purpose of obtaining the requisite eligible horizontal interests in securitizations so that the condition would not have the unintended consequence of prohibiting general lending facilities from existing between the third-party purchaser and a securitization participant.

(c) Duty to comply

Under § _.10(b) of the Proposed Rules, sponsors are required to monitor third-party purchasers' compliance with the special risk retention requirements for CMBS. Clause (1) of § _.10(b) provides that sponsors are responsible for third-party purchasers' compliance with the risk retention rules, and clause (2) of § _.10(b) requires sponsors to maintain and adhere to policies and procedures to monitor third-party purchasers' compliance with the risk retention rules and to report non-compliance. We generally agree that sponsors are in the best position to fulfill the monitoring role; however, in our view, clause (1) of § _.10(b) should be deleted, inasmuch as it is not only unnecessary but also would be impossible to satisfy. For example, no sponsor could prevent or even know whether a third-party purchaser has violated the hedging prohibition. With respect to clause (2) of § _.10(b), we propose that the Final Risk Retention Rules provide that sponsors of CMBS transactions that rely on third-party purchaser risk retention are deemed to satisfy their compliance monitoring requirements if the transaction documents contain representations and warranties and covenants obligating the third-party purchaser to comply with risk retention requirements and to report any non-compliance to the sponsor.

(d) Sharing of the risk retention obligations in CMBS

Section _.13 of the Proposed Rules would allow a sponsor to allocate the retention obligation among the sponsor and multiple originators. However, the Proposed Rules do not appear to allow the retention obligation to be shared with the sponsor or originators if the CMBS third-party purchaser retention option is utilized. In order to provide as much flexibility in structuring CMBS transactions as reasonably possible, and to minimize the potential for higher borrowing costs to borrowers under CMBS loans, we request that the Agencies consider allowing a sponsor to satisfy its retention obligation through the third-party purchaser option in combination with other retention alternatives – e.g., allocation among sponsor, originators and third-party purchaser. For example, a sponsor in a CMBS transaction could allocate (i) 60% of the retention obligation (e.g., a 3% vertical slice) to an originator that originated 60% of the loans in the transaction, (ii) 20% of the retention obligation to the sponsor (e.g., a 1.042% vertical slice) and (iii) 20% of the retention obligation to the CMBS third-party purchaser (e.g., a 1% eligible horizontal interest).

There are a limited number of investors that invest in the first-loss tranches of CMBS deals. Requiring these investors to retain a 5% eligible horizontal interest (which is more than such investors typically purchase in CMBS deals) and prohibiting the investors from transferring such interests will result in their purchasing capacities being reached more quickly than is the case today. With fewer investors having the capacity to make new investments, higher yields might be necessary in order to attract more investors, which could increase borrowing costs. Providing more flexibility by allowing the third-party purchaser retention option to be combined with other retention options could help alleviate the capacity issues that many of the existing CMBS first-loss investors will face under the existing Proposal.

8. Premium capture cash reserve account (§ _.12)

In addition to the requirements to retain risk in one of the forms discussed above, the Proposed Rules require that any premium or purchase price received by a sponsor with respect to its sale of any premium ABS interest or interest-only ABS interest (or the value of an interest-only strip, even if not monetized) be captured in a separate, deeply subordinated account that will be available to cover losses on the underlying assets until the related ABS interests are paid in full.[80] Although the express intention of the provisions is to prevent the sponsor from negating the intended alignment of interests with investors by extracting greater value from the transaction at closing, the effect of the provision goes well beyond this rationale. Even if the interest-only strip is not monetized but is intended to be held by the sponsor to maturity as an interest in the securitization vehicle—presumably adding further alignment of interests—the value of that interest-only strip would have to be placed in the premium capture cash reserve account unless such strip is the most junior interest in the securitization. In our view, the proposed premium capture cash reserve account is punitive rather than preventive.

We do not want to delve deeply into the economics of the circumstances in which premium interests may arise, as we believe that securitizers, investors and other market participants may be in a better position to articulate this view. Nevertheless, we are concerned that § _.12 as drafted may change the way in which financial assets are originated, sold and hedged, possibly in ways that are adverse to borrowers, and may make it impossible to securitize certain loans. It is unclear whether the Agencies are attempting to prevent the securitization of premium loans or the existence of such loans, or to force sponsors to transfer all value embedded in securitized assets to investors even when those investors do not pay for such value. Certainly, the Agencies do not expect transactions to be issued in which the premium capture cash reserve account is actually funded, because the Proposal states quite directly:

> As a likely consequence to this proposed requirements, the Agencies expect that few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require the establishment of a premium capture cash reserve account, which should provide the benefits described above.[81]

Structuring securitizations to include assets with embedded premium but avoid the need to fund this account is not straightforward and may make securitizations far more difficult and costly without meaningfully addressing the Agencies' concerns.

Mortgage loan pricing and valuation is complex and depends on many variables, including rate lock agreements, inclusion of fees and closing costs in principal balance or rate, and general movements in interest rate. To the extent that an originator has hedged its rate exposure, what may appear as a premium in the value of the loan may be offset by a loss on the hedge which is not captured in the proposed formula. Nor does the proposed formula consider whether the sponsor purchased the asset at a premium and thus is not making a profit on the

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[80] Proposal, at 24113.

[81] Proposal, at 24113.

securitization or whether the "premium" in fact reflects out-of-pocket third-party costs advanced by the originator, such as filing fees or title insurance costs.[82]

As we indicate elsewhere in this letter, each asset class is different, and its pricing attributes have different significance. In credit cards, excess spread is an at-risk amount that varies with the overall performance of the credit card business and reflects continual adjustments by the originator to the pricing of loans based on the payment history of the borrower and market conditions. For mortgage loans, however, the pricing is established at the time of loan origination and there is no similar concept of excess spread. Moreover, loan pricing may reflect borrower choices rather than credit quality. For example, two identical borrowers, with identically valued properties and identical credit scores and income levels, entering into loans on the same date and each taking a conventional 30-year fixed-rate mortgage loan, could well end up with different interest rates on their loans based solely on the choices they made with respect to fees and costs. If one borrower pays her costs out of pocket, and obtains a 5% interest, and the other chooses to add his costs into the rate and obtains a 5.25% interest rate, the extra 0.25% in the second borrower's rate is not a risk premium—it is the rate equivalent of the advanced costs. It is thus not considered excess spread. If, on the same date, a third buyer with a riskier credit profile paid his costs out of pocket and obtained a loan with a 6% interest rate, that loan might still be valued at par because of the increased risk, similarly would reflect no "excess spread" (because the increased risk of that loan would be reflected in the overall securitization pricing), and no premium would be generated in the securitization of that loan.

Accordingly, in our view, the premium capture provisions as drafted at best reflect a fundamental misunderstanding of excess spread and at worst go beyond the Agencies' expressed rationale of prohibiting the evasion of the risk retention requirements by capturing the "substantial excess spread" generated by certain underlying asset classes.[83] As with other provisions of the Proposed Rules, the premium capture requirement presents significant practical and business issues.

The Proposed Rules would prohibit sponsors from recouping the costs of loan origination, requiring, in effect, that sponsors or originators retain the risk relating to such amounts in addition to the 5% base risk retention requirement. As a result, originators will be faced with the choice of either passing origination costs on to borrowers or incurring such

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[82] The provisions of the Dodd-Frank Act which focus on the issues associated with building fees and expenses into rates, though prohibiting practices that are viewed as abusive, specifically provide that the relevant amendments to the Truth in Lending Act shall not be construed as:

> restricting a consumer's ability to finance, at the option of the consumer, including through principal or rate, any origination fees or costs permitted under this subsection, or the mortgage originator's right to receive such fees or costs (including compensation) from any person, subject to paragraph (2)(B), so long as such fees or costs do not vary based on the terms of the loan (other than the amount of the principal) or the consumer's decision about whether to finance such fees or costs.

Dodd-Frank Act, Section 1403 (amending Truth in Lending Act Section 129B). Although we express no views on the proper interpretation of Section 1403 or the language referenced above, we believe that any rulemaking intended to implement or clarify Section 1403 should be done formally in accordance with the procedures established for that provision, rather than indirectly through the risk retention provisions.

[83] Proposal, at 24151.

expenses without any opportunity to recoup such amounts until most of the loans are paid in full. It can be expected that such restrictions will, in any event, increase the cost of borrowing and inhibit the recovery of the primary lending market.

Finally, we believe that it may become difficult or impossible to structure transactions involving assets that generate substantial excess spread in a way that will permit the securitizer to achieve sale treatment due to the adverse effects of the premium capture cash reserve account rule. A securitizer seeking to obtain sale treatment will likely need to use the vertical interest form of risk retention in order to achieve sale treatment, as any option involving horizontal risk retention will likely give the securitizer too much of a continuing interest in the issuing entity. But the premium capture rules will require the securitizer to hold a horizontal interest in the issuing entity, either in the form of the premium capture cash reserve account or in the form of a deeply subordinated interest in the excess spread. But this sort of horizontal interest is precisely the type of interest that can cause the assets to remain on the securitizer's balance sheet.

Moreover, as we discuss elsewhere, the higher retained interest may both jeopardize sale accounting treatment and create questions about whether a legal true sale of the assets has occurred. The accounting issues may further increase the cost of the securitization, and the legal issues may make it impossible for such securitizers to receive the requisite opinions as to true sale and to delink the ratings of the securities from the ratings of the securitizer—essentially making such a transaction impossible.

Accordingly, we believe that the proposed rules are over-reaching, and we do not believe that a premium capture cash reserve account is a necessary addition to the base risk retention requirements. As proposed, the premium capture provisions indiscriminately enforce additional risk retention on many transactions, including many in which the supposed "premium" is nothing more than a return of out-of-pocket expenses, thereby reducing the efficiency of the market and increasing transaction and operating costs, without advancing the purposes of Section 941 of the Dodd-Frank Act— that is, to protect investors and borrowers. Rather than improving and restarting the private securitization market, these provisions will merely hinder it.

III. Transfer of Risk Retention

A. Allocation to the originator (§ _.13)

As a general matter, the Proposed Rules provide that the sponsor of a securitization transaction is solely responsible for complying with the risk retention requirements established under Section 15G. However, Section 15G permits, and the Agencies propose to include, rules permitting a sponsor to reduce its risk retention requirements by the portion of the risk retention obligation assumed by the originator of the assets.[84] The ability of an originator to satisfy a sponsor's risk retention requirement is subject to a number of conditions, including: (1) retention of risk by an originator is permitted only for the vertical and horizontal forms of risk retention; (2) to the extent that both the sponsor and an originator retain a portion of the required risk retention, both must hold in the same manner (which we read to mean the same form) and

[84] See § _.13 of Proposal, at 24163.

subject to the restrictions on hedging, transferring and pledging; (3) an originator must acquire and retain a minimum of 20% of the aggregate risk retention otherwise required to be maintained by the sponsor (but the originator's portion may not exceed the ratio of the unpaid principal balance of the pool assets originated by such entity to the aggregate unpaid principal balance of all of the assets in the securitized pool); and (4) a requirement that the sponsor disclose the method of payment for the interest retained by the originator. In addition, the sponsor remains responsible for compliance with the risk retention requirements, and it must maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by the originator with the risk retention requirements and promptly notify investors of any noncompliance by the originator.[85]

This portion of the Proposed Rules represents an important exception to the prohibition on the transfer of risk retention by a sponsor.[86] We appreciate the fact that the Proposed Rules permit, but do not require, that all or a portion of the required risk retention may be allocated to the originator of the securitized assets. We believe that there are circumstances under which the securitizer and an originator should be able to agree that the originator will retain and maintain the required risk retention for a securitized pool with respect to assets such entity has originated. For example, allocation to the originator of all of the required risk retention would be appropriate when all of the residential mortgage loans backing an ABS issuance were originated by that originator and the loans were sold by it to the sponsor with the intent that the sponsor securitize the loans. In any event, we believe that, as a practical matter, the allocation of risk between the securitizer and the originator must be contractually agreed upon by such parties.

We believe, however, that § __.13 is unduly restrictive in limiting the permissible forms of risk retention to the vertical and horizontal options in §§ __.4 and __.5 and in requiring that the sponsor and the originator utilize the same risk retention option. As we discuss in Part III.B.3 of this letter with respect to L-shaped risk retention, we see no reason for these limitations and we believe that sponsors and originators should be permitted more flexibility in agreeing on the form or forms of risk retention that best suit their individual needs, as well as the asset class and investor expectations, under the Final Risk Retention Rules.

The Agencies have requested comment on whether the Proposed Rule should permit allocation of risk to originators of less than 20% of the pool of assets. We note in that regard that in a securitization involving a sponsor that is an aggregator,[87] which we would assume would wish to allocate the required risk retention to the originators, smaller originators (such as small community banks) may be unable to participate because they will not be able to originate a

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[85] Id.

[86] One technical question that might be raised by the Agencies' inclusion of § .13 in Subpart C of the Proposed Rules is whether the securitizer is obligated to retain the required risk retention initially and then transfer the allocable portion to the originator. For reasons of efficiency and to eliminate additional transfer documentation for the ABS interests, we suggest that, when the securitizer and the originator have contractually agreed to the allocation of all or a portion of the risk retention to the originator in compliance with the risk retention rules, the vertical or horizontal classes of ABS interests could be issued directly to the originator rather than being issued to the securitizer, which in turn transfers the ABS interests to the originator.

[87] See our description of aggregator amortizing trusts in Appendix A.3.

sufficient volume of loans to reach the minimum 20% threshold. Those originators may, accordingly, have less access to the public market for sales of their financial assets. We do not believe that reducing the minimum threshold to 10% or 5%, for example, would result in a disincentive for the originator to monitor the quality of its originations, because most originators will want to continue to be able to sell their financial assets into the market. Moreover, for a small originator, retention of 5% of the risk of its securitized originations may represent a significant investment.

The fact that the originator must retain risk not only on the pool assets originated by it but also on all other assets in the pool could be problematic in a securitization transaction in which the originator's assets are not the only pool assets. By long-standing practice, originators have retained contractual liability for breaches of representations and warranties on the assets they originate for whole loan sales and securitizations. Retention of the credit risk on the assets of the originators is not fundamentally different from that concept. On the other hand, retention of risk on the pool as a whole is likely to be unattractive to an originator that has no control (other than possibly by contract with the sponsor) over the quality of the other assets in the pool. There are two alternative approaches we believe would make the risk allocation to originators workable but nonetheless achieve the Agencies' objectives. First, the ABS transaction could be structured so that the assets of each originator are included in a separately identified asset group with respect to which a separately identified group of ABS interests, backed solely[88] by that asset group and payable from cash flows on that asset group, are issued. Under this structure, which has been utilized, for example, in RMBS transactions for a number of years and is relatively easy to construct, an originator would be subject to the risk of loss only on the assets originated by such entity and not on the other pool assets. A second approach relates to our proposal, discussed in more detail in Part III.B.1 of this letter, to allow the use of participation interests as a form of vertical risk retention. Using this form of risk retention would allow each originator to retain or take back a 5% participation interest in each asset such entity originates, with the issuing entity holding the 95% interest in the assets. The risk retention requirement would be satisfied, but the originator would not be exposed to the risk of loss on the pool assets such originator did not originate.

The Agencies also have asked whether the rule should permit allocation to originators if the sponsor elects the horizontal cash reserve account option.[89] We expect that any allocation of risk between a securitizer and an originator will be the subject of written agreement and will include the originator's express agreement to maintain the portion of the risk allocated to such originator in accordance with the final rule and to comply at all times with the final rule's restrictions on hedging, transfer and pledging. As noted above, the securitizer and originator should be able to structure the risk retention for a particular securitization transaction using any of the risk retention forms, not just the vertical or horizontal risk retention forms, so long as such form works for the type of assets and structure of the transaction.

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[88] In a transaction with overcollateralization, the cash flow from a group with excess overcollateralization may be used to cover a group that is undercollateralized, such arrangement would minimize, but not eliminate altogether, the originator's exposure to the risk of loss on the entire securitized pool.

[89] See Proposal, at 24115.

Our final comment regarding § __.13 pertains to paragraph (b), which provides in clause (1) that a sponsor allocating risk retention to an originator remains responsible for compliance with the risk retention rules and imposes in clause (2) a duty on the sponsor to maintain and adhere to policies and processes for monitoring compliance by the originator and to disclose to investors if the sponsor determines that the originator no longer complies with § __.13(a)(1) and (a)(3). We generally agree that sponsors are in the best position to monitor compliance, but, in our view, clause (1) of § __.13(b) should be deleted, as it is not only unnecessary but also impossible to satisfy. For example, no sponsor could prevent or even know whether an originator has violated the hedging prohibition. With respect to clause (2) of § __.13(b), we propose that the Final Risk Retention Rules permit securitizer that rely on originator risk retention to be able to satisfy their compliance monitoring requirements if the transaction documents contain representations and warranties and covenants obligating the originator to comply with risk retention requirements and to report any non-compliance to the securitizer.

B. Hedging, transfer and financing prohibitions (§ __.14)

1. Restrictions on transfer

The proposed restrictions on hedging and pledging the retained interests appear to be appropriately tailored and to reflect the requirements of Section 15G.

We support the Agencies' approach to hedging and pledging retained interests. We believe that the hedging restrictions, which would allow sponsors to protect themselves against interest rate and currency fluctuations and broad movements in the market, but would not allow hedging against the specific credit risk of the securitized assets, strike the appropriate balance and properly interpret the prohibition on hedging credit risk. Similarly, we believe that allowing retained interests to be pledged on a full recourse basis strikes the correct balance between the need to prevent the sponsor from transferring the risk of the asset through a pledge arrangement and allowing the sponsor to include retained interests in its available collateral pool for necessary corporate funding. We appreciate the Agencies' efforts to approach these issues in a balanced and prudent manner.

2. Other considerations

We fully appreciate that the risk retention provisions of the Dodd-Frank Act anticipate that the securitizer will in fact *retain* the risk.[90] However, Section 941(c)(1)(C)(i) specifically states that the Agencies, in promulgating the rules, must specify the minimum duration of the risk retention. We believe that, for some asset classes, a minimum duration that is shorter than the maturity of the assets is appropriate and consistent with the intention of these provisions. We further believe that there are specific circumstances in which a transfer of the risk, even where the minimum duration for the hold has not been met, would be appropriate.

With respect to assets with long maturities, such as residential mortgage loans, there is a point, typically a few years after origination of the loan, at which a problem arising under the

[90] We believe that a transfer to a consolidated affiliate, as proposed, is consistent with that requirement.

loan would be unlikely to relate to poor origination standards or due diligence but instead would reflect changed circumstances of the borrower or changed economic conditions in general. Requiring the sponsor to continue to retain risk in the securitization beyond that point will act as a long-term constraint on that sponsor's ability to sponsor new securitizations, and will no longer provide meaningful alignment of interests with investors. We believe that, at that point, transfer of the interest should be permitted.

For CMBS transactions where the sponsor wishes to rely on the investment by the third-party purchaser to satisfy the risk retention requirement, we believe that it would be reasonable to allow the position to be transferred to another third-party purchaser that re-underwrites the entire pool. Investors will be reluctant to invest the cost of the due diligence if they do not intend to make a long-term investment, but they may also be cautious about committing to assume the risk retention for the entire term of the transaction. Allowing such investors to transfer only to another entity meeting the basic requirements of the option and re-underwriting the pool would allow important market flexibility, while still ensuring that the original third-party purchaser bears the risks of its due diligence (if it underestimates the risks of the pool, presumably that will be reflected in the price a replacement purchaser is willing to pay for the interest).

Finally, there may be circumstances in which a transfer is necessary for reasons other than a reluctance to continue to hold the risk. For instance, it should be permissible to transfer the interest as part of the sale of the entire business unit that originated that risk, whether that transfer is structured as a stock transfer or an asset transfer. It should likewise be permissible to transfer the interest if a financial institution's prudential regulator determines that such a transfer is necessary for the safety and soundness of the institution. The Final Risk Retention Rules should maintain the flexibility to accommodate such situations.

IV. General Purpose Definitions and Scope

A. General Purpose Definitions

We comment in this section of the letter on several of the defined terms that are used throughout the Proposal. We previously commented on defined terms that are related to specific risk retention proposals, such as the definition of "eligible horizontal residual interest," in the section of the letter dealing with the relevant provision.

1. ABS Interest

The term "ABS interest" starts with the words "includes any type of interest or *obligation* issued by an issuing entity . . ., payments on which are primarily dependent on the cash flows of the collateral" (emphasis added). We believe that the Agencies intended the use of the term "obligation" to refer to of an investment that is denominated as a debt obligation. However, we express some concern that "obligation" might be construed to include requirements imposed on the issuing entity to remit amounts such as servicing fees, trustee fees and indemnities and to reimburse servicing advances and servicing costs, inasmuch as the requirements to make these payments and reimbursements are, in a sense, "obligations" that are paid from the cash flows on the collateral.

We believe the Agencies should understand that these types of payment provisions are not appropriately considered within the scope of ABS interests. Such payments are in consideration of services rendered to the issuing entity or the investors and reimbursements for costs incurred on behalf of the issuing entity or the ABS investors. The payments are not investment interests, which is what we believe "ABS interest" is meant to cover.

We suggest that the Agencies add the following at the end of the definition of ABS interests:[91]

> *(3) does not include fees, costs, indemnities, reimbursements and other expenses owed by the issuing entity,*

2. Asset

The specification in this definition of a "self-liquidating financial asset" does not easily fit a typical closed end motor vehicle lease. In such a lease, the rental payments by the lessee survive for a number of months specified in the lease, after which the lessee has an option to purchase the vehicle. If the lessee does not purchase the vehicle, then the lessor is required to dispose of it. The lease payments typically represent less than half of the overall value of the lease and vehicle. The need to dispose of the leased property in order to realize a portion of the value might not easily meet the definition of "self-liquidating."

Accordingly, the Commission, in its definition of "asset-backed security" in Item 1101(c) of Regulation AB, and the FDIC, in a letter construing the meaning of "financial asset" in the FDIC Securitization Rule,[92] have both recognized the need for a special provision in their respective securitization rules to include leases as financial assets notwithstanding the need to dispose of the leased property.

We suggest that the following sentence be added to the end of this definition to address this point:

> *A leased asset shall not be excluded from this definition solely because there may be a need to dispose of the underlying leased property in order to liquidate the residual interest in the property.*

3. Depositor

Clause (3) of the definition of "depositor" covers "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."

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[91] We have identified a second issue with the definition of ABS interest. We discuss that issue in Part II.A.4(b) of this letter, which addresses the definition of issuing entity, as the issue relates directly to identification of the issuing entity.

[92] Letter dated October 29, 2010 from David N. Wall, Assistant General Counsel of FDIC, to Jason H.P. Kravitt re Treatment of Auto Leases as Financial Assets under 12 C.F.R. § 360.6.

We find this clause puzzling. The first half of clause (3) mirrors clause (1) of "depositor," making clause (3) seem to be just a more specific situation that is already covered in clause (1). In addition, clause (3) is circular, as both halves of it seem to refer to the same person.

We note that clause (3) resembles the third sentence of the definition of "depositor" provided in Item 1101(e) of Regulation AB, which reads as follows:

> "For asset-backed securities transactions where the person transferring or selling the pool assets is itself a trust, the depositor of the issuing entity is the depositor of that trust" (emphasis added).

We believe that the Regulation AB provision referenced above is preferable to the existing clause (3) of the definition of "depositor," and we suggest that the Agencies adopt that formulation in lieu of the existing clause (3).

4. Issuing entity

(a) Multiple entities within the issuing entity.

Clause (ii) of the definition of "issuing entity" contemplates that the issuing entity "owns or holds the pool of assets to be securitized." In most securitization transactions, the issuing entity does hold the assets directly. However, there are two commonly used securitization structures in which the entity issuing the ABS interests (the "named issuing entity") does not hold the assets directly; instead, one or more separate but affiliated entities (each, an "asset holding entity") holds a portion of the securitized assets and perhaps other assets and issues an interest in those assets to the issuing entity.

The first situation in which an asset holding entity is used is the so-called note issuance trust described in Part 2(b) of Appendix A. Many credit card and some dealer floorplan securitizations utilize this structure, in which the assets are held directly by a revolving asset master trust. The master trust issues a collateral certificate, which typically represents an undivided interest in all of the assets of the master trust, to the note issuance trust. From time to time, the note issuance trust issues ABS interests that are purchased by investors. The note issuance trust will issue multiple series or tranches over time.

Asset holding entities are also used in securitizations of auto leases, where one or more entities generically known as "titling trusts" are used, as described in Part VII.D of this letter. A sponsor typically originates all or substantially all of its auto leases directly into the titling trust(s). When the sponsor decides to effect a securitization, it identifies a specific pool of leases and leased vehicles for the securitization, and an interest representing those leases and leased vehicles (in the form of either a certificate of beneficial interest or a secured note) will be issued by the titling trust(s) to a new trust or other entity established for the particular securitization. This entity, unlike the note issuance trust, will be used for a single securitization transaction only.

In transactions utilizing asset holding entities, the asset-backed securities are still dependent on the cash flows from the underlying assets held in the asset holding entities. The assets are held by each asset holding entity rather than the named issuing entity due to legal or

structural considerations, but the assets still form the basis on which the asset-backed securities are issued by the named issuing entity.

We believe it is important to clarify that ownership of the assets does not need to be in the legal entity that issues the ABS interests to investors. We believe that the definition of issuing entity should be clarified to treat the asset holding entities and the affiliated named issuing entity collectively as the "issuing entity." By limiting the clarification to situations in which the asset holding entities are affiliated with the named issuing entity, it will be possible to avoid unintended expansions of the concept of the issuing entity.

Accordingly, we suggest that the definition of "issuing entity" be supplemented by the following proviso, to be inserted at the end of the existing definition:

> ; provided, however, if (x) the assets to be securitized are held by one or more entities (each, an "asset holding entity") that are affiliated with the entity in whose name the asset-backed securities are issued (the "named issuing entity") and (y) each asset holding entity has issued an interest in its portion of the assets to be securitized that is directly or indirectly held by or pledged to the named issuing entity, then "issuing entity" shall mean a collective reference to the named issuing entity and each asset holding entity.

(b) Avoiding double-counting of ABS interests

The recognition that the issuing entity could be a collective reference to multiple entities also raises the question of how to treat the interests in the pool of securitized assets that are issued by the asset holding entities (each, an "Intermediate Asset Interest") for purposes of the definition of "ABS interest." It would be inappropriate to count each Intermediate Asset Interest as an ABS interest issued by the issuing entity, as that would lead to double- or triple-counting in the determination of the required retention by the securitizer.

For example, we ask the Agencies to assume that a sponsor has decided to securitize a pool of automobile leases and leased vehicles that has an aggregate value of $1 billion. The sponsor causes its titling trust, which is the asset holding entity, to issue a special unit of beneficial interest, or SUBI, to a newly formed trust, which is the named issuing entity. Transfer of the SUBI to the named issuing entity constitutes a transfer of all of the credit risk of the underlying pool. The named issuing entity then issues $950 million of ABS interests to investors and, in compliance with § _.5(a), a $50 million eligible horizontal residual interest to its depositor.

In this example, it would be inappropriate to treat both the $1 billion Intermediate Asset Interest issued by the asset holding entity and the $1 billion of ABS interests issued by the named issuing entity as ABS interests issued by the issuing entity. The total amount of ABS interests that should be counted for purposes of the retention requirement is $1 billion, and the retention by the depositor of the named issuing entity of a $50 million eligible horizontal residual interest should satisfy the retention requirement.

As a second example, we ask the Agencies to suppose that a sponsor has decided to issue additional securities in a credit card securitization program that utilizes multiple entities. The sponsor causes the revolving asset master trust, which is the asset holding entity, to increase by

$1 billion the amount of underlying assets represented by the collateral certificate held by its affiliated note issuance trust, which is the named issuing entity. In compliance with § _.7(a), the master trust simultaneously increases by $52.64 million the required seller's interest held by the depositor of the master trust. The note issuance trust then issues $1 billion of ABS interests to investors.

In this second example, it would similarly be inappropriate to treat both the $1 billion increase in the Intermediate Asset Interest issued by the asset holding entity and the $1 billion of ABS interests issued by the named issuing entity as ABS interests issued by the issuing entity. The total amount of ABS interests that should be counted for purposes of the retention requirement is $1 billion, and the retention by the depositor of the named issuing entity of an incremental $52.64 million seller's interest should satisfy the retention requirement.

Generally speaking, we believe that the appropriate means for avoiding double- or triple-counting is to exclude interests issued by asset holding entities from the definition of ABS interests, provided that those interests collateralize the ABS interests issued by the named issuing entity. Note, however, that the asset holding entity in the second example is the entity that issued the interest used to satisfy the retention requirement. For this reason, we recommend that the revision should include an interest issued by an asset holding entity if that interest satisfies the retention requirement.

Our recommendation to the Agencies in addressing this issue is to add the following clause (4) at the end of the "ABS interest" definition:

> *(4) when the issuing entity consists of one or more asset holding entities and a named issuing entity (as such terms are used in the definition of issuing entity), does not include any interest issued by an asset holding entity, so long as such interest directly or indirectly collateralizes the ABS interests issued by the named issuing entity, except that an interest issued by an asset holding entity for the purpose of retaining an economic interest in the credit risk of the securitized assets shall be included.*

5. Par value

The Proposal uses the term "par value" in many locations throughout to reference the value of ABS interests. However, no definition of the term is expressly included, which causes uncertainty as to the term's application.

In most cases, the determination of the par value of an ABS interest is a straightforward exercise. If the ABS interest is an interest-bearing debt security, the par value will be the outstanding principal balance. If the ABS interest is a non-interest bearing debt security (as is often the case for asset-backed commercial paper), then the par value should be the accreted value of the security.

The circumstances in which the par value of an ABS interest cannot be determined easily are those where the ABS interest is not a debt security with a principal balance. Such will be the case for interest-only securities and for residual interests, which we will refer to as "Notional

Principal ABS Interests." A securitizer that has selected the retention methodologies under any of § _.5 through § _.10 or under § _.12 of the Proposed Rules must be able to calculate the aggregate par value of all ABS interests, and that is not possible unless the securitizer is permitted to assign a value to Notional Principal ABS Interests.

We note several locations in the Proposal where the Agencies seem to provide some guidance for the valuation of certain Notional Principal ABS Interests. First, the Proposal provides in the disclosure section in many of the risk retention alternatives that the securitizer should disclose the "material assumptions and methodology used in determining the aggregate dollar amount of ABS interests . . ., including those pertaining to any estimated cash flows and the discount rate used."[93] We believe that in doing so, the Agencies suggest that it may be appropriate to use a discounted cash flow methodology to value a Notional Principal ABS Interest (particularly a residual interest), and we agree that such an approach is appropriate.

Second, the Proposal provides in the premium capture cash reserve account rules that the valuation of ABS interests that do not have a par value (and are not residual interests being held in satisfaction of the retention requirement) should be at their "fair value."[94] That approach, too, seems to us to be a generally appropriate expression of the valuation of these types of interests.[95]

A particular valuation concern arises when a securitizer is planning to hold an eligible horizontal residual interest to satisfy part or all of the retention requirements. This type of securitizer needs to know how to value that residual interest. In many securitization transactions, the aggregate par value of the debt securities issued by the issuing entity will equal 99% or more of the aggregate principal balance of the underlying assets. That does not mean, however, that the residual value should be valued at 1% or less of the aggregate principal balance of the underlying assets.

In these securitization transactions, the underlying assets usually generate interest income, or spread,[96] at a rate[97] that is expected to exceed the interest expense, servicing fees and other costs incurred by the issuing entity. In this section of this letter, we refer to that excess as "gross excess spread." In these transactions, the gross excess spread is the first level of credit enhancement that protects investors against the credit losses on the securitized assets or "charge-offs." The gross excess Spread will, effectively, be applied to make payments or allocations of

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93 See, e.g., Proposed Rules, § .5(c)(3), § .7(b)(3) and § .8(g)(5).

94 Proposed Rules, §__.12(c)(1).

95 Although we endorse the valuation approach in the premium capture cash reserve account rules, we otherwise take strong issue with those rules, as described in Part II.B.8 of this letter.

96 Interest income could be generated by interest or finance charges accruing on the assets, as well as by fees assessed to obligors and interchange received from other parties.

97 The interest income generated by the assets could result (i) if the assets bear interest at a sufficiently high rate, from actual interest generated by the assets, (ii) if the assets bear interest at an insufficient rate (such as subvened auto loans), from a discounting within the securitization of the principal balance of the assets, which has the effect of reducing the effective principal balance of the assets and increasing the effective interest rate, or (iii) if assets do not bear interest or do not have a principal balance (as with leases and trade receivables), from discounting of the anticipated payments on the assets.

principal to investors to the extent of charge-offs. (Gross excess spread may well be applied for other purposes, too, such as paying principal on ABS interests until an overcollateralization target has been reached.) Only to the extent that the gross excess spread for a given period exceeds the charge-offs for that period (and other applications) will the net amount, which we refer to in this section as the "net excess spread," be remitted to the holder of the residual interest.

The fact that the ABS interests issued to investors have an aggregate par value that is so close to the aggregate principal balance of the underlying assets indicates that the investors and rating agencies are confident that the gross excess spread will be more than sufficient to cover charge-offs.

As the gross excess spread in such a transaction is directly exposed to the credit risk of the underlying assets, we believe that the par value of a residual interest to which the net excess spread is paid (after charge-offs and other applications have been covered) should not be reduced for the effect of the charge-offs.

Taking the foregoing considerations into account, we suggest that the Agencies include the following definition in the revised rules:

Par value *means, with respect to the valuation of an ABS interest at issuance*:

(i) if such ABS interest is not described in clauses (ii) or (iii), the principal balance of such ABS interest;

(ii) if such ABS interest has a principal balance but interest on that principal balance is not payable, is payable only at maturity, or is payable at a rate below fair market value, the purchase price for such ABS interest upon issuance (or, if such ABS interest is not sold in an arms-length transaction, its fair value upon issuance);

(iii) if such ABS interest has no or a nominal principal balance or is entitled to receive interest in excess of a fair market rate, the fair value of such ABS interest.

For purposes of clauses (ii) and (iii), the "fair value" of an ABS interest shall established without taking into account credit losses to which such ABS interest may be subject.

B. Impact Analysis and Related Administrative Law Matters

When the Final Risk Retention Rules are adopted by the Agencies, they will be the most substantive economic regulations ever applied to the market for ABS. Given the sheer magnitude of the ABS market and securitization's central role in credit creation, the economic impact of the risk retention rules will be profound.[98]

[98] The substantial size and breadth of the ABS market is summarized in the FRS Report under the heading "Issuance Activity."

As noted above, we acknowledge the significant challenge posed by the Dodd-Frank Act's mandate to the Agencies to adopt risk retention rules. However, we do not believe that the Agencies have adequately considered the economic impact, or sufficiently weighed the costs and benefits, of the Proposed Rules. For the reasons set forth below, we believe that the Final Risk Retention Rules should not be adopted until the economic impact, as well as the costs and benefits, of the risk retention rules are more fully considered by the Agencies.

1. Studies mandated by the Dodd-Frank Act emphasize the need for a thorough impact analysis by the Agencies

We note that in developing the Proposed Rules, the Agencies had the benefit of the findings and conclusions contained in the FSOC Risk Retention Study[99] and the FRS Report[100] (collectively referred to herein as the "Dodd-Frank Studies"). However, the Dodd-Frank Studies were limited in scope[101] and, importantly, did not (because they could not) retrospectively address the likely impact of the specific terms of the later-released Proposed Rules.

Because of these fundamental limitations, the Dodd-Frank Studies provide the Agencies with little guidance as to the potential economic impact, or the likely costs and benefits, of the Proposed Rules. Accordingly, the Dodd-Frank Studies stressed the importance of a thorough analysis by the Agencies of the impact of the specific terms of the Proposed Rules. We believe that the analysis conducted by the Agencies is insufficient and that further analysis should be conducted by the Agencies before final risk retention rules are adopted.

Read together, the Dodd-Frank Studies recommend that the Agencies conduct an analysis of multiple considerations in light of specific objectives prior to implementing final risk retention rules. Those considerations and objectives are summarized in the table below.

Considerations[102]	**Objectives**[103]

[99] Section 946 of the Dodd-Frank Act requires the Chairman of the FSOC to carry out a study of the macroeconomic effects of the risk retention requirements of the Dodd-Frank Act. Pursuant to this mandate, the FSOC published the FSOC Risk Retention Study in January 2011.

[100] Section 941(c) of the Dodd-Frank Act requires the Federal Reserve Board, in coordination and consultation with various other Agencies, to conduct a study of, among other things, the combined impact on each individual class of ABS of the new credit risk retention requirements contained in Section 941(b) of the Dodd-Frank Act. Pursuant to this mandate, the Federal Reserve Board published the FRS Report in October 2010.

[101] With respect to the FSOC Risk Retention Study, no quantitative assessment or detailed empirical analysis is presented. Rather, "the study discusses the pro-cyclicality of credit with respect to asset-backed securitizations and the potential for risk retention requirements to minimize this pro-cyclicality." See FSOC Study, at 5. The FSOC attributed the modest scope of the FSOC Risk Retention Study to three factors: (1) lack of sufficient data with which to make specific quantitative assessments, (2) limited and insufficiently robust academic literature and other information on risk retention and (3) availability of only existing literature and data, rather than original research and more specific quantitative assessments. Id., at 5-6. Similarly, the FRS Report contains very little prospective quantitative assessment or analysis of the likely impact of risk retention. Rather, the FRS Report focuses on historical risk retention practices, previous issuance activity and the like.

[102] See FRS Report, at 3-4.

[103] See FSOC Risk Retention Study, at 3.

The Agencies should consider:	The risk retention rules should:
• the specific incentive alignment problems to be addressed by each credit risk retention requirement; • the economics of asset classes and securitization structure; • the potential effect of credit risk retention requirements on the capacity of smaller market participants to comply and remain active in the securitization market; • the potential for other incentive alignment mechanisms to function as either an alternative or a complement to mandated risk retention; • the interaction of credit risk retention with both accounting treatment and regulatory capital requirements; • the credit risk retention requirements in the context of all rulemakings required under the Dodd-Frank Act, some of which may magnify the effect of, or influence, the optimal form of credit risk retention requirements; • that investors may appropriately demand that originators and securitizers hold alternate forms of risk retention beyond that required by the credit risk retention regulations; and • that capital markets are, and should remain, dynamic, and thus periodic adjustments to any credit risk retention requirement may be necessary to ensure that the requirements remain effective over the long term, and do not provide undue incentives to move intermediation to other venues where such requirements are less stringent or may not apply.	• align incentives without changing the basic structure and objectives of securitization transactions; • provide for greater certainty and confidence among market participants; • promote efficiency of capital allocation; • preserve flexibility as markets and circumstances evolve; and • allow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner.

The Commentary does not contain a comprehensive discussion of these considerations or a sufficient explanation of how the Proposed Rules satisfy the foregoing objectives. Although Part VIII of the Commentary (Administrative Law Matters) addresses certain related topics, the discussion in Part VIII falls short of providing the impact analysis that is required for regulations as consequential as the Proposed Rules. Moreover, as explained below, we believe that the analysis that is provided in Part VIII is flawed and incomplete in a number of important respects.

2. The Commission's economic analysis is flawed and incomplete

As noted in Part VIII.C, the Exchange Act requires the Commission to consider the impact on competition that the Proposed Rules would have, and prohibits the Commission from

adopting any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act.[104] In addition, the Securities Act and the Exchange Act require the Commission, when engaged in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.[105]

In conducting the analysis described above, the Commission stated that it "examine[d] the costs and benefits of alternative implementations of a risk retention requirement meeting the requirements of the Dodd-Frank Act, rather than the existence of a risk retention requirement."[106] For example, in explaining the menu of risk retention options, the Commission said that it "believes that the proposed menu-of-options approach and the accompanying disclosures will have no competitive effects, and will implement the mandates of Section 15G without causing economic inefficiencies or hindering capital formation."[107] However, the Commission stated that this conclusion "refers to the choice made by the Commission and other agencies by having proposed a menu of options rather than the statutory mandate to require risk retention."[108]

The premise that the Commission need not consider the effects of the "existence of a risk retention requirement" but only "alternative implementations" of a risk retention requirement is, in our view, fundamentally flawed. Section 941 of the Dodd-Frank Act does not impose a risk retention requirement on all securitizations. Indeed, Section 941(c) of the Dodd-Frank Act specifically *requires* that the Agencies "provide for a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors." *Therefore, the Commission should have considered the effects of the existence of a risk retention requirement for any securitization for which the Proposed Rules do not provide a total or partial exemption.*[109]

Even when considering the effects of only "alternative implementations" of a risk retention requirement, the Commission does not consider the effects of many of the choices made by the Commission and the other Agencies in the Proposed Rules. Most prominently, the Commission does not analyze the effects of its decision to calculate the 5% risk retention amount by reference to ABS interests rather than by reference to the actual credit risk of the securitized assets, as contemplated by Section 941(b). As we note in Part II.A.1 of this letter, we believe that approach imposes substantial incremental costs on securitizers.

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[104] See Proposal, at 24150.

[105] See Section 2 of the Securities Act and Section 3 of the Exchange Act.

[106] Id., at 24150.

[107] Id., at 24151.

[108] Id., at footnote 235.

[109] As noted above, under the Exchange Act or Securities Act, among the effects of the existence of a risk retention requirement that the Commission should have considered is whether such requirement will promote efficiency, competition and capital formation.

3. The Agencies should conduct a regulatory flexibility analysis under the Regulatory Flexibility Act

As noted by the Agencies, the Regulatory Flexibility Act generally requires that, in connection with a notice of a proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities. However, this analysis is not required if an agency certifies that the rule will not have a significant impact on a substantial number of small entities and publishes its certification and an explanatory statement with the proposed rule.

In Part VIII.A. of the Commentary, the Agencies certify that the Proposed Rules will not have a significant impact on a substantial number of small entities. Therefore, in the view of the Agencies, the regulatory flexibility analysis described above is not required with respect to the Proposed Rules. In support of this conclusion, the Agencies focus exclusively on the size of the sponsors that would be required to retain risk under the Proposed Rules.

However, as the FRS Report makes clear, the effects of risk retention on small businesses extend far beyond the small businesses that sponsor securitizations. For example, the FRS Report notes that:

- risk retention rules could affect the volume of federally subsidized lending, including small business loans;[110]
- many types of loans to small businesses are routinely securitized in the private market;[111]
- the Agencies should consider the potential effects of credit risk retention requirements on the capacity of smaller market participants to comply and remain active in the securitization market;[112]
- among the types of securitization transactions conducted in the market are securitizations of insurance premium finance loans that are extended to small businesses to enable them to pay their property and casualty insurance premiums;[113]
- small business use credit cards to finance purchases of a wide variety of services or merchandise;[114]

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[110] See FRS Report, at 3.

[111] Id.

[112] Id.

[113] Id., at 8 (footnote 10).

[114] Id., at 19.

- middle-market CLOs are collateralized by loans to relatively smaller borrowers;[115] and

- securitized "small ticket" equipment loans tend to be loans taken out by smaller businesses.[116]

Given securitization's pervasive role in our economy and the importance of securitization to the availability of credit to small businesses, it is difficult to see how the Proposed Rules, if adopted, would not have a significant impact on a substantial number of small entities.[117] Therefore, the Agencies should provide a regulatory flexibility analysis pursuant to the Regulatory Flexibility Act.

C. Reproposal of the Proposed Rules

As we have noted throughout this letter, the Final Risk Retention Rules are likely to have a substantial impact upon the securitization market. If the Final Risk Retention Rules impose dramatic new financial requirements on securitizers, or fail to permit the use of existing risk retention methodologies, or undercut the legal framework on which the market has developed, they could cause significant harm. Inappropriately crafted rules could reduce securitization issuance, steer credit away from underserved segments of the consumer market and delay the economic recovery.

We have also sought to convey in this letter the extraordinary diversity of transaction structures, asset classes and terms of securities in the securitization market. The task of constructing regulations to implement risk retention requires thoughtful consideration and dialogue between the Agencies and the securitization industry.

Even with the extended comment period that the Agencies provided for the Proposal, we simply do not believe that it will be possible to formulate an appropriate set of Final Risk Retention Rules based solely on one round of comments on the Proposal. We believe it is essential that the Agencies re-propose the risk retention rules in order to give market participants an additional opportunity to help the Agencies formulate sound rules. We strongly encourage the Agencies to follow this route, as we believe the end result will be a much improved risk retention regime.

D. Interplay between the Proposal and the FDIC Autoconform Provisions

In the FDIC Securitization Rule, the FDIC included an "autoconform" provision that sought to provide a transition from the risk retention requirements in the FDIC Securitization Rule to the risk retention rules that will be adopted by the Agencies. We believe that the FDIC's

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[115] Id., at 22.

[116] Id., at 23

[117] Indeed, we fully expect the Agencies will receive a great many comments on the Proposed Rules from small businesses and organizations that represent small businesses.

autoconform provision raises a number of issues that should be addressed either by the Agencies in the final rules or by the FDIC in a clarification of the FDIC Securitization Rule.

The relevant text of the FDIC Securitization Rule reads as follows:[118]

> Upon the effective date of regulations required under new Section 15G of the Securities Exchange Act, 15 U.S.C. 78a et seq., added by Section 942(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, such final regulations shall exclusively govern the requirement to retain an economic interest in a portion of the credit risk of the financial assets under this rule.

The issues we note with regard to the FDIC Securitization Rule are as follows:

1. Effective Date

Based on statements made at the FDIC board meeting in connection with adoption of the FDIC Securitization Rule, held on September 27, 2010, we believe it is unclear whether the FDIC intended that the Final Risk Retention Rules would take effect for insured depository institutions ("IDIs") (i) upon the *adoption* by the Agencies of the Final Risk Retention Rules, or (ii) not until the Final Risk Retention Rules actually become effective (which, per the Dodd-Frank Act, will not be until one year following adoption for securitizations of residential mortgages and two years following adoption for all other asset classes). Although the FDIC Securitization Rule itself reads as though the FDIC intended the latter, statements made at the board meeting suggested that the former interpretation was intended.

This question is relevant only to those transactions and structures which are currently subject to the risk retention requirements of the FDIC Securitization Rule ("Subject IDI Securitizations"); those transactions which may currently be effected by IDIs without compliance with the risk retention requirements of the FDIC Securitization Rule should not be impacted, as it is clear that the currently exempt transactions will be required to meet the retention requirements upon the effectiveness of the Final Risk Retention Rules.

We think that it would be appropriate, upon the adoption of the Final Risk Retention Rules, to provide Subject IDI Securitizations with the option to use either the retention requirements embedded in the FDIC Securitization Rule or the Final Risk Retention Rules.

Accordingly, we suggest that either (i) the Agencies provide in the Final Risk Retention Rules or (ii) the FDIC provide in a rulemaking or statement that is effective upon adoption of the Final Risk Retention Rules that Subject IDIs have the option described in the preceding paragraph.

2. Pre-existing securitizations

We presume that the FDIC intended that the Final Risk Retention Rules would apply only to securitizations transacted after the date on which those rules become effective with respect to

[118] 12 C.F.R. §360.6(b)(5)(i)(B).

IDIs. However, there is no language in the FDIC Securitization Rule to that effect, which raises the possibility that the Final Risk Retention Rules could be applied retroactively to pre-existing securitizations that were effected after adoption of the FDIC Securitization Rule but before the effectiveness of the Final Risk Retention Rules. The result in such a situation would be to deny securitizers and investors the benefits of the safe harbor under the FDIC Securitization Rule, even though the securitizer complied with the FDIC Securitization Rule when designing the transaction. We do not believe that the FDIC intends such a result.

We ask that either (i) the Agencies provide in the Final Risk Retention Rules or (ii) the FDIC provide in a rulemaking or statement that is effective upon adoption of the Final Risk Retention Rules that these pre-existing securitizations are not subject to the Final Risk Retention Rules.

3. Impact of failure to maintain required risk retention

We note that the autoconform provision in the FDIC Securitization Rule is not formulated with the phrase "the documents shall require that" the securitizer comply with the Final Risk Retention Rules. This omission raises the potential that a failure to comply with the autoconform provisions could result in the safe harbor becoming unavailable. Both sponsors and investors were extremely concerned about the risk that the safe harbor could be lost if safe harbor requirements were implemented by a securitizer in a way that the FDIC later found to be insufficient; as a result, the FDIC included that phrase in many locations throughout the FDIC Securitization Rule — notably including the provision that governs risk retention prior to the effectiveness of the Final Risk Retention Rules.

We request that (i) the Agencies include a provision in the Final Risk Retention Rules or (ii) the FDIC provide in a rulemaking or statement that is effective upon adoption of the Final Risk Retention Rules that a securitization will be entitled to the benefits of the FDIC Securitization Rule so long as the securitization documents require compliance with the Final Risk Retention Rules.

V. Asset Class Exceptions and Exemptions

A. Qualified Residential Mortgages (§ __.15)

Section 15G of the Exchange Act provides that the risk retention requirements shall not apply to an issuance of ABS if all of the assets that collateralize the ABS are QRMs[119] and directs the Agencies to define jointly what constitutes a QRM, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default.[120] The Proposal indicates that the Agencies were guided by several factors and principles in considering how to define QRMs, including identifying underwriting standards and product features that should help ensure that such residential mortgages are of very high credit

[119] See 15 U.S.C. 78o-11(c)(1)(iii).

[120] See id., at sec. 78o-11(e)(4).

quality,[121] and providing QRM standards that are transparent to, and verifiable by, originators, securitizers, investors and supervisors.[122]

We appreciate the Agencies' efforts to establish QRM standards that the Agencies believe will result in residential mortgage loans that have low credit risk even in very stressful economic environments.[123] Many of the standards set forth in the proposed definition, such as standards relating to the borrower's ability to repay the mortgage loan (as measured by the person's debt-to-income ratio), the borrower's credit history, down-payment amount and sources, the loan-to-value ratio of the loan, and the forms of verification and valuation, do not present any significant legal issues of which we are aware, but, rather, present practical and business issues. As we have noted elsewhere in this letter, we believe that comments on such matters are best left to securitizers, investors and other participants in the securitization industry. Therefore, we are not providing detailed comments on many aspects of the proposed definition nor do we attempt to respond to many of the questions posed by the Agencies in the Proposal. However, we discuss below several concerns of a somewhat general nature which we have with the proposed definition.

1. Impact on private securitization market

Although we agree with the Agencies that the definition of QRM, as proposed, will likely result in only a small percentage of residential mortgage loans meeting those standards, as securitization practitioners, we do not share the Agencies' optimism that the additional risk retention options provided in the Proposed Rules will be benign enough to reduce the potential to disrupt securitization markets, including those for non-QRM residential mortgages, or materially affect the flow or pricing of credit to borrowers, nor do we share the Agencies' belief that

> [T]he amount of non-QRM residential mortgages should be sufficiently large, and include enough prudently underwritten loans, so that ABS backed by non-QRM residential mortgages may be routinely issued and purchased by a wide variety of investors. As a result, the market for such securities should be relatively liquid, all else being equal. Indeed, the broader the definition of QRM, the less liquid the market ordinarily would be for residential mortgages falling outside the QRM definition.[124]

To the contrary, we believe that the narrowness of the QRM definition, coupled with the proposal to exempt the Federal National Mortgage Association ("Fannie Mae") and the Federal

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[121] Proposal, at 24117.

[122] Id., at 24118. The Agencies recognize the need to address the interaction of the QRM definition with the definition of "qualified mortgages" under the Truth-in-Lending Act ("TILA"), as modified by the Dodd-Frank Act. With rule-making authority under TILA split between the Federal Reserve Board and the Consumer Financial Protection Bureau and under a different time frame, the Agencies opted to proceed with their QRM definition and to revise it later if necessary to ensure that it is no broader than the "qualified mortgage" definition eventually promulgated by the Federal Reserve Board or the CFPB. Id. We assume that the Agencies will provide the industry with the opportunity to comment on any modifications made to the QRM definition as a result of changes to the TILA definition of "qualified mortgages."

[123] Id.

[124] Id.

Home Loan Mortgage Corporation ("Freddie Mac" and, together with Fannie Mae, the "GSEs") from the application of the risk retention rules, will simply maintain the status quo and further entrench the discrimination inherent in the current market. Residential mortgage loans that satisfy the QRM requirements will be privately securitized, while mortgage loans that satisfy the requirements for sale to the GSEs (so-called "conforming loans") will be sold to a GSE, in each case, utilizing an exemption under the risk retention rules. Non-QRMs and non-conforming loans will only be made if they are eligible for sale under the Federal Housing Administration's or the U.S. Department of Veterans Affairs' loan guarantee or insurance programs. As a consequence, we believe that the credit available for mortgage loans to borrowers that do not meet all of these eligibility requirements will be severely limited, and, to the extent available, will be significantly more costly. Accordingly, rather than seeing a negative correlation between a broader definition of QRM and a more liquid public market for non-QRM residential mortgages, we believe it is more likely that no robust public market for non-QRM residential mortgages will develop.

We ask the Agencies to consider whether a less narrowly tailored QRM definition that nonetheless includes prudent underwriting criteria will better serve to revive the private RMBS securitization market and assure the continued availability of affordable credit to the housing market. For example, the definition of QRMs could be expanded to include any residential mortgage loan that is eligible to be sold to a GSE. Such treatment would, in our view, level the playing field between the private market and the GSEs. Securitizers of non-QRM loans that are nonetheless prudently underwritten could justify private securitization as an economically viable alternative to sale to a GSE because neither option would impose the additional cost of risk retention to the transaction. Moreover, as the eligibility criteria for sale of residential mortgage loans by the GSEs is tightened by Congress or the Federal Housing Finance Authority in an effort to reduce the level of government support of the mortgage market (for example, by reducing the conforming loan limit), the number of loans eligible for treatment as QRMs would reduce as well. A gradual withdrawal of the government from the mortgage market, while nonetheless maintaining a level playing field between the public and private mortgage markets, would, we believe, enable development of a safe, attractive and robust private residential mortgage market.

2. Inclusion of servicing requirements in loan documentation

In addition, we are particularly troubled by the Agencies' proposal to require that the originator of a QRM incorporate into the mortgage loan transaction documents certain requirements regarding servicing policies and procedures for the mortgage loan, including requirements regarding loss mitigation actions, subordinate liens, and responsibility for assumption of the servicing obligations if the servicing rights to the QRM are transferred.[125] For the reasons discussed below, we believe that it is not possible to implement the requirement to include the servicing requirements in the documents evidencing the mortgage loan and, therefore, we do not support the inclusion of the servicing requirements in the QRM definition.

[125] See Proposal § __.15, at 24164.

As we have seen over the past several years, servicing practices in connection with default mitigation for residential mortgage loans have been evolving; no doubt such practices will continue to evolve as regulators, legislators and the marketplace grapple with the impact of defaulted residential mortgage loans on borrowers, investors and the economy. Including servicing requirements in the loan documentation signed at the closing of the mortgage loan may well hamper the implementation of different or better servicing practices that are not clearly permitted by the loan documents. Servicers will be reluctant to make such changes if it is unclear if a servicer will be subject to liability for adopting the newer practices, which might be inconsistent with, or even violate, the terms of the loan documents, without seeking modifications to the loan documents. As we have seen, modifications to the loan documents, even those that are made to benefit borrowers, are difficult, time consuming and expensive. The Agencies discuss in the Proposal an ongoing interagency effort among certain federal regulatory agencies, including some of the Agencies, to develop national servicing standards that would apply to servicers of residential mortgage loans irrespective of the type of entity servicing the loan or whether the loan is securitized.[126] Any final rules adopted by this interagency group could be inconsistent with the proposed servicing requirements included in the QRM definition. Here too, the ability to implement any servicing requirements different from those included in the loan documents may well be stymied by the difficulties (including the time and expense) of amending the loan documents.

The inclusion of servicing requirements in the mortgage loan documentation may well result in less standardization of loan documents, impose an unnecessary paperwork burden and create confusion among borrowers. Currently, most, if not all, residential mortgage loans (whether or not conforming loans) are made on standard forms provided to the industry by Fannie Mae or Freddie Mac. Because the GSEs have no risk retention requirement pursuant to § __.11 of the Proposed Rules, the GSE standard forms need not include the proposed servicing requirements, and it seems unlikely to us that the GSE forms will be revised to include provisions that are not applicable to the loans they purchase.[127] Originators of QRMs would need to develop separate documentation for those loans, or at least appropriate supplements, addenda or riders to include the servicing requirements, and those forms are less likely to be standardized across originators. The result will be more, and potentially less standardized, documents for borrowers to execute at closing. The result will be uncertainty at origination of a particular loan as to whether it will be retained by the originator in its portfolio, securitized in a private securitization for which the originator or a third party is the sponsor or sold to the GSEs. The residential mortgage market functions more efficiently with standard documentation that

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[126] Proposal, at 24127.

[127] Fannie Mae recently announced the adoption of new servicing standards for delinquent mortgage loans, but it does not appear that changes have been made to its form mortgage loan documents to include any servicing standards. See Fannie Mae Announcements SVC-2011-07 and SVC-2011-08 (June 6, 2011)(available at https:fanniemae.com/sf/servicing/index.jsp). The updates to Fannie Mae's modification requirements included in SVC-2011-08 require the servicer to modify a loan if its "mark-to-market loan-to-value ratio" using the gross unpaid principal balance of a delinquent loan is greater than or equal to 80%. We note that this modification standard differs from the standard proposed in the QRM servicing provisions, which provides that a delinquent loan must be modified (or another loss mitigation alternative used) if the estimated resulting net present value of such action exceeds the estimated net present value of recovery through foreclosure.

facilitates any of these options, and it will simply be less efficient if non-standard documentation must be used depending on the intended disposition of the loan.

In addition, the servicing requirements, with terms that few may understand, will be difficult to explain to borrowers. For example, will the agent closing the loan be able to explain to a borrower what "net present value" means and how the lender will or might calculate it? Moreover, the servicing standards would apply only to QRMs, even though QRMs would be considered the least likely to suffer default by the borrower and represent a very small segment of the residential market. Accordingly, including the servicing standards in the QRM requirements would not provide any protections to the less creditworthy borrowers for whom such protections are more likely to be much more meaningful.

The proposed QRM definition also would require the loan documents to implement or maintain servicing compensation arrangements consistent with the definition's loss mitigation servicing standards. We note that the market has yet to develop standards for servicing compensation tied to loss mitigation activities, and we find it troubling that the Agencies would require that the servicer's compensation, which for a securitized loan may be unknown at the time of origination and typically is a matter of negotiation among the servicer, the securitizer and the investors for a particular securitization, be made the subject of the contracts between the borrower and the lender.

Section 15G directs the Agencies to consider "underwriting and product features" that historical loan performance data indicate result in a lower risk of default by the borrower, such as documentation and verification of income and standards with respect to debt-to-income ratios and product features such as protections against payment shock in adjustable rate loans and prohibitions or limitations on the use of balloon payments, negative amortization, prepayment penalties, interest-only payments and other features that have been shown to exhibit a higher risk of borrower default. The servicing requirements that the Agencies propose are not related to the underwriting of mortgage loans nor do the requirements constitute product features. In our view, the servicing requirements do not serve to bolster the credit quality of the mortgage loans as originated. Nor do we believe that the servicing requirements necessarily further the interests of ABS investors, some of whom might well object to the inclusion of loss mitigation requirements which could have an adverse economic impact on the ABS interests but which provide no relief on other issues of concern to investors.

Taken together, we believe that our concerns raise serious questions about the propriety of including servicing standards in the Final Risk Retention Rules. We urge the Agencies to delete this requirement from the QRM definition and to consider mortgage loan servicing standards as part of an interagency rulemaking that would apply to all servicers regardless of whether the mortgage loan is a QRM or is even securitized. Such a rulemaking would not, we believe, raise many of the issues we discuss above, and would result in a more appropriate and broad-based regulatory approach. However, if the Agencies nonetheless believe it is appropriate to include servicing requirements as an eligibility criteria for QRMs, we believe that a better approach, which would further the Agencies' objectives but still avoid some of the issues we discuss above, would be to require the servicing standards to be included in the documentation for the securitization transaction rather than in the individual loan documentation.

3. Additional concerns

Of lesser importance, we discuss below two additional concerns relating to the QRM exemption.

(a) Reporting repurchases of loans subsequently determined to be non-QRM loans; substitutions in lieu of repurchases

The proposed QRM definition includes a requirement for the securitizer to notify, or cause to be notified, the holders of any ABS collateralized by QRMs of any repurchase by the securitizer of a loan that is subsequently determined not to be a QRM.[128] We ask the Agencies to consider whether any such reporting obligation can be deemed to be satisfied if the securitizer reports the repurchase of such mortgage loan pursuant to the requirements of the Commission's recently adopted Rule 15Ga-1. Rule 15Ga-1 requires securitizers of ABS the documentation for which includes an obligation to repurchase an asset collateralizing the ABS in connection with breaches of asset representations and warranties to file quarterly reports on Form ABS-15G to report demand and repurchase activity in connection with such breaches. In addition, if the ABS is sold in an offering registered under the Securities Act, the issuer of the ABS also must report such demand and repurchase activity, or cause such activity to be reported, on Form 10-D distribution reports. Assuming that the securitizer of ABS collateralized by QRMs will represent and warrant as to the QRM status of each residential mortgage loan, then the securitizer would already be subject to the reporting requirements of Rule 15Ga-1. We believe it will promote market efficiency to allow such reporting to satisfy the reporting obligation proposed to be included in the QRM definition.

The Agencies request comment on whether securitizers should be permitted to substitute a new loan that satisfies the QRM definition in lieu of repurchasing a loan that is subsequently determined to be a non-QRM.[129] We believe that such substitutions should be permitted in lieu of repurchasing such loans. Substitution of a qualified mortgage loan in place of a defective mortgage loan, at least for a period of time after closing, is a standard market feature in connection with breaches of loan representations and warranties, and we do not believe that the ability to make such substitutions would have a material affect on the quality of the loans a sponsor originates or purchases, because any such substituted loan must itself be a QRM.

(b) Delinquency advances in connection with QRMs

The Agencies request comment on whether the QRM definition should contain any restrictions on the obligation of the servicer to advance scheduled payments of principal and interest on the mortgage loan if the borrower fails to make such payment (often referred to as "delinquency advances" or "P&I advances"). The Agencies note that the delinquency advances are intended to maintain regular cash flow to investors, rather than to guarantee payments of principal and interest on the loans, but worry that funding such advances creates liquidity constraints for servicers and may influence their decision to foreclose upon a residential

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[128] See Proposal § __.15(e)(3), at 24167.

[129] See Question 142, Proposal, at 24129.

mortgage loan (which usually enables the servicer to reimburse itself for outstanding delinquency advances) instead of utilizing another loss mitigation technique that might delay reimbursement of such advances.[130] We believe this is an issue that is more appropriately addressed by RMBS sponsors, investors and servicers and, accordingly, we take no position on whether servicers' obligations to make delinquency advances should be curtailed.

However, we believe that inclusion of a prohibition or limitation on delinquency advances in the Final Risk Retention Rules raises many of the same concerns we discussed above with respect to the Agencies' proposal to include general servicing requirements among the QRM criteria. As we note above, Section 15G is aimed at promoting the underwriting of high quality residential mortgage loans. Imposing servicing standards, whether the more general servicing requirements or relating to delinquency advances, appears beyond the scope of the Dodd-Frank Act. Thus, if the Agencies believe that curtailment of the use of delinquency advances is needed, we believe that this matter is better addressed in any national mortgage servicing guidelines promulgated on an interagency basis rather than in the risk retention rules.

We note, as well, that one of the practical effects of eliminating altogether a servicer's obligations to make delinquency advances is that a longer time period must elapse between the borrowers' payment due dates and the dates on which the servicer remits and reports to the investors in the RMBS. A servicer under a servicing agreement that obligates it to make delinquency advances will remit and report on what is referred to as a "scheduled/scheduled" basis. For example, most first lien mortgage loans specify that the borrowers are to make their scheduled payments (that is, scheduled interest and scheduled principal) on the first day of each month, but provide for a grace period for late payments, so that many payments can arrive late. At the same time, many servicing agreements require the servicer to report the scheduled payments received on the loans around the tenth of the month and to remit the payments to the trustee for the RMBS transaction around the 18th day of the month. A servicer that is servicing thousands, or even millions, of mortgage loans will not necessarily be able to confirm that every borrower had made his or her scheduled payment by the reporting and remitting dates. Accordingly, a servicer typically will advance all of the scheduled payments for all of the loans backing the RMBS (other than loans as to which under the RMBS transaction documents the servicer is no longer required to make such advances[131]) to the investors and determine after the fact whether there were any delinquent borrowers. If the Agencies prohibit or restrict a servicer's obligation to make delinquency advances, the servicer will service mortgage loans on what is referred to as an "actual/actual" basis, passing through to investors only the scheduled payments (and unscheduled principal) it actually receives from borrowers. In order to report accurately, the servicer will need to delay the monthly reporting and remitting dates so as to allow the servicer to determine whether or not it received such payments. The shift from "scheduled/scheduled" servicing to servicing on an "actual/actual" basis would be a significant change for many RMBS transactions (particularly securitization of first-lien mortgage loans), and it would delay investors' receipt of funds.

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[130] See Question 137, Proposal, at 24128.

[131] Securitization servicing agreements typically authorize the servicer to cease making delinquency advances if the servicer determines that such advances would not be recoverable from borrower late payments, insurance or liquidation proceeds.

B. Qualifying Commercial Loans (§ __.18)

Although we appreciate that the Agencies consider commercial loans an important asset class within the U.S. economy, the criteria for Qualifying Commercial Loans in the Proposed Rule are too narrow, and we believe the result is that it would be impractical economically to structure a Managed CLO holding only such loans. We believe the requirements for a Qualifying Commercial Loan should be reasonable and based on sound principles of commercial loan underwriting to which the majority of the participants in the corporate loan market would agree are feasible.

One example of how unworkable are the current specifications of § _.18 is the requirement that the originator must confirm that the obligor of each commercial loan, for two years before and after the closing of the loan, has (i) a total liabilities ratio of 50% or less, (ii) a leverage ratio of 3.0 or less, and (iii) a debt service coverage ratio of 1.5 or greater.[132] From the perspective of human capital, this type of diligence would require tremendous resources on the part of the collateral manager. Moreover, from a practical perspective, there are relatively few companies that could satisfy these leverage requirements. Standard & Poor's, for example, reviewed the top 100 corporate obligors in the Managed CLOs that it rates and found that the average leverage ratio of these obligors is greater than 6.0.[133]

Another requirement we view as impractical for Qualifying Commercial Loans is the prohibition against reinvestment periods. Reinvestment periods are necessary for Managed CLOs since the buying and selling of loans in the portfolio help to generate the excess spread that these securitization vehicles require in order to satisfy their liabilities to the investors. Some of the other requirements, e.g., requiring the commercial loans to straight-line amortize completely within five years is not the industry standard as business cycles of certain businesses do not fit within this five year target.

Standard & Poor's concludes from its review that no existing nor new CLO transaction could satisfy the Qualifying Commercial Loan conditions.[134] Such a regulation does nothing to benefit investors or create the sound and sustainable securitization practices that Congress sought. Therefore, we ask that the Agencies reach out to the CLO market participants and revise the requirements for Qualifying Commercial Loans so that exemptions from risk retention are reasonable and practicable.

C. Qualifying Auto Loans (§ __.20)

While we appreciate the Agencies' efforts to establish standards they believe will result in the origination of high quality, prudently underwritten auto loans, we do not believe that the

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[132] See § _.18(b)(1)(iii).

[133] See Standard & Poor's, "CDO Spotlight: Most Top 100 Obligors in Cash Flow CLOs Would Not Qualify for Risk-Retention Exemption in New Proposal," April 13, 2011. Available at: http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245302658900.

[134] See id.

requirements of a qualifying auto loan set forth in the Proposal are typical of even the most creditworthy auto loans made, and we do not view the exemption as proposed to be workable.

In general, we note that some of the criteria establishing what constitutes a qualifying auto loan exemption are based upon criteria used to determine what constitutes a qualifying residential mortgage. We question whether it is appropriate to treat auto loans as though they represent the same credit risk as residential mortgage loans. From a practical standpoint, for most borrowers a mortgage loan represents by far the largest obligation the borrower will owe with a typical maturity date of 15 to 30 years or more. By contrast, the typical auto loan represents a fraction of the amount borrowed for the purchase or refinance of a personal residence and the auto loan will be outstanding for a far shorter time period, typically four to six years. As a consequence, the typical auto loan originator does not make the same investigation as to the borrower's ability to repay an auto loan as would a lender making a mortgage loan available to the same borrower.

Further, at least one requirement appears impossible to determine, which is the requirement that "[a]t closing of the automobile loan, the borrower makes a down payment from the borrower's personal funds." If a borrower made the required down payment with proceeds from another loan, we are not sure the lender would know this information; to have the loss of the exemption contingent on such a requirement seems infeasible.

In addition, we note that the requirement that the originator, subsequent holder of the loan or an agent physically hold the title to the vehicle until the loan is repaid is impossible to satisfy in several states. For example, New York requires that the title be delivered to the owner of the vehicle, not the secured party, and several states, such as Pennsylvania, either permit or require that vehicle titles be electronic, which would prevent any physical holding of the vehicle title. Furthermore, the trend has been for states to develop electronic systems, which would only increase the impossibility of satisfying this requirement, as more states migrate to electronic recordkeeping.

For these reasons and others, we encourage the Agencies to reconsider the requirements relating to qualifying auto loans.

VI. Other Exceptions and Exemptions

A. General Exemptions (§ __.21)

1. Exemption for certain resecuritization transactions

In addition to the other exemptions from the risk retention requirements to be adopted under the general exemption provisions of Section 15G(e)(1), the Agencies propose to exempt certain resecuritization transactions from the risk retention rules. The Proposed Rules would exempt ABS issued in a resecuritization transaction only if three conditions are met: (i) the ABS collateralizing such exempt transactions (other than cash or cash equivalents) be limited to ABS which complied with, or was exempted from, the risk retention rules ("15G Compliant ABS")[135],

[135] See Proposal, §__.21(a)(5)(i), at 24172.

(ii) only a single class of ABS interest is issued ("Resecuritization ABS")[136] and (iii) such Resecuritization ABS equals 100% of the principal and interest on the ABS collateralizing such Resecuritization ABS (net of expenses).[137] We believe that the requirements under the Proposed Rules and the limited exemptions are overly restrictive and will result in a reduction in liquidity by eliminating the ability of current holders of ABS to utilize well established resecuritization transaction structures.

(a) Single class of resecuritization ABS representing 100% of principal and interest

The proposed exemption requires that only a single class of Resecuritization ABS be issued by a related securitizer. This requirement effectively limits the exemption to resecuritization transactions that aggregate outstanding ABS[138] and issue a fractional underlying beneficial ownership in such ABS.[139] We believe that such restrictions are unnecessarily narrow and will effectively eliminate many current resecuritization transaction structures.

In our experience, the majority of resecuritization transactions are secondary market transactions that typically occur at some interval of time following the issuance of the underlying ABS.[140] In addition to resecuritization transactions that aggregate smaller ABS into a single instrument, resecuritization transactions are also undertaken as a means for providing additional credit enhancement to outstanding ABS or allocating identified cash flows to one or more classes of Resecuritization ABS.[141] Such resecuritization transactions by their nature do not directly impact the underwriting of the assets backing the underlying securities and are effected primarily for the purpose of creating a liquid and efficient market for outstanding ABS. The application of the risk retention requirements pursuant to the Proposed Rules will severely limit, if not eliminate, the economic feasibility of ABS holders to effect many types of resecuritization transactions (for example, IO/PO securities and planned amortization ABS interests). A further consequence will be to impede, not promote, the redevelopment of a fully functioning ABS market and reduce the efficiency of the secondary ABS market.

We believe that application of the risk retention requirements to every multi-class resecuritization transaction is over-reaching and unnecessary. Imposing risk retention on resecuritizations of the types described above will not further Congress' goal of improving the

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136 See Proposal, §__.21(a)(5)(ii), at 24173.

137 See Proposal, §__.21(a)(5)(ii), at 24173.

138 Proposal, at 24138.

139 Id., at footnote 191.

140 For example, the exemption from registration afforded resecuritizations by Rule 190 under the Securities Act, requires, among other things, that the underlying securities be freely tradable and that the issuer of the underlying securities not be affiliated with the sponsor, depositor, issuing entity or underwriter of the Resecuritization ABS.

141 For example, a resecuritization may provide for the issuance of interest-only and principal-only ABS interests, planned amortization class (PAC) classes (or similar time-tranched securities) or securities based on other identifiable payments on the underlying ABS interest.

underwriting of assets underlying the ABS interests that are resecuritized, and could be potentially harmful to the ABS market as a whole.

(b) 15G Compliant ABS

The requirement that any resecuritization transaction be collateralized by 15G Compliant ABS in order to qualify for an exemption from risk retention will serve to limit the resecuritization of any non-exempt ABS issued prior to the effectiveness of the Proposed Rule.[142] We agree with the Agencies that ABS interests created after the effective date of the Proposed Rules that are subsequently resecuritized are appropriately exempted from the Proposed Rules, but we do not agree that most types of currently existing ABS should be ineligible for resecuritization without complying with the risk retention requirements. It is clear that the Proposed Rules requiring risk retention on existing non-15G Compliant ABS will have no impact on underwriting standards for the assets backing existing ABS or securities structures for such ABS. Therefore, we believe that the limited exemption proposed by the Agencies is unnecessarily narrow and will serve only to artificially reduce the value of existing ABS. Similarly, we believe that the exemption from the Proposed Rules should encourage resecuritizations of ABS that provide additional collateral, such as insurance policies, interest-rate agreements or other instruments. These enhanced resecuritizations should be exempted, or else the securitizer should receive risk retention credit for the value of the enhancement provided. Doing so would avoid the seemingly incongruous result that a securitizer must hold the full measure of risk retention when its principal action was to enhance the credit of the underlying ABS.[143]

We believe that a less restrictive exemption that allows additional classes of Resecuritization ABS as well as additional assets (both ABS and otherwise) would still advance the goals of Congress in adopting Section 941(b) of the Dodd-Frank Act without unintentional and unnecessary adverse impacts on the secondary ABS market and the value of existing ABS to current holders.

B. Safe harbor for certain foreign-related transactions (§ __.22)

We strongly support the concept of including a safe harbor for certain foreign-related transactions within the Final Risk Retention Rules. Considering the generality of the legal authority addressing the extraterritorial effect of U.S. laws and regulations, it would be exceedingly difficult for a foreign issuer to conclude with confidence that a transaction is beyond the jurisdictional reach of the Final Risk Retention Rules without the protection offered by a safe harbor.

We understand from the Commentary that the Agencies' intention in proposing the safe harbor was solely to define, and then exempt from the Final Risk Retention Rules, foreign-related transactions with sufficiently limited connections to the U.S. and U.S. investors. We

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[142] Proposal, at 24139.

[143] See Memorandum from the Division of Corporate Finance dated May 2, 2011, regarding and April 28, 2011, meeting with representative of Assured Guaranty Corp. and the Association of Financial Guaranty Insurers.

concur that such transactions should be identified and exempted. However, we believe that it would also be appropriate for the Agencies to use the safe harbor to provide exemptive relief to other types of foreign-related transactions based on other legitimate policy grounds. In particular, we believe it would be appropriate for the Agencies to modify the proposed safe harbor to protect U.S. issuers and investors from anomalies in the Proposal that could, if left unchanged, materially disadvantage U.S. issuers (in one case) and U.S. investors (in the other case) without a corresponding compelling regulatory benefit in terms of investor protection.

Our first concern relates to the fair treatment of U.S. issuers, and results from the requirement in subsection (a)(3) of proposed § __.22 that precludes the safe harbor from ever being available to an issuer that is a U.S.-located entity (as defined in the Commentary). As a result of this provision, an issuer that is a U.S.-located entity must comply with the U.S. risk retention rules even if the issuer sells ABS to non-U.S. investors that are adequately covered by a non-U.S. regulatory scheme that the applicable foreign regulators deem sufficiently protective of investors in their jurisdictions.

This is not a theoretical concern; rather, it is already a looming issue for U.S. issuers desiring to sell to European financial institutions. As previously discussed, the European Commission has adopted a risk retention regime in Article 122a of the Capital Requirement Directive that is similar in many basic respects to the proposed U.S. scheme, but which varies considerably in its detail regarding acceptable types of retention and exempted transactions, among other things.[144] Unlike the Final Risk Retention Rules, which will apply to securitizers and originators, Article 122a applies in the first instance to "credit institutions" in EU member states — principally banks, savings institutions and other regulated lenders. Essentially, Article 122a prohibits such credit institutions from investing in an ABS unless the risk retention requirements of Article 122a have been complied with by the originator, sponsor or original lender.

The looming issue is that a U.S. issuer that proposes to issue and sell ABS to European credit institutions (which we understand comprise the largest part of the European ABS investor market) would be required to comply with the risk retention requirements of ***both*** the Final Risk Retention Rules and Article 122a. This would not be a serious problem if the two sets of rules were identical. However, there are considerable differences between the two risk retention regulatory regimes. These differences will, in effect, require U.S. issuers desiring to sell ABS to European credit institutions to adopt a "lowest common denominator" approach in which they must comply with the most restrictive risk retention requirements of the two jurisdictions, thereby placing U.S. issuers at a competitive disadvantage to European issuers selling to the same investors.

An obvious example of this differential treatment is the Proposal's requirement that U.S. issuers maintain a premium capture cash reserve account under the circumstances set forth in the Proposal. There is no corresponding requirement under Article 122a. As discussed elsewhere in this letter, we believe that the requirement to establish and maintain a premium capture cash reserve account entails a material economic cost for U.S. issuers. Accordingly, a U.S. issuer

[144] See "European Union Risk Retention Requirements" in Part III.B.2(a) of this letter.

selling securities to European credit institutions at a premium will be burdened by the economic cost of maintaining this reserve account that will not be borne by a similarly situated European issuer selling the substantially identical security to a European credit institution. This cost will be manifested either in the form of less favorable pricing that can be offered by the U.S. issuer, or in the form of reduced profit for the U.S. issuer as compared to the European issuer.

It may be assumed that the European regulators, which are primarily responsible for the well-being of European financial institutions, have concluded that the particular combination of requirements that makes up the Article 122a regime—with which the hypothetical U.S. issuer must fully comply when selling to European financial institutions—provides sufficient protection to European financial institution investors. Requiring the U.S. issuer to comply with such costly additional U.S. provisions provides little, if any, incremental benefit to the European investor in this example, and materially disadvantages the U.S. issuer in the global marketplace.

We believe that the simplest and fairest approach to dealing with this unfair differential treatment is to provide that U.S.-based issuers placing securities entirely outside the U.S. are not required to comply with the U.S. risk retention rules if they comply with other risk retention rules that provide adequate protection to investors in the target jurisdiction that are explicitly or implicitly deemed by local regulators to provide adequate protection to such investors.

Our second concern relates, at least indirectly, to the protection of U.S. investors. Prior to the financial crisis, large ABS issuers around the world frequently undertook "global" ABS offerings with parallel selling efforts in the U.S., Europe and Asia. In the U.S., these offerings were often formulated as Rule 144A private offerings, and were not subject to U.S. registration or disclosure requirements. Under the Proposal, private ABS offerings into the U.S. by foreign issuers, including such global offerings, will be required to comply with the same restrictions as those that apply to securities that are publicly offered in the U.S. This fact, coupled with the provision of subsection (a)(2) of § __.22 limiting application of the safe harbor to transactions in which 10% or less of the securities are offered to U.S. persons, provide a powerful incentive to a foreign issuer to avoid offering ABS in the U.S. altogether.

This is because, we believe, many foreign issuers will find it non-economical either to limit their offerings in the U.S. to 10% or less of an overall offering to avoid U.S. risk retention rules, on the one hand, or to comply with the U.S. risk retention rules, on the other hand. We believe that many substantial, high quality global issuers are likely to consider both alternatives—limiting the U.S. portion of an offering to 10% or less or complying with the U.S. risk retention rules—to be unpalatable, causing these issuers to choose to withdraw from the U.S. market altogether. The result will be to deprive U.S. investors of the benefit of investing in high-quality ABS that would typically serve to diversify the portfolios and risk exposures of such investors.

Even aside from complying with risk retention requirements, offering ABS in the U.S. requires considerable expense to ensure compliance with a regulatory regime that is perhaps the most complex in the world. We believe that many issuers are unlikely to be willing to incur the expense and effort of issuing into the U.S. if the U.S. portion is limited to 10% or less of an offering. On the other hand, exceeding the 10% threshold and complying with the U.S. risk retention rules is also problematic for many foreign issuers. Foreign issuers considering

offerings in the U.S. are less likely than U.S. issuers to undertake an offering limited to the U.S., and are therefore more likely to have to comply with non-U.S. rules in their home or other target jurisdictions, in the first instance, such that compliance with U.S. rules is likely to constitute a complex overlay on another regulatory regime, which many foreign issuers will likely choose to avoid. Moreover, a number of U.S. specific aspects of the rule make complying with the rule particularly troublesome for foreign issuers.[145] Foreign issuers are therefore also discouraged from complying with the rule so as to permit offerings in excess of 10% of a total issue into the U.S.

As a result of the difficulties faced by foreign issuers in pursuing either exempt or compliant offerings, it may be expected that many fewer global ABS issues will be placed in the U.S. if the Final Risk Retention Rules are adopted as proposed. Since many global issues are sponsored by particularly high quality multi-national companies, U.S. investors will be disadvantaged if these issues are not available to them as they are to other, non-U.S. investors.

There are two principal approaches to mitigating these problems. The first is to withdraw the proposed application of the risk retention rules to privately placed transactions, such as Rule 144A offerings, in the case of offerings by foreign-based issuers. The second approach would be to increase the 10% threshold in subsection (a)(2) for securities sold to U.S. persons to something more practicable – say, 30% – that would still ensure that the offering in question was not principally a U.S. offering, but which would permit a foreign issuer to sell a sufficient portion of its offering in the U.S. to justify incurring U.S.-specific offering costs.

C. Additional Exemptions (§ __.23)

1. Generally

The risk retention provisions of the Dodd-Frank Act grant extraordinary regulatory discretion to the Agencies. Among the more prominent examples are the following:

- § 15G(c)(1)(C) – the Agencies can specify the permissible forms and minimum duration of risk retention
- § 15G(c)(1)(F) – the Agencies can specify appropriate standards for risk retention for CDOs and ABS CDOs
- § 15G(c)(1)(G) – the Agencies can provide a total or partial exemption of "any securitization"

[145] One example is the limitation of invested reserve account assets to certain U.S. bank deposits and U.S. government securities which, by their nature, are payable in U.S. dollars. This may create an uneconomic mismatch for foreign issuers, which are more likely than U.S. issuers to offer ABS in which the underlying assets, the offered securities, or both, are denominated in a foreign currency. A complete discussion of the various issues raised by the application of the Proposal to foreign investors is beyond the scope of this letter. We understand that AFME, the principal European securities industry trade group, as well as some of the U.S. industry groups, will submit comments identifying and addressing many of these issues. Although we do not specifically endorse the comments of AFME or any other organization in this regard, we urge you to consider carefully the points raised in their letters.

- § 15G(e)(1) – the Agencies may jointly adopt or issue "exemptions, exceptions or adjustments to the rules issued under this section"

In certain respects, the Agencies have made use of the discretion granted to them. Most prominently, the Agencies have proposed a number of different forms through which the retention requirements can be satisfied.

In other respects, however, we are disappointed that the Agencies have not made use of their regulatory discretion. The express exemptions from risk retention that the Agencies have granted have virtually all been required in, or suggested by, the text of the Dodd-Frank Act: QRMs and the other qualifying loan provisions; ABS insured or guaranteed by the United States or an agency thereof; qualified scholarship funding bonds; and several others.

Another way in which the Agencies have not exercised their discretion is through the granting of partial exemptions from the retention requirements. Every portion of the Proposed Rules (other than the premium capture cash reserve account) contemplates a risk retention level of either 5 percent or nothing. This "barbell" approach is not mandated by the Dodd-Frank Act; in fact, the legislative history we cite in Part I of this letter, as well as the FSOC Risk Retention Study and the FRS Report, clearly articulate a view that the Agencies should not employ a "one size fits all" approach. It seems to us that the Proposed Rules are predicated on a simplistic analysis of the securitization market. The securitization market is characterized by a multitude of asset classes, structures and forms of asset-backed securities. Many asset classes have performed exceptionally well, even through the extraordinary financial crisis of the past few years. Yet the Proposal, by and large, represents a very mechanical approach to risk retention, with only two states: five percent or nothing.

2. Full or partial exemptions for asset classes

We believe that the Agencies should consider other classes of asset-backed securities for exemptions from the retention requirements. In four places in the Asset Class Considerations, we advocate for specific exemptions from the retention requirements for asset classes that we believe present compelling cases:

- Managed CLOs (in Part VII.A.)
- Federally guaranteed student loans (in Part VII.G.)
- Utility Legislative Securitization (in Part VII.H.)
- Corporate debt repackagings (in PartVII.I.)

We also believe that the Agencies should make an effort to provide partial exemptions from the basic 5% risk retention requirement, or a framework through which partial exemptions may be obtained. For a sponsor that is accustomed to retaining a subordinated interest of, say, 2.0% in an asset class where defaults have never occurred, it would be far more palatable to satisfy a risk retention requirement of 2.0%, or even 3.0%, than the full 5.0%. The Agencies

must be mindful of the potential for the risk retention rules to stifle issuance; a more nuanced approach to regulation could be extremely important in this area.

D. Process for Interpretive Guidance

As we have noted throughout this letter, there are many ways in which the Proposed Rules attempt to capture critical aspects of securitization, such as the seller's interest, but do not quite get the technical details right. Even after the rules are revised to address points raised in this and other comment letters, we expect that ongoing interpretive issues will arise as the complexities of risk retention and the complexities of securitization collide. We are therefore very concerned that the process for providing interpretive guidance at best will be unwieldy, and at worst may be wholly unworkable. The Agencies state in the preamble:

> In light of the joint nature of the Agencies' rule writing authority under section 15G, the appropriate Agencies will jointly approve any written interpretations, written responses to requests for no-action letters and legal opinions, or other written interpretive guidance concerning the scope or terms of section 15G and the final rules issued thereunder that are intended to be relied on by the public generally. Similarly, the appropriate Agencies will jointly approve any exemptions, exceptions, or adjustments to the final rules.[146]

We understand that joint regulation is, and will continue to be, a requirement of the statute with respect to "exemptions, exceptions or adjustments." We do not, however, believe that joint action is statutorily mandated in connection with interpretations of the rules, and we urge the Agencies to agree on a more efficient and responsive process than the one we would imagine would result from a requirement for joint interpretation.

One alternative would be to allow interpretive guidance (including in the form of no-action relief) to be granted by the sponsor's primary federal prudential regulator, if it has one, or by the Commission, if it does not. Another alternative would be to place such authority with the Commission, but with the understanding that the Commission will consult with the other regulators in making its determinations. A third would be to establish a standing committee of representatives from each of the relevant agencies with authority to make determinations, a clear mandate to do so within a reasonably short time frame (for instance, within 30 days of the request), and the ability to act by majority, rather than unanimous, vote. We are less concerned about the form of the process or the agency or agencies that will control the determination than we are about having an efficient process that does not rely on the ability to obtain the focused and cooperative attention of four to six different regulatory agencies. We ask only that the Agencies develop a process that will allow determinations to made in a timely manner and consistent with supporting capital formation in the securitization markets.

VII. Asset Class Considerations

As we have noted throughout this letter, the securitization market provides funding for a great many asset classes. Each of these asset classes has its unique considerations. In this part of

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[146] Proposal, at 24097 (footnotes omitted).

the letter, we provide insight into many of those considerations for a number of different asset classes.

A. Managed Collateralized Loan Obligations

We believe that collateralized loan obligation securitizations ("CLOs") that are advised by collateral managers ("Managed CLOs")[147] are inappropriately being lumped together with ABS CDOs and other types of collateralized debt obligations. We believe that Managed CLOs should be considered a separate asset class that is entitled to more favorable treatment under the Proposed Rules.[148]

This section of the letter seeks to (i) describe the superior performance of Managed CLOs by highlighting important features of Managed CLOs that contributed to such performance and (ii) propose a total exemption for Managed CLOs from the risk retention requirements.

1. CLOs have performed well through the financial crisis and serve a valuable function in the corporate loan markets

During the recent financial crisis, no Managed CLO triggered an event of default.[149] Few investments of any kind in the capital markets have been immune to the effects of the financial crisis, and CLOs were neither an exception nor an outlier. However, as of November 2009, nearly 95% of the tranches of CLOs that were originally rated "AAA" remained at the "A" level or higher.[150] As the economy stabilizes and the performance of the underlying corporate loans has improved, the performance of CLOs has likewise improved. In June 2009, over 50% of CLOs in the U.S. failed one or more their overcollateralization ratio tests, usually triggering protective features to divert cash flow to amortize the most senior tranches. A year later, that measure had dropped to approximately 15%,[151] as a result of both the strong relative performance of the underlying collateral during the intervening time period and structural

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147 An important characteristic of Managed CLOs is that the assets held by the issuing entity are not originated by the issuing entity or its collateral manager, but rather are purchased by the issuing entity in the open market. See Part 5 of Appendix A below for further discussions of actively managed securitizations.

148 We note that there is a separate type of CLO, generally known as a "balance sheet CLO," for which we are not seeking an exemption from the risk retention requirements. A balance sheet CLO is generally sponsored by a lender that has directly originated a pool of loans; that lender, or its affiliated depositor, often retains the equity in the issuing entity.

149 Standard & Poor's "Cash Flow and Hybrid CDO Event of Default Notices Received as of Jan. 25, 2011," available at: http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245302658900.

150 See "U.S. CLO AAA notes remain relatively well rated" in the LSTA Presentation. In contrast, the same slide in the LSTA Presentation indicates that more than 90% of the "AAA"-rated tranches of the ABS CDOs have been downgraded below investment-grade. See also Lioce, Stephen, "The Unintended Credit Impact on CLOs of Dodd-Frank Proposed Risk Retention Rules," (June 2, 2011) in Moody's CLO Interest for May, 2011, available at: http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF247163, stating "90 percent of CLO notes outstanding [as of June 2011] and initially rated 'Aaa' currently carry ratings of "Aa" or higher." Lioce further notes that these ratings on many CLO tranches are expected to experience upgrades in connection with recent changes to Moody's ratings methodology.

151 See "U.S. CLOs heal as loan market recovers" in the LSTA Presentation.

features that improved those ratios as senior interests were paid.[152] The exemplary performance of Managed CLOs can be attributed to a variety of factors relating to the structure of this securitization model, the primary ones being the nature and diversity of the securitized assets, the quantum of information regarding those assets that are provided to the investors of Managed CLOs, and the alignment of the economic interests of the collateral manager with the investors through the largely performance-based compensation arrangement for the collateral manager.

The generally favorable performance of Managed CLOs stands in stark contrast to the results for ABS CDOs. During the financial crisis, no less than 435 ABS CDOs experienced an event of default.[153]

The assets in a Managed CLO are primarily syndicated leveraged loans made to corporations. Furthermore, the composition of the investment portfolios of Managed CLOs are required to be diversified by issuer and industry,[154] which helps in part to explain why CLOs performed better than the single-industry (residential mortgage) ABS CDOs. Another explanation for the better performance of CLOs is that the loans bundled in the CLOs were of fundamentally better quality. Indeed, while the default rates of corporate loans spiked in 2009, the corporate loan market recovered in 2010 and, in fact, the default rates in 2011 thus far are well below the rolling 12-year average annual default rate for corporate loans.[155] In addition, the portfolio requirements in Managed CLOs are generally structured to disincentivize, among other things, the retention of lower credit quality loans. With the majority of corporate loans in which Managed CLOs invest being broadly syndicated loans of large companies, the general liquidity of these loans in the secondary corporate loan market enables Managed CLOs to trade in and out of positions in order to improve the performance of the underlying portfolio.

The amount and type of information available to investors of Managed CLOs may also have had a significant impact on the ability of investors to understand the nature and performance of the ABS they purchase. Typically, monthly or quarterly reports detailing the pertinent information about each of the assets in the investment portfolio of a Managed CLO are provided to the investors. The availability of this type of information enables investors of Managed CLOs to analyze the performance of such CLOs. In addition, because the majority of the assets in a Managed CLO's investment portfolio are loans to large companies, significant amounts of financial and other information about the corporate borrowers are generally available. Furthermore, over the past eight years, the CLO industry has adopted software and internet platforms that provide participants with detailed information on the performance of CLOs and enable investors to model CLO cash flows under various default and recovery

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[152] See Jeremy Gluck, "CLOs versus CDOs: It's the 'L' That Matters" (July 2010) in Moody's CLO Interest for July, 2010, available at http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF210409.

[153] Standard & Poor's, "Cash Flow and Hybrid CDO Event of Default Notices Received as of Jan. 25, 2011."

[154] See id. For example, no corporate obligor may represent more than 2% of a CLO's investment portfolio, and no corporate industry may represent more than 12% of a CLO's investment portfolio.

[155] See Wells Fargo Research, at 7. Since 1999, the average annual default rate for corporate loans has been 3.7% by principal amount and 3.5% by obligor. For 2011 year to date, the default rate by principal amount is below 2% by principal amount and slightly above 2% by obligor.

scenarios.[156] As a result, the collateral manager and the Managed CLO's investors have at their disposal a variety of information sources and analytical tools to assess the risks of such corporate loans and, by extension, the cash flows stemming from a particular CLO.

Another aspect of Managed CLOs is the relatively small number of individual assets held by a typical Managed CLO. The number of assets held by an originate-to-distribute securitization of residential mortgage loans was typically much larger—perhaps 2,000 separate assets. Even though the assets in originate-to-distribute securitizations might have been subjected to third-party diligence, the sheer quantity of such assets did not invite close scrutiny of such assets individually. On the other hand, Managed CLOs generally contain a portfolio of 100-200 individual corporate loans, which makes it feasible for the collateral manager and the investors to analyze the credit risk of such loans.

The performance of Managed CLOs during the recent financial crisis may also be due in part to the alignment of the collateral manager's economic interests with the interests of the investors in the Managed CLO. The usual CLO manager compensation arrangement includes a base fee (payable at a high level of the waterfall), a subordinate fee (payable only after and if current debt service is met) and an incentive fee (payable only if the equity holders receive more than a specified return—generally toward the end of the term of the CLO). The base fee is generally sized to cover the collateral manager's overhead expenses; the subordinate and incentive fees generally constitute the profit the collateral manager earns for performing its services.[157] Hence, as the performance of the CLO's investment portfolio is optimized, so too is the collateral manager's compensation.

In addition, the collateral manager's interests are aligned with investors' interests by virtue of a different regulatory scheme. Most if not all collateral managers will soon be required to register with the commission as investment advisers under the Investment Advisers Act. The Investment Advisers Act specifies, among other things, that investment advisers have fiduciary duties to their clients. A breach of that duty could levy severe penalties on the investment adviser. This obligation of investment advisers provides a strong incentive to the collateral manager to act appropriately, and it gives the investors in a Managed CLO another potential remedy.

We believe that CLOs should be considered an asset class that is separate from other CDOs and, in particular, from ABS CDOs. CLOs invest in a diversified pool of corporate loans and do not have the concentration of risk that has plagued ABS CDOs. CLOs serve an important

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[156] See "A Sharper Focus," Hardeep Dhillon, Journal of Credit Risk, available at: http://www.journalofcreditrisk.com/public/showPage.html?page=94658 (Nov. 1, 2003). The private markets have been improving transparency with respect to structured finance products. The analytic software provided by Intex is widely used by investors today in modeling the cash flows of various ABS, including CDOs and CLOs. See also Joy Wiltermuth, "New iBoxx Index Said to Offer View For CLO Investors" (July 14, 2010), at Total Securitization & Credit Investment, available at: http://www.totalsecuritization.com/Article/2630882/New_iBoxx_Index_Said_To_Offer_View_For_CLO_Investors.html.

[157] FRS Report, at 47.

function in the corporate loan market, providing substantial liquidity[158] and funding for this market and ensuring that this market remains robust.[159] CLO structures have been tested through several economic cycles and have proven to be resilient. CLO structures and CLO market practices have evolved, and continue to evolve, through the efforts of industry participants.[160] Rating agency methodologies also continue to be modified in response to the performance of CLOs in various economic environments.[161]

2. It is appropriate to grant a complete exemption from the Proposed Rules for Managed CLOs

As discussed in Part I of this letter, Congress intended Section 941 to address two significant problems Congress perceived to exist in the securitization markets: first, the divergent economic interests in originate-to-distribute securitizations and, second, the complexity and opacity of securitization markets during the financial crisis.[162] Managed CLOs are not originate-to-distribute securitizations, and CLO reporting conventions enable investors to assess the risks in the CLO's underlying loan portfolio. Furthermore, the structure of Managed CLOs does not fit into the Dodd-Frank Act's construct, as there is no entity that constitutes a securitizer.

Given the unique structure and operation of Managed CLOs and the value of Managed CLOs in the corporate loan market, we believe that Managed CLOs should not be subject to the credit risk retention requirements.

(a) CLOs are not originate-to-distribute securitizations

Critics believe that the originate-to-distribute model is susceptible to moral hazard or adverse selection because the company that originated the securitization asset, once the asset has been securitized, no longer has any capital at risk in that asset. In the originate-to-distribute model the operating parent company of the securitization issuer is generally in the business of creating or aggregating such assets and directly or indirectly transfers such assets to the securitization vehicle. As such, the operating parent company receives the upfront benefit of transferring the credit risk of the securitization assets to third-party investors.

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[158] See "U.S. CLO issuance and market share" in the LSTA Presentation (illustrating, that from 2004 to 2007, CLOs purchased more than 60% of new institutional loans).

[159] It should be noted that the consumer enjoys "downstream" benefits from a robust corporate debt market, as the savings in borrowing costs are passed through to the consumers.

[160] The LSTA notes that recent "new issue transactions have been driven by strategic equity investors who prefer larger investment size, partnership with a particular portfolio manager and customized product." See "2010 CLO primary market participants" in the LSTA Presentation. Furthermore, the LSTA provides that investors currently "view the cash flow based, non-recourse nature of CLO financing as an attractive and stable alternative to market value based structures." See "State of the primary CLO market" in the LSTA Presentation.

[161] See, e.g., "Announcement: Moody's issues request for comment on changes to its CLO rating methodology" Moody's Investors Service, *available at*: http://www.moodys.com/research/Moodys-issues-request-for-comment-on-changes-to-its-CLO?lang=en&cy=global&docid=PR_216226.

[162] See the Senate Report No. 111-176, at 128.

In Managed CLOs, on the other hand, the collateral managers do not originate and rarely own the loans. Instead, the collateral manager researches and selects the loans for the issuing entity to purchase in the corporate loan markets. Corporate loans are generally provided by an initial syndicate of lenders to a business. The arranger of this syndicate facilitates the provision of the borrower's information to prospective lenders in the syndicate, to enable these prospective lenders to conduct their own analysis and due diligence of the borrower. Lender meetings are often held to permit questions regarding the borrower and its operations from such prospective lenders. In addition to the diligence performed by the lending syndicate, as mentioned above, the collateral manager also perform its own diligence on the borrower.

Performance of the collateral manager in selecting the loans for a CLO also impacts the reputational risk for the collateral manager. A recent poll of equity investors in Managed CLOs shows that, in determining whether to invest in a CLO, 44% believe the historical cash-on-cash performance of the collateral manager is the most important criterion, and 33% look to the organizational stability and reputation of the collateral manager.[163] In contrast, only 15% believe that the level of equity retained by the collateral manager is the primary consideration.[164]

(b) Contingent and incentive compensation aligns manager interest

Managed CLOs utilize conditional cash flows and performance-based compensation to mitigate the risks sought to be addressed by the risk retention requirements. As discussed in Part 1(a) of this section, the structural constraints of the Managed CLO have been modified over the years to protect the CLO investors. Managed CLOs also have structural protections for their capital obligations, the most important of which are the performance-based tests[165] which, if unsatisfied would require the CLO to, among other things, amortize its most senior capital obligations or suspend its reinvestment activities until such performance tests are satisfied. The alignment of the collateral manager's economic interests with the interests of the investors is a powerful proxy for risk retention. As previously noted, the bulk of the collateral manager's compensation is payable only after all accrued payments to the ABS Interests senior to the equity of the Managed CLO have been made and, in the case of the incentive fee, only after the equity investors have obtained a targeted return.

(c) There is no "sponsor" in a Managed CLO and, therefore, no party that would be required to retain credit risk

No party in a Managed CLO clearly constitutes a "securitizer" under Section 15G. As described above, the underlying assets are typically acquired directly by the issuing entity. The sellers that transferred the assets to the issuing entity are often unaware that they are dealing with a securitization entity. These sellers would not seem to fall within the "sponsor" branch of the

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[163] See LSTA Weekly Review, April 15, 2011, available at http://www.lsta.org/WorkArea/showcontent.aspx?id=13160http://www.lsta.org/WorkArea/showcontent.aspx?id=13160, citing a Citigroup poll of investors in CLOs.

[164] See id.

[165] See Part 5 of Appendix A.

definition; although they transferred assets to the issuing entity, they generally have no intention of, and are not involved in, "organizing" or "initiating" an asset-backed securities transaction. In addition, the underlying loan portfolio in CLO structures is actively managed, and as a result, assets may be acquired and sold over the life of the transaction. If the sponsor branch of "securitizer" were interpreted to include any seller transferring loans to a CLO in the secondary market, that interpretation would lead to the incongruous effect that the identity(ies) of the securitizer(s) would change over time as the underlying loan portfolio changed.

In addition, it does not seem that any party in a Managed CLO fits into the "issuer" branch of the definition of "securitizer." As noted earlier, Rule 191 under the Securities Act specifies that the depositor, as the party transferring assets to the issuing entity, constitutes the issuer with respect to that issuing entity. In a Managed CLO, no person fills the role of a depositor, inasmuch as the issuing entity generally acquires its assets directly from many different parties, none of which are typically otherwise involved in the CLO. Furthermore, because of the active management of the assets, it is also difficult to treat any person in a Managed CLO as an "originator." As discussed above, the counterparties from whom the CLO purchases loans have no reason to believe that the loans they have purchased or under which they were an original lender and have subsequently sold are going to be included in a securitization, and they do not necessarily have any knowledge of the motivations of a purchaser.

Imposing risk retention on collateral managers in Managed CLO transactions is, we believe, contrary to both the letter and the spirit of Section 15G(b). As we have sought to demonstrate, collateral managers are not participants in originate-to-distribute schemes. Collateral managers risk their subordinated and performance-based management fees, giving them skin in the game. They are, or shortly will be, subject to the fiduciary duties imposed by Investment Advisers Act, further aligning their interests with those of investors. Finally, neither collateral managers nor any other participant in a Managed CLO is a securitizer. Accordingly, we believe that Managed CLOs should be exempted from the risk retention requirements.

B. Credit Card Loans

Credit card loans are generally securitized using a master trust structure. (See Appendix A, Section 2 for a description of a Classic Sponsor Master Trust.) Credit card loans are short-term assets that are often backing longer- term liabilities; accordingly, a credit card securitization must be structured to allow newly generated receivables to be added to a master trust on an ongoing basis to replace those that are repaid. Principal receivables are balances incurred on credit cards for goods and services and cash advances. Finance charge receivables are periodic finance charges (i.e,. interest charges assessed on principal balances), fees such as annual fees, late payment fees, over limit fees and cash advance fees, recoveries, which are amounts collected on charged-off accounts, and interchange—that is, fees payable to the originator as card issuer through MasterCard, Visa or a similar organization in connection with cardholder charges.

In a credit card securitization transaction the depositor, which may be the sponsor in a one-step structure or an affiliate of the sponsor in a multi-step structure, holds the seller's interest in the trust. Credit card securitization transaction documents generally require the seller's interest to be maintained at a level not less than a minimum threshold, generally 4% to 7%. If the seller's interest would be less than the minimum required seller's interest, principal

collections that would otherwise be paid to the holder of the seller's interest would be captured in an excess funding, or special funding, account and be treated as part of the collateral used to measure the seller's interest. If the seller's interest would still be less than the minimum seller's interest, the depositor may be obligated to add additional assets to meet the minimum seller's interest requirement; if the requirement is not met for a specified period of time, an early amortization event would generally occur.

As noted in Part III.B.4. of this letter, a seller's interest risk retention alternative is appropriate for credit card securitizations and if properly constructed, would likely be the form of risk retention relied upon by most sponsors of credit card securitizations. If, however, the terms of the final rule do not accommodate existing securitization structures and are not consistent with current market practices, credit card securitizations would need to satisfy the risk retention requirement through another form of risk retention. In addition, in some credit card securitizations the minimum seller's interest requirement is less than 5%, which could lead the securitizer to prefer another form of risk retention. Moreover, we believe that credit card securitizers would like the ability to hold combined forms of risk retention.

Given the transition issues with the vertical risk retention alternative and the various issues with the horizontal risk retention alternative described above, the L-shaped risk retention alternative as proposed, which combines vertical and horizontal retention, is not viable for credit -card securitizations. The most significant issue for a credit card securitization program with respect to the vertical risk retention requirement is that many series and tranches of notes will be outstanding at the time the final rules become effective. It would be possible to retain five percent of each tranche or each class of ABS interest issued on or after a specified date, but it will not be possible to retain 5% of each class of ABS interests in the issuing entity which are outstanding on the effective date or the date of first issuance thereafter. An accommodation in the final rule should be made to allow the vertical risk retention alternative to be used by revolving asset master trusts in existence prior to the effective date which would impose the five percent retention requirement only on each issuance and sale to third parties of ABS interests on and after the effective date. This accommodation will be particularly significant for credit card securitization programs if the final seller's interest proposal does not accommodate existing structures, and as discussed below, the other risk retention alternatives are not viable for credit card securitizations.

The horizontal risk retention alternative does not appear to contemplate revolving asset master trust issuance. As defined, an "eligible horizontal residual interest" must be allocated all losses on the securitized assets. In a revolving asset master trust transaction, the seller's interest would always be allocated a portion of the losses which would prevent any subordinated note from qualifying as an eligible horizontal residual interest. In addition, a revolving asset master trust could have multiple subordinated notes issued from time to time under separate series or as separate tranches of a single series. No single subordinated note could satisfy the requirement to absorb all losses. For a revolving asset master trust the eligible horizontal residual interest requirement should give credit for all subordinated notes that are retained and not be limited to any single retained note. A subordinated note would also not satisfy the requirement to absorb all losses before any other ABS interest if excess spread were viewed as an ABS interest in the trust. A subordinated note would not satisfy the requirement to absorb all losses before any other interest if a spread account or reserve account absorbed losses before the subordinated note. A

reserve account or spread account could potentially meet the requirements of a horizontal cash reserve account, but as with subordinated notes, these accounts are often series or tranche specific, and no single account would meet the horizontal cash reserve account requirements.

An eligible horizontal residual interest can only receive principal after all other ABS interests in the issuing entity are paid in full or pro rata from "scheduled payments of principal." Subordinated notes in de-linked structures typically can be repaid on scheduled dates while senior notes remain outstanding if required subordination levels are maintained. If the subordinated notes are part of a series issued from a trust with multiple series, such notes may be repaid after senior notes of their series but while senior notes of other series remain outstanding. There are no "scheduled payments of principal" for revolving credit cards.

An eligible horizontal residual interest must have the most subordinated claim to payments of principal and interest. In most credit card securitizations interest is paid on a current basis to each class of notes from available finance charge collections in accordance with the payment priorities in a finance charge collections waterfall for each series, and may be paid to a junior class on a current basis while senior classes remain outstanding and even when the invested amount of such junior class is zero.

For each of these reasons, the proposed eligible horizontal residual interest and related horizontal cash reserve account risk retention alternatives do not work for credit card securitization transactions as currently structured.

Given the issues with the vertical risk retention alternative and the horizontal risk retention alternative, the L-shaped risk retention alternative as proposed is not viable for credit card securitizations. Consideration should be given to greater flexibility to combine forms of risk retention. For a credit card securitization program with a four percent minimum seller's interest, the depositor may retain a four percent seller's interest, the excess spread, reserve accounts or spread accounts and the junior most class of notes for total risk retention well in excess of five percent. The final rules could provide credit for each of these forms of risk retention, as we propose in Part II.B.3 of this letter.

C. Retail Auto Loans

Retail Auto Loan securitizations are typically structured as two-step Classic Sponsor Amortizing Trusts described in Appendix A.1. Auto loans can be securitized using a simple grantor trust structure, but this structure is becoming increasing rare.[166] In almost all cases, the sponsor or an affiliate is appointed to service the retail auto loan receivables that are held by the trust and the depositor is a subsidiary of the originator and sponsor.[167]

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[166] In a grantor trust structure, due to U.S. federal income tax requirements, only two ABS interests can be issued, a senior interest and a subordinated interest.

[167] The participants in the retail auto securitization chain—the originator, sponsor, depositor and servicer—are usually affiliated, and the originator, sponsor and servicer are often the same entity. It is rare in the retail auto loan market for a third party to service retail auto loans.

Retail auto loans are typically originated by the sponsor, as there is not an active whole loan market for auto loans.[168] Retail auto loans are typically fixed rate, simple interest loans with level monthly payments and maturities up to 84 months. Originators of retail auto loans include commercial banks, thrifts, credit unions, "captive" finance company subsidiaries of vehicle manufacturers and independent finance companies. Both the captive and independent finance companies typically rely heavily upon securitization for funding their retail auto loan portfolios. Although some banks and thrifts issue auto securitizations, depository institutions tend to hold a large share of their auto loans in portfolio.

Retail auto loan securitizations also use credit enhancement in one of several forms, including overcollateralization[169], excess spread, reserve accounts and the issuance of subordinated ABS interests. Most retail auto loan securitizations use a combination of overcollateralization, excess spread and subordination for credit enhancement. Many also have reserve accounts. A reserve account used in a retail auto loan securitization maybe funded fully at closing or partially funded at closing. If the reserve account is partially funded at closing, excess spread is applied to increase the amount held in the reserve fund until a required maximum is reached and excess spread is used to replenish the reserve account if funds are withdrawn from it to make payments required by this issuing entity.

Some retail auto loan securitizations include retail auto loans with below market interest rates. These loans are referred to as "subvened" loans. When subvened loans are included in a retail auto loan securitization, extra funds must somehow be generated by the securitized retail auto loan portfolio so that the carrying costs of the securitization (such as servicing fees, interest expense and trustee fees) are covered, even in a situation where the only loans remaining unpaid are the subvened loans. There are several ways to ensure that the securitization will have sufficient funds to pay both its carrying costs and the principal on the ABS interests:

- calculating a yield supplement overcollateralization amount for each month end during the term of the securitization, which is used to establish minimum overcollateralization amounts

- discounting the cash flows on the subvened loans at a higher interest rate, which results in valuing the subvened loans held by the issuing entity at an amount less than their outstanding principal balance

- creating a reserve account that is funded with sufficient cash to cover the difference between the lower interest rate and the securitization costs

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[168] On occasion, aggregators have purchased portfolios of retail auto loans from unrelated originators and included those loans in securitizations structured as Aggregator Amortizing Trusts (described in Appendix A.3). This type of transaction is not common and there exists no market for retail auto "whole loans" in any way comparable to the residential mortgage whole loan market. In addition, when a portfolio of retail auto loans is sold, the servicing of the purchased loans is typically retained by the purchaser of the loan portfolio.

[169] Overcollateralization exists when the principal balance of the ABS interests is less than the principal balance of the securitized assets. Overcollateralization may exist at the closing of the securitization or it may be created following the closing of the transaction by the application of excess spread (see Part II.B.2(b)(i)(2) of this letter) to pay principal on some or all of the more senior ABS interests.

- creating a spread account which may be funded initially with some portion of the difference between the lower interest rate and the securitization costs and into which excess spread are added from the securitization to increase the amount on deposit to an amount necessary to cover the difference between the lower interest rate and the securitization costs

Collections on the securitized retail auto loans are not typically separated into interest collections and principal collections. One reason for this is because substantially all retail auto loans are simple interest loans that have a fixed monthly payment, but no fixed principal or interest payment. Because no distinction is made as the principal portion or interest portion of collections received during a collection period, all collections are applied to pay the expenses of the issuing entity under a single payment waterfall.

Because retail auto loan securitizations use a single waterfall and do not distinguish between principal and interest collections, losses are not typically allocated in a formal manner. Nevertheless, losses are recognized and reported. The documents typically specify that the amount of principal to be paid to investors (generally the most senior ABS interest then outstanding) be increased by the amount of those losses. The effect of this approach is to maintain a specified overcollateralization percentage. If the losses result in collections received being less than the amount necessary to pay the specified principal payment to investors and if a reserve account is present, funds are withdrawn from the reserve account to cover the shortfall, up to the amount on deposit in the reserve account. If the amount in the reserve account is not sufficient cover the shortfall and one or more subordinated ABS interests are outstanding, then reductions are made to the principal amount of the most subordinate ABS interest and/or interest otherwise payable to the most subordinate ABS interest may not be paid. The residual interest bears the effect of these losses, because the increase in principal payments on the most senior ABS interest reduces the amount that will be distributed to the residual interest on a dollar-for-dollar basis.

As currently structured, retail auto loan securitizations already provide for the depositor (which is a subsidiary of the sponsor) to have exposure to the securitized assets through the ownership of the residual interest in the trust and, if a reserve account is present, by the reserve account. Because the residual interest in the trust receives funds only if all other payment priorities have been satisfied, the holder of that residual interest remains at risk for the performance of the securitized assets. Similarly, because funds not needed to build or maintain the required amount in the reserve account are distributed to the holder of the residual interest and because the amount in the reserve account after the ABS interests have been paid in full either reverts to the sponsor or is distributed to the holder of the residual interest, the sponsor, either directly or as owner of the equity in the depositor remains at risk for the performance of the securitized assets. Therefore, we believe that the current retail auto loan securitization structures already provide meaningful risk retention by the sponsor and we recommend that the Agencies carefully consider the current risk retention features of retail auto loan securitizations and adopt rules that recognize that structure as a permissible option for risk retention.

We note, with regard to the eligible horizontal residual interest option (and therefore the L-shaped risk retention option), that its use in a retail auto loan securitization would be problematic because of the requirements applicable to both the eligible horizontal residual

interest and the horizontal cash reserve account that principal may be paid to the holder of the eligible horizontal residual interest and funds released to the sponsor from the horizontal cash reserve account only in connection with the receipt of scheduled principal payments. Prepayments applied only to the senior ABS interests will cause the percentage represented by eligible horizontal residual interest and the horizontal cash reserve account to exceed the required risk retention percentage. In addition, because most retail auto loans are simple interest loans, which means that the payment is fixed per month, but the portion of that fixed monthly payment that is interest and principal will vary depending upon when the borrower makes the payment, there is no scheduled principal payment related to a simple interest retail auto loan. Therefore, we urge the Agencies to reconsider their requirement that only scheduled principal payments received be the basis for release of funds to the holder of the eligible horizontal residual interest and from the horizontal cash reserve account.

In addition, if subvened loans are included in a retail auto securitization, both the eligible horizontal residual interest and the L-shaped risk retention option would be problematic for use by a sponsor. As mentioned above, one method of creating the extra funds needed to cover the expenses of the issuing entity when subvened loans are included in a securitization is to have the sponsor transfer the subvened loans to the issuing entity at a reduced percentage of the subvened loans' actual principal balance (which effectively results in a discounting of the subvened loans). When discounting is used, the issuing entity treats the discounted loans as having a principal balance equal to the discounted amount, rather than the actual principal balance. If, however, the Agencies retain the requirement that only scheduled payments of principal may result in payments to the holder of the eligible horizontal residual interest or releases from the horizontal cash reserve account, there will be no way to account for the payments received on subvened loans. This problem occurs because, by discounting, a larger portion of the fixed monthly payment is deemed to be interest and a smaller portion deemed to be principal, as compared to a situation where the same loan were not discounted.

D. Auto Leases

As noted in Part II.A.4. and in Appendix A, 2.(b), auto leases are generally securitized using special purpose trusts known as a "titling trusts." Titling trusts are used in order to facilitate the transfer of interests in auto leases and the related leased automobiles (collectively, "Lease Assets") to the issuing entity by eliminating the need to have the leased automobiles retitled in the name of the issuing entity.[170]

[170] When ordinary accounts receivable or chattel paper are securitized, each of the transfers required can often be completed with a simple one-page assignment document. An automobile, however, can be transferred only if (1) the originator signs the back of the certificate of title and certifies the odometer reading, and (2) the transferee applies for a new certificate of title in its own name. In some states it is also necessary to have the emissions checked. The procedures are time-consuming and require some effort and expense, particularly on a large scale. The retitling fees payable to the state Departments of Motor Vehicles alone often would be prohibitively expensive.

A titling trust purchases Lease Assets directly from auto dealers.[171] Title to the leased automobiles is then held by the titling trust. The sponsor is not listed on the certificates of title, but instead owns a beneficial interest in all Lease Assets that have not been securitized. At the time of a securitization, instead of transferring a portfolio of Lease Assets to the issuing entity, the sponsor transfers directly or indirectly to the issuing entity either (a) a special unit of beneficial interest in the titling trust (a "SUBI") representing the rights in the securitized pool of Lease Assets or (b) a note (an "exchange note") secured by the securitized pool of Lease Assets. In most states, there is no need to undertake the effort and expense of retitling the vehicles because the legal owner of the vehicles, the trust or trustee, does not change.

As noted in Part IV.A.4. of this letter, the definition of issuing entity should be revised to take into account securitization structures that utilize asset holding entities like titling trusts. Specifically, the definition of issuing entity should make clear that the owner of the securitized Lease Assets does not need to be the same legal entity that issues ABS interests to investors. The definition of issuing entity should also be revised to prevent the "double counting" of ABS interests in securitization structures that utilize asset holding entities like titling trusts. These proposed revisions are discussed in detail in Part II.A.4.

As with retail auto loans, in nearly all auto lease securitizations, the depositor holds a residual interest constituting overcollateralization, and thus credit enhancement, for the issued ABS. Therefore, the issues with the definition of eligible horizontal residual interest described with respect to retail auto loans are generally applicable to auto leases as well. The use of the eligible horizontal residual interest option in auto lease deals is further complicated by the fact that lessees do not make principal or interest payments on their leases; rather, they make lease, or rent, payments. If the Proposed Rules are adopted in their present form, sponsors of auto lease securitizations could not utilize the eligible horizontal residual interest option because that option is tailored to fit only those securitized assets that generate payments of principal and interest. Therefore, in addition to the modifications recommended with respect to retail auto loans, the final rules should be modified to permit the holder of the eligible horizontal residual interest to receive its proportionate share of all lease, or rent, payments under the securitized Lease Assets.

E. Dealer Floorplan Loans

Dealer floorplan securitizations are typically structured as two-step Classic Sponsor Master Trusts described in Part 2.a of Appendix A, sometimes including the utilization of note issuance trusts described in Part 2.b of Appendix A. In almost all cases, the sponsor or an affiliate is appointed to service the floorplan receivables that are held by the master trust.

Each dealer floorplan receivable is typically generated under an account or other lending arrangement between the originator, as lender, and the dealer, as obligor. A separate receivable is generally created for each vehicle that a dealer acquires that is financed by the originator. In

[171] To form a trust, the person forming the trust, also known as a "grantor" or "settlor," signs a trust document conveying property to the trust or the trustee, and provides that the property, and any additional property to be held by the trust in the future, will be held by the trust for the benefit of the trust beneficiaries. The grantor can provide that beneficiaries will share some or all of the property, or that different beneficiaries will have interests in different property. The interest of a beneficiary is called a "beneficial interest" in the trust.

some cases, however, a receivable may represent multiple loans relating to all or a portion of the dealer's inventory. In addition, some receivables may be interests in floorplan receivables or loans, such as participation interests. Although scheduled repayments of floorplan receivables may be required under certain circumstances, in general floorplan receivables are not paid according to a specified schedule or on a predetermined date. Rather, the entire amount of each receivable is due upon sale of the related financed vehicle.

A dealer floorplan securitization virtually always contains eligibility standards and concentration limits for receivables. In some floorplan transactions, these ineligible or overconcentration receivables are not purchased by the depositor or the master trust and are retained by the originator. In other floorplan transactions, for administrative convenience, the ineligible and overconcentration receivables are sold to the depositor and included in the master trust, but are not included in the master trust receivables balance, and collections on these receivables are generally not available to holders of the issued ABS.

Most, but not all, dealer floorplan securitizers are not required to hold a seller's interest in the master trust in order to obtain ratings or sell ABS to investors. To be sure, there is a seller's interest in each master trust to the extent that the total assets exceed those required to support the outstanding ABS, but there is no minimum required seller's interest. As a result, we believe that dealer floorplan securitizers do not wish to be forced to rely upon the seller's interest retention option.

In all dealer floorplan securitizations, the depositor holds a residual interest constituting overcollateralization, and thus credit enhancement, for issued ABS. This residual interest may be a certificated trust interest, an uncertificated interest, a deeply subordinated note or another form. It is usually an interest in the specific series of ABS. (To date, dealer floorplan sponsors have not elected to utilize the "de-linked" structures utilized by many credit card sponsors and described in Part 2.b. of Appendix A. However, it is possible that floorplan sponsors could migrate to such structures in the future.)

In most dealer floorplan securitizations, a reserve account or spread account established for a particular series also provides credit enhancement for issued ABS of that series. The amount is typically relatively small, often equating to 0.25% or 0.50% of the issued ABS. Funds in such an account might be drawn to cover losses prior to the allocation of those losses to the residual interest.

In recent years, the level of credit enhancement required in dealer floorplan securitizations has risen dramatically. To issue a "AAA" rated floorplan ABS, issuing entities often must have subordinated interests of 25% to 30% of the sum of the total principal balance of ABS interests issued to investors and the principal amount of the subordinated interests. For a "BBB" rated ABS, the enhancement level is often in the 12% to 15% range. For this reason, dealer floorplan securitizers wish to utilize the eligible horizontal residual interest to satisfy their retention requirements, and they believe that they should be able to combine the risk retention represented by a reserve account or spread account with their residual interests for this purpose.

However, the residual interests held by depositors in floorplan securitizations would not qualify as eligible horizontal residual interests in a number of respects. Many of these issues are common to credit card ABS, as described in Part VII.B.2 of this letter:

- With respect to the apparent requirement in the definition that there be a single eligible horizontal residual interest for the issuing entity, in dealer floorplan securitizations:
    - there is a residual interest for each series, meaning that there would likely be multiple residual interests at any given time
    - in some structures, the depositor holds both a residual interest and a subordinated note that is senior only to the residual interest in terms of priority of payment within a given waterfall
- With respect to the requirement in clause (1) of the definition that all losses be first allocated to the eligible horizontal residual interest, in dealer floorplan securitizations:
    - losses on floorplan receivables are allocated to the seller's interest as well as to the subordinated residual interests
    - losses might be allocated to a spread account or reserve account prior to being allocated to any residual interest
- With respect to the requirement in clause (2) of the definition that the eligible horizontal residual interest have the most subordinated claim to payments of interest and principal, in dealer floorplan securitizations a subordinated note may be entitled to receive its interest payment out of the interest waterfall prior to the application of remaining interest collections to cover principal losses for the benefit of investors, which could be construed as giving the subordinated note priority over the investor ABS
- With respect to the requirement in clause (3) of the definition that the eligible horizontal residual interest not receive payments of principal until all more senior ABS interests are paid in full, in dealer floorplan securitizations principal will not be paid on term ABS notes (or, perhaps, on variable funding notes) until their scheduled maturity dates (or upon an earlier amortization event), with principal collections in the interim generally being made to the depositor in explicit or implicit exchange for new receivables

F. Equipment Leases and Loans

There are special considerations for ABS ("Equipment ABS") arising from securitizations collateralized by equipment leases or loans which should be reflected in the final regulations. The Proposal has identified several permissible forms of risk retention: horizontal; vertical; L-shaped; a representative sample; and a seller's interest. The latter two are not expected to be of general use for Equipment ABS, especially since the representative sample is better suited for fungible assets such as consumer auto loans rather than individually negotiated commercial equipment leases and loans. In addition, the master trust format has become relatively unused in Equipment ABS during recent years, inasmuch as issuers and warehouse line

of credit providers have tended to favor a revolving line of credit to a pass-through entity such as a limited liability company, rather than funding revolving purchases by a master trust (which is better suited for revolving assets such as credit card loans). Vertical and L-shaped risk retention have not attracted much interest among investors and warehouse credit providers, which have become accustomed to risk retention in the form of first-loss horizontal credit enhancement such as overcollateralization, sponsor-retained subordinated securities, cash collateral accounts, and equipment residual values.

For the reasons set forth below, we recommend that the Final Risk Retention Rules permit Equipment ABS to utilize horizontal risk retention in the form of overcollateralization, which is the economic equivalent of subordinated securities in a structure under which all of the fair market value of the assets is reflected by the special purpose entity's issuing multiple classes of securities. We further recommend that the Final Risk Retention Rules recognize the aspects (discussed herein) of cash collateral accounts which institutional investors in Equipment ABS have permitted for many years. Finally, we recommend that horizontal risk retention include the residual values of equipment owned by the ABS issuer (or pledged by the sponsor to the issuer).

1. Overcollateralization

Unlike transactions in some asset classes which rely upon gross excess spread (discussed in Part II.A.4. of this letter), Equipment ABS transactions utilize the concept of the "advance rate" which is applied to calculate the original principal amount of Equipment ABS which will be issued against the discounted balance of each lease contract or the remaining principal balance of each equipment loan in the collateral pool. For instance, a 90% advance rate would mean that $90 million of Equipment ABS would be issued against lease and loan receivables with a present value aggregating $100 million. The securitizer thus has risk retention of 10% of the value of the assets that have been securitized, inasmuch as any losses incurred by reason of defaulted contracts would reduce the cash flow payable to the securitizer on each periodic distribution date; investors in the Equipment ABS would not suffer any loss until the entire 10% risk retention had been exhausted. It is vital that the Final Risk Retention Rules recognize that this form of credit enhancement constitutes a valid form of risk retention.

Similarly, in certain cases, overcollateralization takes the form of one or more subordinated classes of securities. These classes frequently are retained by an affiliate of the issuer and not sold to third-party investors.[172] As an economic matter, the subordinated cash flow resulting from an advance rate of less than 100% is indistinguishable from the subordinated cash flow payable to the most subordinated classes of securities (or to the depositor, as equity owner of the residual interest). Because such subordinated cash flow remains as securitizer risk retention for the entire time that the Equipment ABS are outstanding (or until the credit enhancement has been exhausted), it is unnecessary for the final regulations to require that overcollateralization be documented as a Z bond. It would be uneconomic to mandate that class

[172] There are a variety of reasons why issuers retain these classes, such as low rating that such classes receive or their inability to meet investor requirements for securities that constitute valid debt for federal income tax purposes.

A interest and principal be paid in full before any class B interest or principal be payable, and so forth.

Furthermore, it would be inappropriate for the securitizer to receive scheduled payments, but not its subordinated share of loan prepayments, lease early termination payments, or proceeds from foreclosure and disposition of equipment under defaulted leases and loans. This approach would run counter to industry standard practice in Equipment ABS, under which all payments and proceeds from the collateral are deposited into a single collection account and allocated pursuant to a unitary waterfall--in contrast to RMBS transactions, where there are separate waterfalls for interest collections and principal collections. There is a fundamental legal reason for this treatment of Equipment ABS: equipment rentals are not divided between principal and interest elements but styled merely as rentals. There is no legal or economic reason to impose upon Equipment ABS an artificial distinction of interest and principal components; Equipment ABS properly treats all collections—whether scheduled payments, prepayments or foreclosure proceeds—as fungible amounts.

Additionally, equipment finance contracts experience a seemingly high level of prepayments—not because obligors seek to exit these arrangements, but because upgrades and additions to financed equipment typically are accomplished by terminating the existing contract (and prepaying the remaining lease or loan amount) and entering into a new lease or loan for the reconfigured equipment. This procedure is necessary because the issuer may not be able or willing to refinance the upgrade. This is particularly relevant for Equipment ABS, where the provisions of the securitization document are never expected to anticipate every possible contract rewrite and, consequently, the only way for the securitizer to accommodate the obligor is to arrange for termination and prepayment of the original contract. Therefore, the equipment lessor or lender will negotiate a termination and prepayment of the original contract and the simultaneous execution of a new agreement for the reconfigured equipment.

2. Reserve accounts

It has been customary for Equipment ABS to include a reserve account. Typically, this account is fully funded at closing, thereby reducing the cash proceeds ultimately received by the securitizer; however, in many Equipment ABS transactions approximately half of the reserve account requirement may be funded at closing with the balance thereafter deposited on the ensuing three to six monthly payment dates, from a relatively high "bucket" of the cash distribution waterfall. Furthermore, most transactions require the reserve account, if it has fallen below its required level, to be replenished from cash flow otherwise payable to the securitizer. However, once the reserve account balance has reached its maximum level, the securitizer uniformly has been entitled to withdraw any excess amounts, so long as the Equipment ABS have not suffered an event of default. We recommend that the Agencies recognize that reserve account property not only can be released in this manner (provided that the aggregate risk retention amount remains in effect), but also can be utilized to pay transaction-essential payments in the upper sectors of most waterfalls, such as fees and expenses of trustees, rating agencies and servicers.

The reserve account is important in Equipment ABS transactions, and the ability to select from a variety of safe investment alternatives is well-established. We believe that the Agencies

should make the changes to the reserve account investment alternatives and release provisions articulated in Part II.B.2(b)(ii) of this letter.

3. Equipment residual values

As described in Part II.B.2(b)(i)(2) of this letter, the residual value of leased equipment often serves an important role in an equipment lease securitization, notwithstanding that this residual value is not nominally considered part of the asset value. For the reasons articulated in that part of this letter, we believe that the Agencies should give securitizers credit for these residual values when computing the amount of risk that has been retained.

G. Student Loans

Student loans that are securitized have traditionally been grouped into the following two categories: (i) student loans originated under the Federal Family Education Loan Program under Title IV of the Higher Education Act ("FFELP") which, in effect, carry a guarantee by the federal government, and continue to be held on the balance sheets of numerous state agencies, banks and finance companies, and (ii) non-government guaranteed private student loans which typically supplement the federal student loan programs, and are either financed through securitization or are retained for investment by financial institutions, funds or other investors.

1. General class exemption for federally guaranteed student loans

Established in 1965, FFELP provided for the origination of loans pursuant to minimum prescribed criteria to "qualified students" who are enrolled in eligible institutions, or to parents of dependent students, to finance their educational costs. A "qualified student" is an individual who is a U.S. citizen, national or permanent resident; has been accepted for enrollment or is enrolled and is maintaining satisfactory academic progress at a participating educational institution and meets certain other requirements for the particular loan program. In addition, federally insured consolidation loans have been originated for FFELP borrowers following the completion of their education. Loans originated under FFELP are guaranteed by the federal government and administered by guarantee agencies. FFELP loans were originated by commercial banks, thrifts, nonprofit organizations, independent finance companies, and credit unions and are often held in an investment portfolio or securitized.

The Proposed Rules do not include an exemption for FFELP loan securitizations from the risk retention requirements. Instead, Proposed Rule § __.21(b)(1) fully exempts any securitization transaction if the asset-backed securities issued in the transaction are collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States. As noted above, FFELP permitted eligible lenders to originate loans that were guaranteed by the federal government. Under FFELP, lenders received a government guaranty of 97 to 100 percent of the defaulted principal and accrued interest (in accordance with statutory requirements) in the event that the student defaulted on the loan, so long as the loan was serviced in accordance with

Department of Education guidelines.[173] The Commentary notes that a justification for exempting various categories of government-generated loans is that the "federal department or agency issuing, insuring or guaranteeing the ABS or collateral would monitor the quality of the assets securitized, consistent with the relevant statutory authority."[174] Through the guaranty program administered by the Department of Education, that is certainly the case with FFELP loan securitizations, and it is a principal reason why we believe that an exemption for FFELP loan securitizations would be appropriate.

Other types of federally insured or guaranteed loans are designated in the Proposed Rules as exempt from the risk retention requirements under Proposed Rule § __.21(a)(1) include securitizations that are collateralized by "residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States." For example, as noted in the Commentary, the "Department of Veterans Administration also guarantees between 25 percent and 50 percent of lender losses in the event of residential borrower defaults. United States Department of Agriculture Rural Development also guarantees a sliding amount against loss of up to 90 percent of the original loan amount for single family loans." Each of these types of loans is only partially guaranteed, but the implication from the Commentary is that a securitization of these loans would be exempt from the risk retention.

For the reasons set forth above, we believe that the guaranty by the federal government of FFELP loans warrants a general class exemption for FFELP loan securitizations from the risk retention requirements in the Proposed Rules.

We also note that implementing risk retention requirements on outstanding FFELP loans, which complied with government-specified parameters in the first place (and were not subjected to commercial underwriting standards), will not impact future underwriting standards for this product, as FFELP was eliminated as of July 2010 under the Health Care and Education Reconciliation Act of 2010. Although we support the Dodd-Frank Act's goal of encouraging sound underwriting decisions by improving the alignment of interests among sponsors of securitizations, originators of loans and investors in ABS, this goal would not be served by requiring risk retention in FFELP transactions. We believe that an adjustment down to zero would be appropriate given these special circumstances.[175]

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[173] In addition to borrower default, FFELP provides for the same guaranty against the death, bankruptcy or permanent, total disability of the borrower; closing of the borrower's school prior to the end of the academic period; false certification by the borrower's school of his eligibility for the loan; and an unpaid school refund. The federally mandated guaranty has decreased slightly over time. Currently, the required guaranty percent of the principal and accrued interest is as follows: 100% for loans initially disbursed before October 1, 1993; 98% for loans initially disbursed between October 1, 1993 and July 1, 2006; and 97% for loans initially disbursed on or after July 1, 2006.

[174] Proposal, at 24137.

[175] Alternatively, the risk retention requirement could be measured against the uninsured portion of the FFELP loans collateralizing the securitization, for example, the risk retention required could equal five percent of three percent of the aggregate principal balance of the collateral, assuming a pool of FFELP loans that were reinsured at 97% of the initially disbursed amount.

Numerous state agencies and various banks and finance companies continue to hold outstanding FFELP loans on their balance sheets. Requiring securitizers of FFELP loans to retain risk would make securitization a less attractive option and these loans would be more likely to remain on the balance sheets of these institutions, invariably tying up significant amounts of capital that could otherwise be extended in the form of private loans or other forms of financial assistance to students. As noted in the FRS Report, "[M]any financial institutions hold significant legacy portfolios of FFELP loans, and some still sell these loans to each other. Risk retention requirements may damp these whole loan sales if it becomes more costly to finance these loans via securitization."[176] With respect to state and nonprofit agencies, programs awarding grants and other forms of financial assistance for students will receive a boost from incremental capital if risk retention is not required.

2. Form of risk retention for student loan ABS

The securitizer (or an affiliate) of a private student loan securitization generally retains ownership of the first-loss piece of the transaction. The first-loss piece is an equity ownership or debt interest in an issuing entity which is subordinated to all tranches of issued ABS and represents the right to receive cashflow at the most subordinated level of the flow of funds. Our understanding is that this form of "horizontal slice" risk retention, which has been utilized in past private student loan securitizations, is effective in aligning incentives between securitizers and investors due, in large part, to the amount of credit risk to which such interest is exposed. A securitizer holding a "horizontal slice" in the form of a subordinated residual interest is further motivated to structure and service a securitization transaction properly because doing so maximizes the value of such securitizer's retained interest. Our understanding is that future transactions would likely employ the "eligible horizontal residual interest" form of risk retention set forth in the Proposed Rules, although future structures for student loan ABS may employ other forms of risk retention included in the Proposed Rules. Accordingly, we strongly support the proposed menu of risk retention structures that are included in the Proposed Rules as appropriate for student loan backed ABS.

3. Exemption for nonprofit student loan lenders

The Proposed Rules' exemption for certain types of state agency and nonprofit student lenders should be revised to reflect the exemption's intent. Sections _.21(a)(3) and (4) of the Proposed Rules appropriately grant complete exemption for state agency and nonprofit student lenders that utilized funding pursuant to Section 150(d) of the Internal Revenue Code (the "IRC"), as authorized by Section 15G(c)(1)(G)(iii).

However, the Proposed Rules deny any exemption for nonprofit student lenders that do not or cannot issue bonds under Section 150(d) of the IRC. In denying such an exemption, the Proposed Rules draw a distinction between those nonprofit lenders that use Section 150(d) of the IRC and those who do not. Securitizations by both types of nonprofit student lenders offer the same level of retained risk. For example, state agency and nonprofit student loan providers do not utilize bankruptcy-remote, special purpose vehicles for securitizations. In general, nonprofit

[176] FRS Report, at 3, 83-84.

and state agency student lenders are exempt from involuntary bankruptcy under the federal Bankruptcy Code[177] and thus it is not necessary to use "bankruptcy remote" entities. Nonprofit and state agency student lenders are chartered to perform the specific public purpose of providing financing to prospective students to enroll in institutions of higher education. The practical effect of not using special purpose vehicles is that the student loan ABS remain "on the books" of these lenders, regardless of whether they are a state agency, 150(d) nonprofit, or other state designated nonprofit student loan organization. Nonprofit issuers account for their residual interests in student loan ABS issued by them as income is earned throughout the life of the deal; they do not monetize the value of the residual as a one time boost to income in the year that the ABS are issued.

Our understanding is that most nonprofit student loan providers would be unable to absorb the additional cost of capital that would result from a risk retention requirement which exceeds that which is already imposed by the requirements of the capital markets. As such, most nonprofit student loan providers would be forced to pass this cost on to borrowers or schools. In all likelihood, this result will significantly disadvantage nonprofit and state-based student loan providers that, unlike for-profit institutions, do not have access to the needed equity to contribute as retained risk. The necessity of charging borrowers or, more likely, schools to offset the cost of an additional risk retention requirement is based on the fact that in many instances such cost cannot be offset by increasing interest rates on the loans. This is particularly true in the federal student loan programs for which the interest rate and yield are set by the federal government. Another impact of additional risk retention is a further reduction in college access and outreach programs. Nonprofit and state-based student loan providers, while historically thinly funded, use a portion of their resources for public purpose programs focused on increasing access to and completion of higher education. An increase in risk retention would further drain resources of nonprofit lenders and result in the inability to continue the viability of programs. Accordingly, additional risk retention will have the dual effect of unfairly advantaging for-profit lenders while frustrating the public purpose of providing reasonable financial access to higher education.

The Final Risk Retention Rules should not inhibit these lenders from using securitizations to originate new loans or to refinance existing bonds. To do this, the final rules should grant a total exemption for state agency, Section 150(d) of the IRC, and other nonprofit student lenders from the risk retention requirements.

H. Stranded Costs and Similar Cost Recoveries by Regulated Utilities

The exceptions provided in the Proposed Rules do not include stranded cost securitizations and closely-related forms of utility securitizations (these are referred to collectively as "Utility Legislative Securitizations"). We believe that, because of the nature of the securitized property, the absence of underwriting (as that term applies to other types of investment instruments), and the active protection afforded by state governments to investors in these products, Utility Legislative Securitizations should be exempt pursuant to the powers granted and encouraged by Section 15G(e)(1) of the Exchange Act.

[177] 11 U.S.C. § 101-1532.

Since their emergence in the late 1990s, "stranded cost" securitizations and other types of securitizations that share similar (almost identical) issuance and payment characteristics have become a notable feature in the capital structure of regulated electric utilities and, importantly, an element endorsed by the legislatures of at least sixteen[178] states to lower the cost of electricity paid by the consumers of that electricity within utilities' service areas. To date, we know of more than $43 billion[179] in ABS that have been issued as a method of recovering incurred costs, including costs associated with the transition to competitive retail electric markets, costs associated with repairing damage caused by natural disasters, and costs associated with installing pollution-control equipment. The authorization to recover those costs is hardly unusual for regulated electric utilities—indeed, a significant portion of the costs of regulated utilities is, after review and adjustment by state government agencies, included in the rates that the customers of those utilities pay in order to receive electricity services.

Utility Legislative Securitizations are set apart from other securitizations by unique characteristics. In its work toward revision of Regulation AB, the Commission has identified and recognized some of the extraordinary characteristics of these securitizations.[180] In Utility Legislative Securitizations, the legislatures have permitted the utilities to impose (subject in individual cases to further public hearings and specific governmental approval) dedicated charges, or tariffs, on existing and future customers within a particular geographical area. The point of these specific tariffs, and the related securitizations, is to create a mechanic for a lowered cost to customers, thereby keeping rates lower than they may otherwise be. Indeed, were it not for the significant state policy of keeping utility rates lower, there would be no Utility Legislative Securitizations. In furtherance of the policy, the legislation (together with related financing orders by state regulatory agencies) permits utilities to sponsor the issuance of

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178 We are aware of statutes for stranded cost securitizations in Arkansas, California, Connecticut, Florida, Illinois, Louisiana, Maryland, Massachusetts, Michigan, Montana, New Hampshire, New Jersey, Pennsylvania, Texas, West Virginia and Washington.

179 Appendix A to Letter of Sidley Austin LLP to the Securities and Exchange Commission, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance corporation, dated April 20, 2011, commenting on the Proposal.

180 Commission Proposed Rule, Asset-Backed Securities, dated April 7, 2010, published at 75 Fed. Reg. .23328, 23360 (May 3, 2010)

> For ABS backed by stranded costs, the underlying asset is transition property or system restoration property. Stranded costs are the costs associated with a decline in the value of electricity-generating assets due to restructuring of the industry, and the underlying property is called transition property. System restoration property is a similar underlying asset, but provides for recovery of system restoration costs incurred by electric utilities as a result of hurricanes, tropical storms, ice or snow storms, floods and other weather-related events and natural disasters. These types of property are usually created by the action of a state legislature or other designated authority. The property generally includes a right and interest to impose, collect and receive charges payable by electric customers in a particular territory. Also, this right usually provides that the designated state authority may periodically adjust the charges billed to customer sin order to recover the stranded costs in the event all collections are not made.

Because transition property is not originated on a customer-by-customer basis, and is instead the right to impose charges on customers based on electrical usage, we preliminarily do not believe it is appropriate to require asset-level data to be provided for stranded cost ABS.

securities in structures under which the amounts received from the tariff fund the issuer's payments of interest and principal on the securities. The proceeds from the issuance of the securities are then used to recover the utility's incurred costs quickly. The forms of Utility Legislative Securitizations are virtually uniform across all of the states that have authorized these programs.

Among the reasons for that uniformity is the effect of guidelines of the Internal Revenue Service which dictate the structure necessary to achieve the most tax-efficient results of financing for these recoveries and repairs.[181] These IRS guidelines require, among other things, the enactment of state legislation authorizing (a) the creation of a property right owned by the utility to collect specified amounts in the form of a tariff and (b) securitization of that right through the issuance of bonds or similar obligations.

The authorizing legislation establishes the collection of the tariff as an irrevocable property right that is transferred by the utility to a special purpose entity to support the issuance of and payments on the securities. The legislation invariably includes a pledge by the state which prohibits future state legislatures and state regulatory agencies from rescinding, altering or amending the tariff in a manner that would reduce the value of payments to service the securities. Once securities are issued under the authorizing legislation and agency order, investors typically receive assurances of the state's commitment to honor the pledge pursuant to the U.S. Constitution's "contracts" and "takings" clauses and similar state constitutional provisions.

Under the authorizing legislation, the tariff is a "nonbypassable" charge that all (or certain classes) of the users of electric utility services in the utility's service area must pay. Accordingly, utilities assess the tariff as a charge on the delivery of the electricity to the retail provider or directly to the consumer. As a result, regardless of which retail provider actually supplies the electricity delivered to the customer or whether the utility itself provides that electricity, the utility collects the tariff based on the delivery of the electricity.

One of the most important features of Utility Legislative Securitizations, which is not present in typical ABS offerings, is a legislative true-up mechanism in which the tariff is required to be adjusted to provide for continued recovery from customers of amounts sufficient to fund debt service and other charges of the securities. For example, true-ups can increase or decrease the tariff based on differences in actual electricity consumption compared to utility's projections. In practice, the true-up mechanism has proven to be an effective method to ensure that the tariff generates revenue sufficient to permit issuers to satisfy their payment obligations under the securities.

Utilities, as sponsors of Utility Legislative Securitizations, capitalize the special purpose entity that issues the bonds in an amount typically ranging from 0.5% to 1% of the principal balance of the bonds. Rating agencies have reached the conclusion that this level of capitalization in Utilities Legislative Securitizations is sufficient to support very high ratings of the securities, due in large part to the other structural features of these securities, such as the state

[181] Rev. Proc. 2002-49.

pledge not to impair the utility's ability to collect the tariff and the ability to adjust the tariff as needed to ensure sufficient revenues.

Requiring sponsors of Utility Legislative Securitizations to retain a portion of the underlying assets would not have a positive effect on the quality of the underlying assets or the related securities. To the contrary, such a requirement would increase the cost of financing for the utility, which would ultimately be passed along to customers.

The risks and difficulties of the *originate-to-distribute* model are not present in the context of Utility Legislative Securitizations. Sponsors of Utility Legislative Securitizations do not select the assets to be securitized – those assets are dictated by the legislature, regulatory authorities and the geographical scope of the utility's service area. There simply is no concept of underwriting of the assets in a Utility Legislative Securitization, and no way in which risk retention would improve the quality of the assets or the likelihood of repayment of the ABS interest. The assets are generated by a tariff that is imposed on the applicable customer base, and the true-up mechanism adjusts the tariff to ensure sufficient funds to repay the ABS interests.

Unlike traditional ABS, the underlying asset in a Utility Legislative Securitization is a state-sponsored right to impose, collect and receive a tariff on users of electricity in a particular geographical territory. The tariffs charged in connection with Utility Legislative Securitizations are enacted by state statute, are specifically approved by regulatory action and are imposed broadly on all, or at least large classes of, electricity users based on their electricity consumption. The securities issued in a Utility Legislative Securitization are backed by the revenue to be received by all customers that are subject to the tariff; sponsors of Utility Legislative Securitizations do not choose which of their customers will participate in the securitization.

In addition, Utility Legislative Securitizations do not need the added credit enhancement that the proposed risk retention rules may provide. Because of the statutory protections afforded to Utility Legislative Securitization, as well as unique features contained in these transactions (such as the state-mandated true-up mechanism), all such securities issued to date have received the highest investment grade credit rating by national ratings agencies. We are not aware of any default or ratings downgrade under any Utility Legislative Securitizations, even during the troubling economic environment of the past few years. Any further credit enhancement in the nature of risk retention would provide little benefit to investors but significant additional burdens to the sponsors.

I. Corporate Debt Repackagings

(a) Corporate debt repackagings should not be subject to the proposed rules

Corporate debt repackagings seem inadvertently to be subject to the risk retention provisions as a result of the operation of the definition of "asset-backed security" in Section 3(a)(77) of the Exchange Act. Corporate debt repackagings do not present any of the concerns that are intended to be addressed by Section 941. The transactions known as "corporate debt repackagings" typically arise as follows. A financial institution purchases debt securities in the secondary market and depositing the debt securities into a special purpose vehicle (usually a trust

or other vehicle that would be treated, for tax purposes, as a pass-through entity) that in turn issues and sells interests to investors in a registered or exempt securities offerings. These are generically referred to as "corporate debt repackagings." The sponsor may purchase debt securities issued by corporate issuers, as well debt securities issued by GSEs or by banks (securities exempt from registration pursuant to the exemption from registration provided by Section 3(a)(2) of the Securities Act). The financial institution also may include Treasuries or derivatives contracts in the repackaging trust.

The assets included in a corporate debt repackaging are debt securities originated by third parties, not by the financial institution that is the sponsor of the repackaging, and the underlying debt securities were not issued or sold in connection with the repackaging. The sponsor of the repackaging purchases the underlying debt securities in the secondary market. As a result, there is no originate-to-distribute issue arising in connection with corporate debt repackagings. The underlying debt securities are purchased by the depositor/sponsor in connection with a repackaging transaction and usually are not on the depositor's/sponsor's balance sheet. Generally, corporate debt repackagings rely on relatively simple structures, with little or no tranching. The majority of these transactions are registered transactions and potential investors are able to obtain detailed information regarding each underlying debt security included in the repackaging, as well as information about the issuer of each underlying security. As a result, we believe that the Agencies should consider whether corporate debt repackagings should be subject to the credit risk retention requirements or whether these transactions should be partially or completely exempt from such requirements.

(b) Corporate debt repackagings inadvertently covered by risk retention rules

By and large, corporate debt repackagings are offered on a registered basis. Most repackagings are registered on Form S-3 in reliance on Regulation AB. Item 1101 of Regulation AB defines an "asset-backed security" as a security that is "primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timing distribution of proceeds to holders . . .." An issuer of ABS is eligible to register its securities on Form S-3 provided that the ABS are rated investment grade and that delinquent assets do not constitute 20% or more of the asset pool. Typically, the repackaging trust would file with the Commission a base prospectus describing only the general terms of a trust. This filing would be subject to review and comment by the Commission. Each issuance would use a prospectus supplement to disclose the specific terms of the offer. The sponsor would have to comply with the disclosure requirements set out in Regulation AB.

Generally, the sponsor will ensure that the repackaging trust contains a diverse mix of securities. Under Regulation AB, if any one issuer's assets make up more than 10% of an asset pool, that issuer would be considered a significant obligor and information about that entity would be required in the registration statement. Provided the underlying issuer is not considered a significant obligor, the Commission has provided guidance with respect to the type of information about the underlying issuer that must be included in the registration statement. If the issuer of the underlying securities is a significant obligor, Item 1112 of Regulation AB sets out additional disclosure requirements. In addition, Item 1112 of Regulation AB requires certain

financial disclosures depending on the percentage of assets relating to the significant obligor. If the pool assets relating to the significant obligor represent 10% or more, but less than 20% of the asset pool, selected financial data required by Item 301 of Regulation S-K is required. If the pool assets relating to a significant obligor represent 20% or more of the asset pool, financial statements meeting the obligations of Regulation S-X are required. In sum, there are well defined and clearly articulated disclosure requirements related to corporate debt repackagings. To the extent that corporate debt repackagings are offered to investors in private placements, market practice has been to provide the same types of disclosures that would be provided to investors in a registered repackaging.

(c) Corporate debt repackagings serve a useful purpose

Corporate debt repackagings have been very popular with investors and serve a number of useful purposes. First, the corporate debt and agency market has always been principally an institutional market. It has been difficult for retail investors to access these securities. Often, corporate and agency debt securities are repackaged, registered and sold to institutional investors and to retail investors. Many corporate debt repackagings programs offer smaller denomination bonds to retail investors. Through corporate debt repackagings retail and institutional investors are able to invest in a single security that provides diversification, so it improves efficiencies. A repackaging also permits the sponsor to create securities with specific characteristics—for example, with a desired interest rate (fixed or floating), or a desired average maturity. The sponsor can accomplish a variety of results sought by investors by combining Treasuries derivatives with corporate or agency bonds. For various tax related reasons, the trust vehicle usually will be a grantor trust with fixed assets—meaning that the sponsor purchases the securities and deposits them in the repackaging trust and subsequently cannot vary the securities or "manage" the securities. Corporate debt repackagings did not experience any significant issues during the financial crisis.

(d) Compliance with the proposed rules

By and large, sponsors of corporate debt repackagings purchase securities in the secondary market. These are securities that themselves were registered with the Commission and for which there is a trading market. The sponsors did not "originate" the underlying securities that are being deposited in the repackaging trust. From time to time, it may be possible that a sponsor will purchase securities in an initial registered offering. These securities will not have been "seasoned" (for securities law purposes), the effect of which may be that the issuer of the underlying securities is viewed as participating in the distribution of the repackaged securities. This introduces a number of complex securities law liability issues and as a result most sponsors limit their repackaging activities to purchasing securities in the secondary market that have been outstanding for at least 90 days.

The Proposed Rules prescribe a variety of permissible forms of risk retention. Depositors/sponsors do not originate the underlying debt securities. The depositors/sponsors purchase the underlying debt securities. Currently, in corporate debt repackagings, depositors/sponsors do not hold any interest in the repackaging vehicle. Depositors/sponsors likely will choose not to pursue corporate debt repackagings. Acquiring an interest (the depositors/sponsors never had any interest) in the repackaging trust will fundamentally change

the dynamics of these transactions and may raise accounting and other issues. The likely result is that investors will have fewer investment choices and less access to the corporate bond market.

As we have made clear throughout this letter, we appreciate the public policy objectives to be served by the risk retention requirements, such as "skin in the game" concerns. However, we note that corporate debt repackagings do not present any of the issues that were the subject of regulatory scrutiny or concern.

First, in a corporate debt repackaging, as discussed above, the sponsor is not "originating" a security—the corporate debt securities exist and trade in the secondary market. The corporate debt securities are not related to the residential or commercial mortgage market or to the consumer market more generally. As explained above, the sponsor generally will avoid including any new issue debt securities. The issuer of the underlying debt securities will have made its own determination to seek financing (through the issuance of debt securities) without reference to the corporate debt repackaging market. The sponsor of a corporate debt repackaging will have had no role in the original issuance. With its advisers and based on market conditions and other factors, the issuer will have determined on its own the terms of the offered debt securities. Again, the sponsor of a corporate debt repackaging will have had no role in setting any of the terms of the underlying debt securities.

Second, the underlying issuers will have registered the issuance and sale of their debt securities with the Commission and those underlying issuers will be Commission reporting companies as to which there is readily available information. An investor in the corporate debt repackaging will have at its fingertips the name of each issuer whose debt securities are included in the repackaging and the CUSIP number and other identifiers for the particular series or tranche of securities of that issuer that is included in the repackaging. Unlike a CDO, where an investor may have had limited information available regarding each underlying asset backed or mortgage-backed security, in a corporate debt repackaging there already is transparency regarding the underlying securities.

Third, corporate debt securities will typically bear a rating. Information about the trading of corporate debt securities is available through FINRA's TRACE reporting system, as well as by CUSIP on Bloomberg and other interdealer quotation systems. This means that an investor can obtain information about the trading price of the underlying debt security if it would like to do so. Finally, the issuer of the underlying debt securities will not participate or be involved in any way in the repackaging process. As a result, it is difficult to understand what policy objective would be served by requiring risk retention in connection with corporate debt repackagings. An express exception can be created for corporate debt repackagings or alternatively the resecuritization exemption can be broadened to accommodate corporate debt repackagings.

TRANSACTION STRUCTURES

There are five types of transaction structures that we reference from time to time in this letter.[182] We describe here the elements of each that are generally found in these structures. As with all securitization structures, though, some features will vary from one asset class to the next, or even from one transaction within an asset class to the next. So our approach below is to describe the standard features of each structure in the "Basic Form" subsection, and then to describe common differences in the subsection entitled "Variations on the Basic Form." In addition, the Asset Class Considerations set forth in the various parts of Part VII. include commentary on the ways in which transactions in that asset class, when effected using a structure described below, will vary from the structure described below.

2. Classic Sponsor Amortizing Trust

(a) Basic Form

Parties. In this type of transaction, which we refer to as a "Classic Sponsor Amortizing Trust," a sponsor that has originated a pool of assets and that decides to securitize them first transfers that pool to a special purpose subsidiary. This subsidiary in turn deposits the securitized assets into a trust or other special purpose entity that is created solely for the purpose of engaging in this transaction and that issues ABS interests. The sponsor, or an affiliate of the sponsor, acts as the servicer of the securitized assets. In this two-step transfer, the special purpose subsidiary is the depositor and the trust or other entity issuing the ABS is the issuing entity. Rule 191 under the Securities Act of 1933 (the "Securities Act") provides that the depositor constitutes the "issuer" for Securities Act purposes.[183] In each transaction, a trustee or other secured party of record will hold an ownership or security interest in the assets for the benefit of investors.

Assets. The transferred assets in this type of transaction are a fixed pool of assets selected by the sponsor, such as residential mortgage loans, retail auto loans, student loans or auto leases. No assets are subsequently added to the pool. The sponsor-originator makes representations and warranties about the quality of the assets as of a cutoff date and typically must repurchase or otherwise compensate the issuing entity for those securitized assets that are subsequently determined to have not met a representation or warranty, perhaps subject to some type of materiality threshold.

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[182] Although we have grouped ABS into these categories for purposes of this letter, there are a large variety of structures and asset classes with significant features that are not completely captured by these categories. The types of transaction structures described here should not be considered exhaustive.

[183] A slight variant on this structure occurs in a one-step transaction in which the special purpose subsidiary holds the assets and issues the asset-backed securities itself, rather than transferring the assets to another issuing entity. In the one-step transfer, the sponsor is the depositor, and under Rule 191 the sponsor is also considered the issuer.

Each securitized asset is typically an installment obligation with periodic (often monthly) payments. If the asset is a loan, then it is usually interest bearing, although subvened auto loans will bear little or perhaps no interest. The obligor will also owe principal on the loan, a portion of which is paid with each installment, although principal may be deferred for a period of time on student loans. If the asset is a lease, then there are no principal or interest payments; rather, each payment is rent.

A Classic Sponsor Amortizing Trust may include other collateral in addition to the securitized assets. Reserve accounts or spread accounts are often used to provide credit enhancement or liquidity, and interest rate swaps may be included in the event of an interest rate mismatch between assets and liabilities. Third party enhancements are also provided in some transactions.

ABS Interests. In a Classic Sponsor Amortizing Trust, all of the ABS interests are created and issued at the closing of the transaction. The ABS interests sold to a conduit in an ABCP conduit transaction sometimes take the form of senior undivided interests in the pool of assets held by the issuing entity. In other ABCP conduit transactions, and in virtually all offerings of term securities, the ABS interests issued to investors will be either notes secured by the securitized assets or certificates constituting a beneficial ownership interest in the securitized assets. The depositor typically is the seller of the ABS interests, and the depositor may elect to retain some potentially salable ABS interests for sale on a later date.

In many Classic Sponsor Amortizing Trust transactions, it is standard for the depositor to retain the residual interest in the issuing entity. We provide more detail on standard practices in this respect in the various subsections in Part VII., "Asset Class Considerations."

Collections and Distributions. Typically, the servicer in Classic Sponsor Amortizing Trust will place all collections from the underlying assets into a collection account, including sale proceeds for repossessed or returned property. Those collections are aggregated for a month or other specified period of time (each, a "Collection Period") and then distributed to investors and others on a payment date or distribution date that occurs a specified number of days following the end of the Collection Period.

The Classic Sponsor Amortizing Trust typically has a single distribution waterfall through which all of the collections received during the Collection Period are distributed. These waterfalls may have a great many different steps, but the purpose is to distribute all of the collections received during the related Monthly Period. The only collections that remain within the issuing entity would be the portion (if any) that is deposited into a reserve account or spread account to provide credit enhancement or liquidity to the transaction. Otherwise, all collections are typically paid out.

(b) Variations on the Basic Form

Among the common variations on the basic form of the Classic Sponsor Amortizing Trust are the following:

Parties. Classic Sponsor Amortizing Trusts used to securitize auto leases will utilize one or more additional entities, generically known as "titling trusts." These entities, and other considerations specific to auto leases, are described in Part C and D of Part VII.

Assets. Some Classic Sponsor Amortizing Trusts will have revolving periods during which additional assets may be added to the transaction. In transactions subject to Regulation AB, the length of the revolving period is limited. In private transactions, or in transactions used to provide warehouse or other ongoing funding, the revolving period may be longer.

3. Classic Sponsor Master Trust

(a) Basic Form

Parties. In this type of transaction, which we refer to as a "Classic Sponsor Master Trust," a sponsor that has originated a pool of assets and that decides to securitize them either deposits them directly, or transfers the assets to a special purpose entity that deposits the assets, into a master trust that is created for the purpose of issuing multiple series or tranches of ABS interests from time to time. The sponsor, or an affiliate of the sponsor, acts as the servicer of the securitized assets. The depositor of the assets into the master trust takes back a seller's interest. When the trust is formed, the interest in receivables is represented entirely by the seller's interest. For example, if a depositor transferred $1 billion of receivables to a master trust, the depositor would initially receive a seller's interest that represented that full $1 billion. When ABS are issued by the securitization trust to investors, a portion of the seller's interest is converted into those ABS, the value of the seller's interest declines by the amount of the newly issued investor interests, and the depositor receives the cash paid by the investors for their interest in the receivables. A $600 million issuance of securities would reduce the seller's interest to $400 million. The seller's interest adjusts for fluctuations in the outstanding principal balance of the securitized assets. If the asset pool were to grow to $1.1 billion while $600 million of investor certificates remained outstanding, the seller's interest would grow to $500 million. If the asset pool then shrank to $900 million while $600 million of investor certificates remained outstanding, the seller's interest would shrink to $300 million. In a one-step structure, the sponsor is the depositor, and under Rule 191 the sponsor is also considered the issuer. In a two-step structure, the special purpose affiliate is the depositor and the master trust is the issuing entity. Rule 191 under the Securities Act provides that the depositor constitutes the "issuer" for Securities Act purposes. In each transaction, a trustee or other secured party of record will hold an ownership or security interest in the assets for the benefit of investors.

Assets. The transferred assets in this type of transaction are a revolving pool where new receivables are added, in most cases for the life of the trust or until certain trigger events occur such as receivership of the originator. For assets arising in revolving accounts, such as credit card or charge card accounts, the sponsor designates a group of accounts and generally all receivables arising in those accounts are transferred to the master trust. In a credit card securitization the receivables are the amounts borrowed by a cardholder when that cardholder uses the card to make purchases, obtain cash advances, or transfer balances, along with related finance charges, merchant discount and fees. For any individual cardholder with a designated account, the receivable for every transaction associated with that account will automatically be transferred to the master trust and all payments by the cardholder will be required to be paid into

the master trust. If the cardholder eventually defaults, the resulting loss is also allocated to the master trust. However, the account relationship remains with the originating bank, which is the entity that makes each advance when the card is used, and the cardholder can expect to deal with the originating bank—and not the trust—in paying bills, asking for credit line increases, and negotiating payment relief. Additional accounts may be designated to have their receivables included in the master trust, and accounts that have previously been designated can be removed from the group of accounts whose receivables are transferred to the master trust. Other revolving assets securitized through Classic Sponsor Master Trusts include dealer floorplan loans and home equity lines of credit. In some dealer floorplan securitizations, only receivables arising in the designated accounts that meet specified eligibility criteria will be transferred to the master trust. In other dealer floorplan securitizations, receivables arising in the designated accounts that do not meet specified eligibility criteria are included in the master trust for administrative reasons but the collections on these receivables are not available to holders of the asset-backed securities.

The sponsor-originator makes representations and warranties about the quality of the assets as of certain dates and typically must repurchase or otherwise compensate the issuing entity for those securitized assets that are subsequently determined to have not met a representation or warranty on the relevant date, perhaps subject to some type of materiality threshold.

Each securitized asset is typically a debt obligation with periodic (often monthly) payments. If the asset is a loan, then it is usually interest bearing. The obligor will also owe principal on the loan. There may also be fees that are assessed with respect to the loans and payments with respect to the fees are generally included in the master trust cashflow.

A Classic Sponsor Master Trust may include other collateral in addition to the securitized assets. Reserve accounts or spread accounts are often used to provide credit enhancement or liquidity, and interest rate swaps or caps and currency swaps may be included. Third party enhancements are also provided in some transactions.

ABS Interests. In a Classic Sponsor Master Trust, ABS interests are issued from time to time after the formation of the master trust. The ABS interests may be issued in separate series. Each series of ABS interests may be comprised of multiple classes of varying seniority. The ABS interests may have a specified principal amount that is intended to remain fixed throughout the relevant revolving period or they may be issued as variable funding notes whose principal amount may be increased or decreased from time to time during the revolving period. Variable funding notes issued by master trusts are often sold to ABCP conduits. The depositor typically is the seller of the ABS interests, and the depositor may elect to retain some potentially salable ABS interests for sale on a later date.

Collections and Distributions. Typically, the servicer for a Classic Sponsor Master Trust will place all collections from the underlying assets into a collection account. Those collections are aggregated for Collection Period and then distributed to investors and others on a payment date or distribution date that occurs a specified number of days following the end of the Collection Period.

The Classic Sponsor Master Trust typically has an initial allocation of collections and losses to each series and then a distribution waterfall through which the collections received during the Collection Period and allocated to the specific series are distributed. These waterfalls may have a great many different steps. The only collections that remain within the issuing entity would be the portion (if any) that is deposited into a reserve account, spread account, principal funding account or excess or special funding account to provide credit enhancement, collateral or liquidity to the transaction. Collections available at the bottom of all the finance charge waterfalls are treated as net excess spread and generally paid to the holders of the seller's interest.

Excess spread is calculated by determining portfolio yield on the receivables (finance charge collections, fees, interchange and recoveries of charged-off receivables are common elements of yield) and subtracting from that amount the servicing fee, the charge-offs, credit enhancement or guarantee fees, and the cost of funds. Typically this is then described as an annualized percentage of principal receivables in the trust. If the excess spread goes below 0%, usually as measured on a three-month rolling average basis, an early amortization event will occur and principal collections will be distributed to the investors rather than continuing to be reinvested in the business, with the result that the originator will lose an important component of its liquidity and will be trying to finance a pool of receivables that yields less than the cost of funding it. The excess spread in a credit card securitization is also a form of credit enhancement for investors. Sometimes the spread is used to fund reserve or "spread" accounts, and it also functions as the first line of defense against losses in the portfolio.

In most cases the seller's interest is allocated finances charge collections and losses on a pro rata basis. The seller's interest is allocated principal equal to 100% minus the amount allocated to the investors which for any series or tranche during a revolving period is generally a pro rata amount, but during an amortization period is based on a percentage the numerator of which is the invested amount of the invested amount of the investor interest at the end of the revolving period and the denominator of which is the aggregate amount of principal receivables in the master trust. As a result the seller's interest is generally time subordinated in its right to payments of principal during the amortization period for investors ABS interests. In some cases the seller's interest is explicitly subordinated to the investor ABS interest. Dilution on the securitized assets, which includes reversed charges related to returns and fraud, is generally absorbed by the seller's interest and not allocated to the investors.

At any given time multiple series or tranches may be amortizing while other series or tranches are in their revolving periods. The revolving period for a series or tranche generally will end on a scheduled date and an amortization period, during which principal is repaid on each payment date or distribution date, or an accumulation period, during which principal is accumulated in a principal funding account until the full amount is available to be paid out on a scheduled date, will begin. Certain events, called early amortization events or pay out events, may occur and cause principal to be repaid on an accelerated basis. Some early amortization events would have a trust wide impact, causing all outstanding investor ABS interests to be repaid, while others would only cause a single series to be repaid earlier than as scheduled.

(b) Variations on the Basic Form

Among the common variations on the basic form of the Classic Sponsor Master Trust are the following:

Note issuance trust. Many structures now include a connected "note issuance trust" in addition to the master trust. The note issuance trust holds a collateral certificate from the master trust and issues true debt securities (as opposed to pass-through certificates, which are technically equity). The economics are generally the same regardless of the form of the security supported by the receivables, but the note issuance vehicles are typically structured to allow more flexible timing on issuances—in particular, junior tranches of notes can be issued ahead of, rather than concurrently with, senior tranches of notes. In a note issuance trust structure where all of the receivables are hold by a master trust that issues a collateral certificate to the note issuance trusts, the only seller's interest would be held by the depositor of the receivables into the master trust. There would be no separate seller's interest held at the note issuance trust level. In some transactions the note issuance trust holds receivables and one or more collateral certificates. If the note issuance trust holds receivables directly, the entity that deposits the receivables into the note issuance trust will retain a seller's interest in the note issuance trust.

De-linked structure. The de-linked structure has been adopted over the last decade by most of the largest credit card ABS issuers. The de-linked structure is a single series with tranches of designated classes issued from time to time. Typically three or four classes of notes are issued. Senior tranches must have a specified amount of subordination beneath them in order to be issued. Each tranche is part of a class of notes and there will be multiple tranches of each class over time. The de-linked structure allows tranches of notes of different classes to have different maturities. A subordinate note with a two year maturity can provide enhancement for a senior note with a five year maturity. The subordinate note can be repaid while the senior note remains outstanding so long as required credit enhancement levels will be maintained upon repayment of the subordinated note. This would generally be accomplished through the issuance of additional subordinated notes.

Multiple depositors. Some master trusts have more than one depositor each depositing receivables into the trust and taking back a seller's interest in the trust.

For a master trust with multiple depositors each of whom holds a seller's interest the five percent risk retention requirement should give credit to the aggregate amount of the seller's interests held by all depositors.

Master trust without seller's interest. In some master trusts, including certain dealer floorplan loan securitizations, there is no explicit seller's interest though there is required overcollateralization for each series that provides similar benefits to investors.[184]

[184] See the discussion in Part VII.E.

4. Aggregator Amortizing Trust

Parties. Sometimes an investment bank or other financial institution, which we will call an "aggregator," will acquire assets from one or more unaffiliated originators and then effect a securitization. We refer to this type of transaction as an "Aggregator Amortizing Trust." The aggregator, or an affiliate of the aggregator, will acquire one or more pools of assets such as residential mortgage loans from unaffiliated sellers. Those sellers may be the originators of the assets that they sell, or they may have purchased the assets from someone else. It may be the case that the aggregator securitizes in a single transaction both the purchased assets and assets that it or its affiliate has originated.

As in the Classic Sponsor Amortizing Trust, the aggregator may transfer the assets to an affiliated special purpose subsidiary that in turn deposits the assets into a trust or other entity that issues the securities. Alternatively, the special purpose subsidiary could acquire the assets directly from the sellers. The asset-level servicing of the underlying assets often, though not always, remains with the originators or their affiliates. The aggregator or an affiliate may act as master servicer for the transaction, although a trustee might instead fill that role.

As with the Classic Sponsor Amortizing Trust, the special purpose subsidiary will be the depositor under Regulation AB if it transfers the assets to an issuing entity, and it will also be the issuer under Rule 191.[185]

Considerations regarding assets, ABS interests and collections and distributions for Aggregator Amortizing Trusts are the same as for Classic Sponsor Amortizing Trusts.

5. ABCP Conduit

Traditional multi-seller conduits discussed in Part II.B.6. of this letter are bankruptcy-remote special purpose entities that issue ABCP for the purpose of acquiring interests in, or making loans secured by, diversified pools of financial assets such as auto loans, commercial loans, trade receivables, credit card receivables, student loans and many other types of financial assets originated by multiple separate originators in privately negotiated transactions.[186] Each ABCP conduit is typically managed by a single highly rated sponsor bank or similar financial institution in order to enable the sponsor's customers to obtain efficient financing from the ABCP market. These sponsors provide significant liquidity support for their conduits' ABCP as well as program-wide credit enhancement in the form of letters of credit or similar instruments. Due to the liquidity and credit enhancement commitments that most sponsors provide, traditional multi-seller conduit sponsors retain a substantial degree of risk or "skin in the game" with respect to their conduits' underlying asset portfolios and have a vested interest (both financial

[185] If a one-step transfer were to occur in which the special purpose subsidiary issues the asset-backed securities, then the person(s) transferring the assets to the special purpose subsidiary would be the depositor(s) and the sponsor(s), and therefor the issuer(s).

[186] ABCP can be, and has been, issued by entities other than the classic multi-seller ABCP conduits discussed herein. Other issuers of ABCP include or have included single seller vehicles, structured investment vehicles, some CLOs and arbitrage conduits. Our discussion of ABCP in Part II.B.6 of this letter addresses ABCP issued by traditional multi seller ABCP conduits, rather than securities of these other issuer types.

and reputational) in ensuring the credit quality and structural soundness of their related conduits' ABCP-funded transactions.

At any given time, a traditional multi-seller ABCP conduit is party to numerous transactions (often in excess of 100 and, prior to the credit crisis, as many as 200). These transactions take many forms, including, but not limited to, the following:

- The conduit purchases an asset-backed security from a customer, which closely resembles asset-backed securities issued in registered offerings, except that the conduit sponsor generally negotiates the terms of the asset-backed securities directly with the customer. Typically, the customer will have sold receivables backing the asset-backed security to an affiliate that acts as depositor to the issuing entity for the asset-backed security. The depositor generally retains a subordinated interest in the receivables, which provides substantial credit enhancement for the conduit's investment.

- The conduit makes a loan to a bankruptcy-remote subsidiary (the intermediate SPV) of the customer, secured by receivables that the customer sells to the subsidiary. The documentation is similar to a secured bank loan, but adjusted to reflect (and protect) the borrower's bankruptcy remote status. The loan is subject to an advance rate that assures a level of overcollateralization to support the conduit's loan. This overcollateralization represents a subordinated interest in the receivables typically held by the customer in the form of an equity interest in its subsidiary or a subordinated note or both.

- The conduit purchases a senior undivided interest in a pool of receivables that a customer has transferred to a bankruptcy-remote subsidiary. The retained, junior undivided interest is economically similar to the overcollateralization described above for secured loan transactions and is typically held by the customer in the form of an equity interest in its subsidiary or a subordinated note or both.

- The conduit purchases a pool of receivables from a customer's bankruptcy-remote subsidiary, paying an initial cash purchase price and also agreeing to pay a deferred purchase price over time. The deferred purchase price is payable only to the extent that the conduit receives collections on the purchased receivables in excess of its cash investment, plus an agreed-upon yield, servicing fees and other transaction costs. Thus the deferred purchase price is economically similar to the retained, subordinated interests (or overcollateralization) in the three preceding types of ABCP-funded transactions.

ABCP conduits finance their assets (i.e., the conduit's interests in, and loans secured by, receivables) by issuing ABCP, which generally has a much shorter maturity than the conduit's underling assets. Because the short tenors of ABCP are not typically matched to the longer tenors of a conduit's various transactions or the underlying financial assets, investors rely primarily on the conduit's ability to refinance or "roll" its ABCP or to draw upon its liquidity and credit enhancement commitments provided by its sponsoring financial institution. These credit enhancement commitments typically take the form of letters of credit or similar

instruments, which require the sponsor to fund unconditionally drawing requests without regard to the quality or performance of the underlying assets or the solvency of the ABCP conduit. In addition to credit enhancement, ABCP sponsors also provide liquidity commitments (often 102% of par to cover both initial principal and accrued interest and discount to maturity), which ordinarily take the form of agreements to purchase the conduit's underlying assets (or participating interests therein) in the event that collections on the assets are not sufficient to repay maturing ABCP and such maturity ABCP cannot be "rolled" or refinanced with new ABCP. Through these liquidity and credit enhancement commitments, ABCP sponsors retain all or nearly all the risk inherent in their conduits' underlying transactions and assets.

In some conduit structures a *de minimis* portion of the first-loss risk is transferred to a third party unaffiliated with the conduit or its sponsor through the conduit's issuance of a subordinated note or similar interest often referred to as a "first-loss note" or "expected loss note." This is typically done for accounting or similar reasons, and the principal amount of and, therefore, the maximum risk borne by, such first-loss notes rarely exceeds 20 basis points (0.20%), and is always less than 100 basis points (1.0%) of a conduit's outstanding ABCP. Therefore, even in conduit structures featuring a first loss note, the sponsor continues to retain all, or nearly all, of the risk associated with the conduit's underlying transactions and assets.

ABCP conduits are usually managed by their sponsors, which are responsible for selecting, structuring and negotiating transactions to be funded by their conduits. The "skin-in-the-game" retained by ABCP sponsors through their liquidity and credit enhancement commitments ensures that ABCP sponsors have strong incentives to safely structure transactions with adequate reserves and risk retained by the relevant originator-sellers. ABCP-funded transactions often provide financing to middle market or small businesses and startup companies that haven't yet acquired the size, market presence or operational systems and personnel to access the term ABS market. During the past two decades, a substantial portion of operating or working capital financing facilities moved from bank-funding to ABCP-funding. Given an ABCP conduit's basic business model of borrowing money at low rates through the issuance of ABCP, "lending" that money to a diverse group of customers and making a profit on the "spread" or "margin" between its cost-of-funds and lending rate, an ABCP conduit functions more like a specialized bank than like a term asset-backed security issuer. Like traditional bank-funded asset-backed loans, ABCP-funded transactions are privately negotiated and flexibly structured to meet the customer's specific needs. This flexibility is particularly important for middle market and small businesses and startup companies, as their business may be less predictable than that of larger more established companies. ABCP conduits' ability to provide tailored deal structures is an important advantage for ABCP programs and their customers.

6. Actively Managed Pools

Unlike most securitization structures, the collateral pool in most CLOs and CDOs[187] are actively managed by the collateral manager that selects the initial portfolio and makes trading decisions over the term of the transaction. These CLOs and CDOs are called "managed" CLOs

[187] Other types of issuances that are similar to CLOs and CDOs, for example corporate debt repacks, generally have static portfolios. Therefore corporate repacks are not discussed herein.

or "managed" CDOs.[188] The collateral manager, which may be an independent asset management firm or an asset management affiliate of a commercial or investment bank, a hedge fund or a private equity fund, provides the related investment advisory services to the issuing entity. Accordingly, the collateral manager will be either a registered investment adviser or exempt from registration under the Investment Advisers Act of 1940. With the passage of the Dodd-Frank Act, we believe that virtually all collateral managers for CLOs and CDOs will be required to be registered with the Commission. Investors typically evaluate the collateral manager as the initial step in an investment decision.

The earliest CLOs were structured in the late 1980s and early 1990s, and generally fell into one of two categories: CLOs,[189] which were collateralized with interests in syndicated bank loans, and collateralized bond obligations ("CBOs"), which were collateralized with corporate bonds. Over time this market has come to include a broader range of collateral, including emerging market bonds, subordinated ABS, MBS and other "multi-sector" collateral, REIT debt, project finance debt, distressed debt, trust preferred securities and, most recently, private equity and hedge funds, commodities and municipal finance. These structures have become known as CDOs. However, despite the proliferation of other types of collateral, more traditional CLOs that invest almost entirely in senior secured corporate loans are a large sector of the this market and an important component of the corporate loan market as a whole.[190]

Managed CLO structures, like many other forms of securitization, are based on the premise that pools of financial assets perform in a predictable manner and that default rates, loss severity, recovery amounts and recovery periods can be reliably forecast. These forecasts consider historical data that indicate how particular types of assets have performed over time and through various economic cycles, and industry participants use that data to develop a capital

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188 For purposes of this section, unless otherwise referenced, we will refer to these structures as "managed CLOs" or "CLOs."

189 There is a category of CLOs commonly known as "balance sheet" CLOs. In these transactions, a bank or other financial institution securitizes a pool of corporate loans (if other than large syndicated corporate loans, sometimes also called "middle market" loans) originated or held by that institution; in this regard, they constitute Classic Sponsor Amortizing Trusts. Balance sheet CLOs frequently involve a static pool of assets, interests in which are sold to obtain liquidity for new lending and/or to manage the risk of certain credit exposures. The sponsor or an affiliate is also generally the "servicer" of the securitized loans. Balance sheet CLOs have historically comprised only a modest portion of the CLO market.

190 According to the Loan Syndications and Trading Association (the "LSTA"), from 2004 through the first half of 2007, CLOs purchased more than 60% of new institutional loans. See the LSTA presentation on "CLO's: Challenges … and Opportunities" (2010) (the "LSTA Presentation"), available at www.lsta.org/WorkArea/downloadasset.aspx?id=10522. See also Wells Fargo Securities, LLC Fixed Income Research "CLOs Through the Cycle: A Look at CLO Performance Through the Great Recession" (February 1, 2011) ("Wells Fargo Research"), available at https://www.wellsfargoresearch.com/Research%20Publications/2011/February/SPECIAL_RPT_CLOS_THROUGH_CYCLE_020111-20110201170054.pdf. During this same time period, CLOs constituted approximately 60% of the primary market for syndicated corporate loans.

In 2010, CLOs have provided approximately 20% or $250 billion of the $1.2 trillion of funded syndicated commercial loans to U.S. companies. See the LSTA's testimony on CLOs and risk retention before the House Financial Services Subcommittee on Capital Markets (April 14, 2011) (the "LSTA Testimony"), available at http://www.lsta.org/WorkArea/showcontent.aspx?id=13144.

structure with appropriate levels of credit enhancement to support the risk that investors are willing to assume.[191] The credit rating agencies that typically rate these transactions have developed various criteria and statistical methodologies and analyses to "stress" a pool of assets to determine the level of credit enhancement required for their respective credit ratings and have continued to modify those criteria to reflect market developments and current financial performance of the underlying assets, including in the most recent credit crisis. Where loss and recovery data are not available or reliable, credit enhancement is more difficult to assess and, as a result, there may be more risk to an investor.

Managed CLOs are typically structured in a way that leverages the risks and returns of the related portfolio. A typical transaction would have a triple-A rated tranche, one or more additional investment-grade tranches, one or more non-investment-grade tranches and an "equity" interest (which might be in the form of subordinated debt) that would receive the residual cash flows from the structure and absorb first losses. Subordinate tranches provide credit enhancement for the tranches senior such tranche.

Investors and credit rating agencies generally tend to evaluate the risk in these structures on the basis of the managed CLO's investment parameters rather than its actual investments, which may not be known at the time of issuance and will likely change over time. The investment parameters are a set of requirements that the collateral must generally meet in order for the collateral manager to complete a trade for the CLO issuer. These parameters typically include the type of asset, diversity, weighted average rating, weighted average maturity, and weighted average spread/coupon, all of which are intended to ensure that the risk attributes of the portfolio are consistent with the loss and recovery assumptions on which the structure is based. Managed CLOs often will allow principal proceeds to be reinvested in additional eligible assets during a specified reinvestment period and may continue to allow limited trading and reinvestment of sale proceeds after the reinvestment period. Most managed CLOs also close without having the portfolio fully "ramped"—meaning the collateral manager is still identifying and acquiring the initial pool of assets—and contemplate a post-closing "ramp up" period in which the balance of the portfolio assets will be acquired. In such a case, asset level data is less important than the guidelines for future investments and trading of such assets.

In addition to the active trading aspect of managed CLOs, a number of other aspects both of the structure and the process around these transactions make them very different from traditional securitizations. First, as with other types of private fund structures, alignment of the interests of the collateral manager with the interests of the investors is a key component of the structure. Typically, the collateral management fee would be structured with senior and

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[191] It may be argued that in addition to the concentration of credit risk within subprime RMBS, the sizes of the tranches of a CDO's capital structure were erroneously calculated. See "Subprime and Synthetic CDOs: Structure, Risk, and Valuation," Dr. Elaine Buckberg, Dr. Frederick C. Dunbar, Max Egan, Dr. Thomas Schopflocher, Dr. Arun Sen, and Carl Vogel, NERA Econ. Consulting (June 3, 2010), available at http://www.nera.com/nera-files/PUB_CDOs_Structure_Risk_Valuation_0610.pdf. See also "DvD Insights – The Links Between CDS Spread and Default Probabilities," Donald R. van Deventer, available at http://www.riskcenter.com/story.php?alter=print&id=20234 (observing that the method by which default probabilities are calculated affects the assessment of CDS spreads and, therefore, risk).

subordinate components (the subordinate fee being payable only if current debt service is met), as well as an incentive fee that is based on the lifetime performance of the transaction.

Second, in managed CLOs, the portfolio is typically acquired, for tax reasons, through secondary market trades, with little or no origination of assets by any party to the transaction. The transaction sponsor, typically an investment bank, will generally have exposure to the assets in advance of the securitization only by funding the warehousing of assets selected by the collateral manager in contemplation of the securitization and will not be in the chain of title for the assets. The ultimate CLO issuer, typically an offshore "orphan" special purpose entity that is unaffiliated with any of the transaction parties, will often hold the portfolio even during the warehousing phase (especially for CLOs, due to the costs associated with transferring, as well as the administrative effort required to transfer, a loan portfolio).

Third, CLO investors actively negotiate the terms of the transaction, including the collateral manager fees, the structure of various tranches, collateral pool guidelines, cash flows, ratings, principal protections, interest rate basis and other criteria. Although equity investors tend to be the most active investors in these negotiations, modifications are commonly made to the structure of every tranche of the transaction to meet the particular needs of the investors in those tranches.

Fourth, managed CLOs do not fit within any of the exemptions from the Investment Company Act that would allow them to be issued pursuant to a registration statement, and therefore managed CLOs rely on the private fund exemptions, Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, with Section 3(c)(7) being by far the preferred exemption. Accordingly, interests in these CLOs are generally sold only to QIB/qualified purchasers in the United States or pursuant to Regulation S.

The most critical performance-based triggers in a managed CLOs are two types of coverage tests, one or more overcollateralization ratio tests and interest coverage tests. These coverage tests are intended to ensure that the structure maintains enough assets to support the ratings assumptions for the rated tranches and receives sufficient cash flow from interest collections to cover interest obligations and related administrative expenses. Failure to satisfy these coverage tests, which have different trigger levels for classes of different seniority, may have a number of consequences, including suspending the reinvestment period or diverting interest and principal proceeds from junior classes to accelerate repayment of the more senior classes. When these coverage tests come back into compliance, the reinvestment period may resume and the waterfall may return to its prior operation.

Proposed Revision of § __.6

§ __.6 Combination risk retention.[192]

(a) *General requirement.* At the closing of the securitization transaction, a combination of two or more of the following interests is retained by the persons referenced below:

(1) The securitizer retains a percentage (the "Vertical Percentage") of each class of ABS interests in the issuing entity issued as part of the securitization transaction;

(2) The securitizer (i) retains an eligible horizontal residual interest in the issuing entity, (ii) establishes and funds in cash a horizontal cash reserve account that meets all of the requirements of § __.5(b) of this part, or (iii) satisfies both clauses (i) and (ii), in an amount (which, in the case of clause (iii), will be an aggregate amount) that in any of the three foregoing cases is equal to a percentage (the "Horizontal Percentage") of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than any portion of such ABS interests that the securitizer retains pursuant to paragraph (1) of this section;

(3) Until all ABS interests in the issuing entity are paid in full, the securitizer retains a seller's interest equal to a percentage (the "Seller's Interest Percentage") of the unpaid principal balance of all the assets owned or held by the issuing entity;

(4) The securitizer retains ownership, as a representative sample, of a percentage (the "Representative Sample Percentage") of the unpaid principal balance of all the securitized assets in the securitization transaction; and

(5) A third party purchases an eligible horizontal residual interest in the issuing entity in an amount that is equal to a percentage (the "Third Party Percentage") of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction other than any portion of such ABS interests that the securitizer retains pursuant to paragraph (1) of this section;

provided that

[192] The purpose of setting forth this proposed revision to § __.6, as well as the numerical example in the third following footnote, is to demonstrate that the combination risk retention requirement can be made suitably flexible without introducing complex mathematical formulas.

(A) the sum of (i) the Vertical Percentage, (ii) the Horizontal Percentage, (iii) the Seller's Interest Percentage, (iv) the Third Party Percentage and (v) the product of (x) 0.95[193] and (y) the Representative Sample Percentage minus

(B) the percentage-equivalent of the product[194] of (i) the Vertical Percentage and (ii) the sum of the Horizontal Percentage and the Third Party Percentage

is not less than five percent.[195]

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[193] 0.95 is a normalizing factor that accounts for the fact that, in proposed § __.8(a) as set forth in the Proposal, a five percent representative sample is a percentage not of the pool of assets that are actually securitized in the securitization transaction but of the pool of assets that are *designated* for securitization. We are proposing a fixed (i.e., invariant) normalizing factor even though the selected representative sample in our proposed revision to § __.6 would be less than five percent. A fixed factor simplifies the formula in clause (A), and using 0.95 (rather than a larger factor that reflects the actual sample size) results in the most conservative (i.e., slightly higher) required risk retention.

[194] Note that when two percentages are multiplied to yield a third percentage, the decimal point in the product must be moved two places to the left. So, for example, three percent times five percent equals 0.15 percent, not 15 percent.

[195] If the Agencies agree with our position, as stated in Part III.A.1 of this letter, that the required eligible horizontal residual interest percentage in § __.5 should be appropriately reduced to reflect the greater credit risk inherent in the horizontal residual interest relative to an equivalent percentage vertical interest, the Horizontal Percentage and the Third Party Percentage, if any, would have to be adjusted by a factor (the "Horizontal Interest Risk Adjustment Factor") that reflects that greater risk. If, for example, a five percent horizontal residual interest could be demonstrated to embody four times the credit risk of a five percent vertical interest (meaning that the Horizontal Interest Risk Adjustment Factor is four), the appropriate Horizontal Percentage and Third Party Percentage would be one fourth the percentage otherwise satisfying our reformulation of § __.6.

A simple numerical example illustrates the principle: For a § __.6 combination that consisted solely of a Vertical Percentage and a Horizontal Percentage, if the sponsor chose to retain a 2.5 percent Vertical Percentage, then § __.6, as we propose to revise it, would otherwise require a 2.564 percent Horizontal Percentage (that result being consistent with the percentage set forth in the Proposal). If, however, the Proposed Rules were modified to enable a sponsor to demonstrate under § __.5 that a five percent horizontal residual interest in ABS collateralized by a given pool of assets was four times as risky as a five percent vertical interest in the same ABS, the Horizontal Percentage of 2.564 percent would have to be divided by four, yielding a Horizontal Percentage of 0.641 percent. In that situation, then, § __.6 would be satisfied with a 2.5 percent Vertical Percentage and a 0.641 percent Horizontal Percentage.

The proviso to our proposed modification of § .6(a) could be rewritten as follows (with an appropriate reference change in proposed § __.6(d) from clause (A)(v) to (A)(iv)) to account for the Horizontal Interest Risk Adjustment Factor:

provided that

(A) the sum of (i) the Seller's Interest Percentage, (ii) the Vertical Percentage, (iii) the percentage-equivalent of the product of (x) the sum of the Horizontal Percentage and the Third Party Percentage and (y) the Horizontal Interest Risk Adjustment Factor and (iv) the product of (x) 0.95 and (y) the Representative Sample Percentage minus

(B) the percentage equivalent of the product of (i) the Vertical Percentage and (ii) the sum of the Horizontal Percentage and the Third Party Percentage

(b) *Additional requirements.* A securitizer using paragraph (a)(1), (a)(2), (a)(3), (a)(4) or (a)(5) of this section shall comply with all of the applicable requirements respectively set forth in § __.4, § __.5, § __.7, § __.8 and § __.10 of this part, other than:

(1) In the case of paragraphs (a)(1), (a)(2) or (a)(3) of this section, the five percent requirement of § __.4(a), § __.5(a) or § __.7(a), respectively, of this part;

(2) In the case of paragraph (a)(4) of this section, the 5.264 percent requirement of § __.8(a)(1) of this part and the 5 percent requirement of § __.8(b)(2)(ii) of this part; and

(3) In the case of paragraph (a)(5) of this section, the five percent requirement implicit in the reference (in § __.10(a) of this part) to § __.5(a) of this part.

(c) *Calculations.* Each of the Vertical Percentage, the Horizontal Percentage, the Seller's Interest Percentage, the Representative Sample Percentage and the Third Party Percentage, as well as the product and the percentage-equivalent in the proviso to paragraph (a) of this section, shall be expressed (or, in the case of the product and the percentage-equivalent in the proviso, rounded) to not more than three decimal places.

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is not less than five percent.

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