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November 12, 2013

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. 34-70277; 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 "Reproposal")[1] 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 Reproposal (the "Commentary") and the text of the proposed common rules (the "Reproposed Rules").

The Reproposal represents a revision of the proposal originally made by the Agencies in 2011, seeking to give effect to the Agencies' mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the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") as defined in the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Terms that have been defined in the Reproposal or the Dodd-Frank Act are used in this letter with the respective meanings as used in the Reproposal or the Dodd-Frank Act, as provided therein, unless we specify otherwise herein.

[1] Proposed Rule, "Credit Risk Retention," 78 Fed. Reg. 57928 (September 20, 2013).

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 Business Law Section. This letter is addressed to the Commission, and not to the other Agencies, due to limitations on the Committees' authority within the Business Law Section, but we will provide copies to the other Agencies. Due to this limit on our authority, our specific requests or suggestions in this letter for changes to the Reproposed Rules are addressed specifically to the Commission. We ask that the Commission share our viewpoint with the other Agencies.

The 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 Reproposal. We recognize that the Commission and the other Agencies have devoted a great deal of time and attention to the Reproposal. The Reproposal builds on earlier risk retention proposals and rules, such as the proposals made by the Commission in its proposal to amend Regulation AB and related laws (the "Reg AB II Proposal") and the securitization rule the FDIC adopted in 2010 (the "FDIC Securitization Rule").[2] The Reproposal also asks a number of thoughtful questions.

The Agencies released their original risk retention proposal (the "Original Proposal"), including a comprehensive set of proposed rules (the "Original Proposed Rules") in April, 2011. Our Committees submitted a comment letter to the Commission, dated July 20, 2011, on the Original Proposed Rules (the "Original ABA Comment Letter"), and a supplemental comment letter regarding the use of participation interests as a form of risk retention dated August 10, 2012 (the "Supplemental ABA Comment Letter").

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 A 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

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[2] 12 C.F.R. § 360.6, "Treatment of financial assets transferred in connection with a securitization or participation."

would be happy to share our experience, not as industry representatives, but as experienced practitioners, in helping shape the final rules that are ultimately adopted (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/ Catherine T. Dixon
Catherine T. Dixon
Chair, Federal Regulation of Securities Committee

/s/ Martin Fingerhut
Martin Fingerhut
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I. Introduction

We recognize 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 these transactions. The securitization market provides credit to a very broad swath of businesses and, indirectly, to many consumers. The range of asset classes that are funded in the securitization market is very broad. There are well-known, "mainstream" asset classes such as auto loans and leases, credit cards, student loans, residential and commercial mortgages, equipment loans and leases, trade receivables and collateralized loan obligations. But there are also many niche or "exotic" asset classes that utilize the securitization market for a portion of their funding, such as servicer advances, aircraft leases, cellular towers, insurance premium finance loans, pharmaceutical royalties and more.

The securitization market has developed many different structures and many different types of ABS in order to meet the funding needs of different originators in these diverse asset classes. Multiple structures and types of ABS also 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 form of ABS transaction in mind often will not fit a form of transaction that has a different design.

During the financial crisis, only a small number of these asset classes backed the ABS that experienced performance problems. The performance problems that arose were concentrated largely in asset-backed securities backed by first lien residential 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 principally consisted of subordinate RMBS (so-called "ABS CDOs"); and, to a much lesser degree, in commercial mortgage-backed securities ("CMBS").

Although the problems were concentrated in a few asset classes, the risk retention rules apply across the board to any security that constitutes an ABS under the Exchange Act. We expressed our concern in the Original ABA Comment Letter that the Original Proposed Rules appeared to have been drafted in many respects on the implicit assumption that many transactions were structured like RMBS, and that risk retention arrangements that were judged suitable for RMBS would be viable for other asset classes.[3] As we argued in the Original ABA Comment Letter, we believe that this assumption was incorrect and resulted in many proposed rules that would have been unworkable for many sponsors.

We are pleased that the Reproposed Rules have, to a large degree, eliminated the concerns that we expressed regarding the RMBS-centric nature of the Original Proposed Rules.

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[3] We recognize that there were a number of parts of the Original Proposed Rules that were expressly designed for non-RMBS ABS, such as the separate risk retention arrangements proposed for revolving master trusts, ABCP conduits and CMBS.

The Agencies took notice of, and addressed, many of the problems identified in our letter and other comment letters. We thank you for the care and thoughtful consideration of these concerns evidenced by the Reproposed Rules.

Even with these changes, we continue to be concerned that the Reproposed Rules, like the Original Proposed Rules, would be too prescriptive if adopted as reformulated. Many of these proposed rules have been tailored very precisely to fit the perceived market practice. But we believe, based on our collective experience, that market practice is both more varied and more nuanced than the paradigm structures that would constitute "permitted" risk retention, with the result that a great many means by which securitizers retain substantial risk would be entitled to no credit under the Reproposed Rules.

We endeavor throughout this letter to provide examples of the ways in which we believe the Reproposed Rules would limit or eliminate the ability to obtain credit for positions that represent substantial retained risk. In our view, the Final Risk Retention Rules can achieve the objective of requiring securitizers to retain meaningful risk in their securitizations in ways that are compatible with current practice, without imposing the restrictive conditions that exclude many of those current practices, and we offer our comments and suggestions with that purpose.

Finally, we wish to point out that, in preparing this letter, we have generally refrained from commenting on provisions that raise business or economic issues, which we expect will be addressed by industry participants. We ask that you not interpret our silence as to these points as endorsement or acquiescence.

II. General Definitions and Scope

A. ABS Interests and REMIC Residual Interests

Clause (1) of the definition of "ABS interest" in the Reproposed Rules includes any type of interest, security or obligation issued by an issuing entity, including a "residual interest," the payments on which are primarily dependent on the cash flows of the issuing entity's assets. The term excludes in clause (2), however, stock, limited liability company interests, partnership interests, trust certificates or similar interests that "are issued primarily to evidence ownership of the issuing entity" and the payments on which are not primarily dependent on the cash flows of the issuing entity's assets.[4] For the reasons discussed below, we believe that the term "ABS interest" should expressly exclude REMIC residual interests.

Tax considerations are a matter of significant focus in structuring any issuance of asset-backed securities. With respect to ABS collateralized by a pool of mortgage loans owned by the issuing entity, paramount importance is given to avoiding the imposition of corporate income tax at the issuing entity level while still allowing the issuing entity to split the cash flows from the mortgage loans among multiple classes of securities. One of the most common vehicles for

[4] Reproposed Rules, § __.2.

structuring mortgage-backed securities is the "real estate mortgage investment conduit" ("REMIC"), a tax structure created by The Tax Reform Act of 1986, which (if specific statutory requirements are met) will not be subject to tax as an entity for federal income tax purposes.[5] A REMIC must issue one (and only one) residual interest and typically issues multiple classes of other securities (which are referred to as "regular interests"). (However, a single trust that holds multiple pools of mortgage loans may be divided into separate REMICs, each of which would issue a residual interest.)

The salient feature of a REMIC is that, although a REMIC is not *itself* subject to taxation, it nonetheless must compute taxable income or loss, and the REMIC residual holders *are* subject to taxation on the REMIC's taxable income. Each regular interest in the REMIC is treated as a taxable debt instrument issued by the REMIC, with the REMIC being entitled to an interest expense deduction for interest accruals on those regular interests. The holder of the REMIC residual interest, in computing its taxable income, must include the taxable income or loss of the REMIC (generally, the difference between the income on the mortgage loans held by the REMIC and the interest accruals on the regular interests).

A REMIC residual interest is not required to have any economic characteristics (*e.g.*, it need not have a principal or notional balance or accrue interest) and it is not required to receive distributions from the REMIC (other than any assets remaining in the trust upon termination). As a result, REMIC transactions may be structured so that all of the cash flows on the mortgage loans owned by the REMIC are distributed as payments on the regular interests. REMICs generally generate taxable income in the early years of the transaction and taxable losses in later years; accordingly, the holder of a REMIC residual interest in most instances will pay tax on income in the early years (without any corresponding cash flow to offset such income) and have the benefit of losses in the later years. Consequently, on an after-tax basis a REMIC residual interest may have a negative net present value. For that reason, a holder who wants to sell a REMIC residual interest frequently must pay the purchaser a fee to accept what in economic terms is a liability for future taxes.[6]

We believe that the Agencies did not intend to include REMIC residual interests in the definition of "ABS interest," but the manner in which the definition has been drafted leads to confusion in its application to these types of residual interests. Although clause (1) of the definition of "ABS interest" specifically includes "residual interests" and, thus, would appear to mean any type of residual interest, because REMIC residual interests are not designed to receive any (or any significant) cash flow from the mortgage loans owned by the issuing entity, such residual interests cannot fairly be considered to be "primarily dependent on the cash flows of the collateral" owned by the issuing entity. It also is not clear that a REMIC residual interest would be excluded under clause (2) of the definition, because REMIC residual interests are not necessarily considered to be issued "primarily to evidence ownership of the issuing entity" and

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[5] Internal Revenue Code ("I.R.C.") § 860A(a).

[6] J. Arnholtz and E. Gainor, Offerings of Asset-Backed Securities (Aspen, 2nd Ed. 2012), at §9.04(D)(3)(b).

the holders of such residual interests are entitled to at least any remaining assets of the REMIC upon its termination. However, because they primarily represent a means to allocate tax liability, the economic values of REMIC residual interests are dependent on their tax attributes and not on cash flows from the underlying assets.

The obligation of the sponsor to retain all or a portion of a REMIC residual interest is especially problematic because the statutes and regulations applicable to REMICs prohibit "disqualified organizations" from holding REMIC residual interests.[7] The term "disqualified organization" generally includes the United States, state and political subdivisions, foreign governments, international organizations, agencies and instrumentalities of the foregoing and various other types of organizations that are not subject to United States federal income tax. For that reason, a seller of a REMIC residual interest typically is required to represent that a person to whom the seller transfers the residual interest is a United States resident or citizen or a corporation or other business entity that is subject to United States federal income taxation. Accordingly, a sponsor that is not subject to United States federal income taxation could face a situation in which the risk retention rules require that sponsor to retain some or all of the REMIC residual interest while the REMIC rules prohibit it from doing so. We do not believe that the Agencies intended such a result.

It also is unclear how the risk retention requirements would be applied to REMIC residual interests. Under the vertical interest method, it is not clear how the sponsor could retain 5 percent of the "fair value" of a class of ABS interests that, because of the tax liabilities associated with that class, may well have a negative value. Under the horizontal interest method, the sponsor could be required to retain 100 percent of the REMIC residual interest. In our view, a REMIC residual interest does not fall squarely within the definition of "eligible horizontal residual interest," but the very name used to designate this risk retention method appears to implicate any "residual interest" whether or not it is entitled to any cash flow or has any principal balance. If a REMIC residual interest with a negative value is considered to be an "eligible horizontal residual interest," then under the horizontal interest method and potentially under the combination method, including such an interest in the calculation of the aggregate fair value of all ABS interests actually would decrease the aggregate fair value of the ABS interests and, accordingly, reduce the amount of risk retention required. Again, we do not believe that the Agencies intended such a result.

In any event, because REMIC residual interests primarily represent a means to allocate tax liabilities and are not designed as part of the "credit tranching" of the underlying assets, we believe such residual interests are not designed to be affected by credit risk. Hence, we believe that such interests should not figure in the calculation of the required risk retention. Accordingly, we ask that the definition of "ABS interest" be modified in one of the following ways: modify clause (1) by inserting the phrase "(other than a REMIC residual interest)" immediately following the words "or residual interest;" or modify clause (2) so that it expressly provides that REMIC residual interests are not ABS interests.

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[7] I.R.C. §§ 860D(a)(6)(A) and 860E(e); Treas. Reg. § 1.860D-1(b)(4).

B. Single Vertical Security

In Part III.B.1.a(i) of this letter, entitled "—Single Vertical Security," we suggest a change to this definition. (We have included the discussion in that part of the letter to conform to the area in the Commentary in which the Agencies discussed the usage of that concept.)

III. General Risk Retention Requirement

A. Minimum Risk Retention Requirement

1. Holding by Majority-Owned Affiliates

The text of § __.3 specifically provides that a majority-owned affiliate, rather than the sponsor, may retain the requisite risk, and the Commentary, when discussing hedging,[8] confirms the decision to permit this treatment. However, none of the sections that outline permissible forms of risk retention (except § __.5(b), about which we comment below) have been revised to reflect this ability to use a majority-owned affiliate; those sections all continue to refer to the "sponsor" as the only entity that may retain the risk. We believe that this approach creates an ambiguity, because § __.3 starts with the words: "Except as otherwise provided in this part …" We are concerned that these sections could be interpreted to mean that none of those risk retention options actually permits the risk to be retained initially by a majority-owned affiliate.

We believe there are several ways to correct this interpretive issue:

(i) add "(or a majority owned affiliate of the sponsor)" in each relevant place in the various specific risk retention provisions;

(ii) define a term that means the sponsor or a majority-owned affiliate of the sponsor (such as "permitted holder" or "retention holder") and use it in each appropriate place; or

(iii) rewrite § __.3 to add a sentence like the underscored language below:

> Except as otherwise provided in this part, the sponsor of a securitization transaction (or majority-owned affiliate of the sponsor) shall retain an economic interest in the credit risk of the securitized assets in accordance with any one of § __.4 through § __.10 of this part. <u>Each reference in § __.4 through § __.10 of this part to the "sponsor" shall be deemed to include any majority-owned affiliate that retains such an economic interest in credit risk.</u>

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[8] 78 Fed. Reg. at 57969.

2. Holding by Wholly-Owned Affiliates

As we note in Part III.B.2.b. of this letter, entitled "—Revolving Master Trusts and Seller's Interests—General Requirements," we believe that the references in § __.5(c)(2) to "wholly-owned affiliate" should instead be to a "majority-owned affiliate."

B. Permissible Forms of Risk Retention

1. Standard Risk Retention

a. Vertical Risk Retention

(i) Single Vertical Security

We are confused by the definition of "single vertical security." It reads as though the security can have different percentage interests in each class, with the operative requirement being that the *dollar value* of the retained interest in each class needs to be identical. We do not believe that is the intention of the Agencies, nor do we believe it is consistent with the statutory mandate. The Commentary says that the single vertical security should represent a "specified percentage (*e.g.*, 5 percent) of the principal and interest paid on each class of ABS interests … that result in the security representing the same percentage of the fair value of each class of ABS interests."[9] We agree with the description in the Commentary, but we do not think the definition itself corresponds to that description.

We suggest that the definition be revised as follows:

> "Single vertical security" means, with respect to any securitization transaction, an ABS interest entitling the sponsor to a specified percentage~~s~~ of the principal and interest paid on each class of ABS interests in the issuing entity (other than such single vertical security)~~, which specified percentages result in the fair value of each interest in each such class being identical~~.

(ii) Disclosure re Eligible Vertical Interests

We do not understand why the disclosure requirements regarding eligible vertical interests in § __4(d)(2)(ii), (iii) and (iv) are so detailed. In particular, we think that the requirement to provide information in respect of the "fair value" of any sort of eligible vertical interest is inappropriate. The percentage interest represented by the eligible vertical interest should be the only information that the securitizer is required to disclose regarding that vertical interest, because that information is what shows that the securitizer is satisfying its risk retention obligation.

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[9] 78 Fed. Reg. at 57938.

We should note that, in our view, disclosure should have a limited "supporting" role in the overall scheme of risk retention. Risk retention is a substantive requirement imposed by the Dodd-Frank Act under which securitizers must maintain a share of the risk of their ABS. Risk retention is not a disclosure directive. Disclosure, we believe, should be utilized supplementally to show that sponsors are complying with their risk retention obligations, rather than as a means of providing investors with information regarding the potential performance of the offered securities.

When a securitizer holds a 5 percent eligible vertical interest, either as a single vertical security or as a separate proportional interest in each class of ABS interests issued by the issuing entity, it has by definition satisfied its risk retention obligations. The value of that interest in dollars is, we believe, really not relevant. Its value is 5 percent of the value of the overall ABS interests, and that is all that we think needs to be disclosed. We are particularly puzzled by the requirement in § __4(d)(2)(iv) (by means of its cross-reference to § __4(d)(1)(iii),(iv) and (v)) that the securitizer disclose all of the key inputs and assumptions used in measuring the fair value of all of the ABS interests and the reference data set used to develop the key inputs and assumptions. We do not understand the justification for imposing such an obligation on a securitizer when there is no question whatsoever as to whether that securitizer is complying with the risk retention requirement. The securitizer is holding its required 5 percent, and that is the fact that should be relevant. Whether losses are minimal or enormous, the securitizer will still be holding a 5 percent interest.[10]

b. Eligible Horizontal Residual Interest and Horizontal Cash Reserve Accounts

We appreciate the many changes that the Agencies have made to the provisions regarding eligible horizontal residual interests ("EHRIs") and horizontal cash reserve accounts ("HCRAs" and, together with EHRIs, "eligible horizontal retentions") in response to comments on the Original Proposed Rules. The Reproposed Rules improve the provisions regarding eligible horizontal retentions in several significant ways, such as the introduction of the "fair value" concept and the elimination of the premium capture cash reserve account.

(i) The Fair Value Concept

As a general matter, we applaud the Agencies for permitting the use of fair value as a means of valuing an EHRI. In appropriate circumstances, the fair value concept will permit sponsors whose securitized receivables include "excess spread" to include that excess spread in

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[10] Even if the securitizer is using a form of eligible vertical interest for just a portion of its risk retention obligation (*e.g.*, 3 percent), we still do not believe that there is any justification for requiring such disclosures. It may be in that situation that the securitizer will have some disclosure obligations with respect to its remaining 2 percent risk retention obligation (if, for example, that is held as an eligible horizontal residual interest). However, the fact remains that the 3 percent eligible vertical interest will be 3 percent, regardless of the performance of the securitized assets.

the valuation of their EHRIs. Under the approach in the Original Proposed Rules, no credit could be given to excess spread.

However, we have several concerns with aspects of the use of fair value in the Reproposal, which we detail below.

(A) Disclosure of Fair Value Assumptions

We are quite concerned by the disclosure requirements in § [__].4(d)(1)(iv) and (v) with respect to fair value. These clauses, if adopted as proposed, would require disclosure of key inputs and assumptions used in formulating fair value (such as prepayments, losses and defaults) and of the "reference data set" used to develop the key inputs and assumptions. Although most securitizations include disclosures with respect to pool assets, there is a difference between providing, on the one hand, current and historical information about the performance of such assets, and on the other hand, assumptions as to future performance. Moreover, such assumptions may allow issuers to determine fair value using various stress scenarios that are inconsistent with treating such assumptions as predictive. Nor do we believe that a disclosure regime that requires predictions of future performance would be appropriate. We are concerned that requiring disclosure of such inputs and assumptions may mislead investors by making such inputs and assumptions seem authoritative and may subject issuers to risks to the extent such disclosures do not have the benefit of safe harbors for forward-looking disclosures.

We respectfully submit that the proposed disclosures, if ultimately adopted, would represent a significant expansion of a cornerstone of disclosure policy under the federal securities laws — to permit, but not mandate, disclosure of "soft" or forward-looking information. This important policy judgment of Congress and the Commission, as reflected in the federal securities laws and the Commission rules and regulations thereunder, is based on a recognition that predictions of future events are fraught with uncertainty, and a strong concern that incorrect projections could easily become fodder for private litigation. In response to these concerns, Congress added Section 27A to the Securities Act of 1933, as amended (the "Securities Act")[11] and Section 21E of the to the Exchange Act [12], to provide safe harbors for forward-looking statements. Commission Rules 175 under the Securities Act and 3b-6 under the Exchange Act also provide some protection against liability for disclosure of forward-looking information.

We do not believe it would be appropriate for the Commission to require sponsors to disclose the kinds of information specified in § __.4(d)(1)(iv) and (v). The static pool data that is supplied by issuers in public offerings and in many private offerings already provides investors with significant useful information. Whether the performance of the static pools will be indicative of the performance of the securitized pool ultimately depends on a number of factors,

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[11] 15 U.S.C. § 77z-2

[12] 15 U.S.C. § 78u-5.

many of which — such as general economic conditions, interest rate movements, housing and other asset prices, and the overall availability of credit — are entirely outside of the control of a sponsor. We believe it is inappropriate to require sponsors to speculate about the anticipated performance of the securitized assets.

We therefore urge the Commission to eliminate any such requirements. In the event the Commission decides to retain any such requirements, we would urge the Commission to provide sponsors with a safe harbor for such information. We note that the statutory safe harbors provided by the Securities Act and the Exchange Act are not necessarily applicable to the proposed information under § __.4(d)(1)(iv) and (v). First, the proposed information might not constitute "forward looking information" within the meaning of those safe harbors, as that definition was written for a corporate issuer, not an asset-backed issuer. Second, those safe harbors apply only to disclosures by reporting companies, whereas risk retention disclosure obligations apply to virtually any securitizer.

(B) Permitting an Alternative to Fair Value

In addition to the problematic disclosure issues we describe above, we are also concerned that the calculation of fair value would introduce (if adopted) a great many complexities for both sponsors and investors. The guidance under generally accepted accounting principles in the United States ("GAAP") is extremely lengthy and complex, and (as the Agencies note in the Commentary) it permits a range of values. Also, sponsors that keep their securitizations on-balance sheet are not required to compute the fair value of their retained interests, which means that these requirements would introduce substantial additional work for sponsors. In addition, foreign sponsors making U.S.-directed offerings would not necessarily have any familiarity with GAAP.

We recommend that an alternative methodology be made available for use by sponsors in computing the value of their securitized assets and their retained horizontal interests in those assets. In our view, a sponsor could elect to use either the fair value or the alternative methodology when valuing an EHRI.

The alternative asset valuation methodology we recommend is known generically in the securitization industry as the "securitization value," and it is used (in one form or another) in many transactions. The outlines of a securitization value approach are as follows:

- The "securitization value" of the securitized assets would be the value specified in the operative documents for the securitization transaction, provided that it could not be greater than the discounted present value of the cash flows on the then-existing[13] securitized assets calculated as provided as described below.

[13] Our purpose in using the term "then-existing" is to specify that it would be just the assets then held within the securitization that would be valued. For a static pool of amortizing assets, this is the standard methodology. For a revolving structure, however, this approach means that the cash flows would be analyzed as if the revolving period was ending and an amortization period was beginning.

- The discount rate would be required to be at least equal to the sum of the weighted average interest rate on the third party ABS interests" and the servicing fee rate.

- If the weighted average interest rate on the securitized assets were at least equal to the discount rate specified above, the sponsor would be permitted to use the aggregate principal balance of the securitized assets as the securitization value.

- "Third party ABS interests" would be those ABS interests that are sold to third parties (or that, although retained by the sponsor or its affiliates, bear interest at a market rate).

- The value of the retained horizontal residual interest, which we call the "residual securitization value," would be computed by subtracting the outstanding principal balance of third party ABS interests[14] from the securitization value.

The foregoing bullet points contain the principal elements of the securitization value methodology. We realize that there can be additional considerations to take into account under various circumstances. Toward that end, we have included proposed language for this recommended valuation approach in Appendix B to this letter.

In our view, the principal virtue of our recommended approach is that it would accommodate a range of practices currently in use in many transactions. As such, it is familiar to both sponsors and investors. The residual securitization value would also be more easily computed than the fair value of an EHRI. We believe this is a conservative approach that would result in a residual securitization value for an EHRI that is no higher, and often lower, than the fair value.[15]

An important rationale behind our suggestion of a simplified and conservative valuation approach is that it could be supported by a simplified set of disclosures, as compared to the fair value approach. The principal disclosure that should be required, in our view, would be a description of the methodology used to calculate the securitization value. In transactions that

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[14] Ordinarily, we think that the only ABS interests issued by an issuing entity would be third party ABS interests and the eligible horizontal residual interest retained by the sponsor. But we acknowledge that a sponsor might retain ABS interests other than third party ABS interests and the eligible horizontal residual interest, and we recognize that the value of such interests should also be subtracted from the securitization value.

[15] The discount rate in transactions that employ a securitization value methodology is often higher than the minimum rate we have specified. That can be the case where investors or rating agencies require an additional cushion in the discount rate. Quite often, the securitization value approach does not permit the sponsor to value high-yielding assets at a premium to their principal balance (meaning that excess spread would receive no credit, which we think would typically not be the case when establishing fair value). If the securitization value of the securitized assets is reduced, then (after subtracting the principal amount of the investor interests from that securitization value), the residual securitization value will be lower. That is a more conservative approach, in that the sponsor would need to have more securitized assets in order for the residual securitization value to reach the requisite 5 percent level than it would need to have the fair value reach that level, all other things being equal.

employ a discounted present value methodology to establish securitization value, the primary disclosure would be a description of that methodology, including the discount rate being used (and a demonstration that the discount rate is at least equal to the sum of the weighted average interest rate on the third party ABS interests and the servicing fee rate). In transactions that do not employ a discounted present value methodology, we believe that the appropriate disclosure would be an explanation of the methodology that is used in the transaction and an explanation as to why that methodology results in a value of the risk retention that is equal to or higher than the value that would be produced using the discounted present value approach.[16] We think that disclosure of items such as loss given default, prepayment rates, lag times, the basis of forward interest rates and the reference data set would not be necessary for investors to evaluate the methodology.

As we noted above in Part III.B.1.a(ii), "—Disclosure re Eligible Vertical Interests," we believe that disclosure should be used in the Final Risk Retention Rules to demonstrate compliance with a securitizer's obligations; it should not be imposed for the sake of providing additional performance-related data to investors. We believe that the disclosure we propose would be consistent with this philosophy, because the more mechanical nature of the computation would require less detail. Under Regulation AB, investors in registered offerings of ABS already receive a great deal of information about the performance of previously securitized receivables. In private offerings, investors often receive essentially the same level of static pool information or else have the sophistication to solicit it. We believe our proposals are entirely consistent with the antifraud provisions of the federal securities laws.

Although this securitization value methodology would often produce lower results than fair value approach, we think that sponsors in such cases would nonetheless be inclined to use securitization value, as the amount of work required to make the computations would be substantially lower and the disclosures would be less onerous.

(ii) The Payout Rates

Two key aspects of the reproposed concept of an EHRI are the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Payment Rate, which we call, collectively, the "Payout Rates." The first of these terms is a percentage that measures, for each payment date, the fair value of the aggregate cash flow projected to be paid to the holder of an

[16] For example, revolving structures typically do not use a discounted present value methodology to establish the requisite amount of credit enhancement. Instead, such structures often utilize an advance rate, expressed as a percentage of the face amount of the assets that defines the maximum size of the investor interests which can be issued and which have a senior claim on the assets and the collections. For a pool of non-interest bearing trade receivables, the advance rate might be, say, 85 percent. The remaining share of the asset value (in this example, 15 percent) is intended to (a) provide funds to pay servicing fees and accrued interest owed to investors (perhaps 3 percent) and (b) constitute the overcollateralization held by the sponsor or depositor as credit enhancement (the remaining 12 percent). Although this approach does not expressly employ a discounted present value to establish the amount of credit enhancement, it uses a methodology for valuing risk retention that can be easily described and compared to a present value approach. We think the sponsor should be entitled to use this approach, so long as the disclosure explains the methodology.

eligible horizontal retention through such payment date against the fair value of the aggregate cash flows projected to be paid on such eligible horizontal retention during the entire period it is outstanding. The second of these terms is a percentage that measures, for each payment date, the aggregate amount of principal projected to be paid on all ABS interests through such payment date against the aggregate principal amount of all ABS interests issued in the transaction.

We have several concerns about the ways that the Payout Rates are used in the Reproposed Rules, as follows.

(A) Maintenance of Original Enhancement Level

In order to utilize an EHRI, a sponsor must, prior to issuance of the ABS interests, certify to investors that the Closing Date Projected Cash Flow Rate does not exceed the Closing Date Projected Principal Payment Rate on any payment date for the life of the transaction.

The effect of the certification requirement would be to require the actual level of credit enhancement represented by the eligible horizontal retention to stay at (or above) the initial level for the life of the securitization transaction. We believe such a requirement is not warranted by the statutory mandate for risk retention. Instead, we believe that the appropriate projection-based test would be the following: So long as the retained risk is projected to equal at least 5 percent of the sum of (A) the projected aggregate fair value of all ABS interests in the issuing entity other than the eligible horizontal retention and (B) the projected fair value of the eligible horizontal retention, the retained risk would be satisfactory.[17] Such a test would not penalize a sponsor who started with more than 5 percent credit enhancement, but it would ensure that the sponsor was keeping the requisite "skin in the game," as contemplated by the Dodd-Frank Act.

This rule as proposed would penalize sponsors who provide more enhancement at the outset of a transaction than required under the risk retention rules, by forcing them to keep it in the transaction. Additional risk may be retained at the outset because of investor or rating agency requirements or for other structural or economic aspects of the transaction unrelated to the Dodd-Frank Act mandate. If the sponsor then receives payments on its enhancement at a faster rate, that practice should not violate the risk retention rules, so long as the sponsor retains at least a 5 percent interest.

(B) Closing Date Principal Payment Rate

It does not seem appropriate to us for the Closing Date Projected Principal Payment Rate to include the "principal balance" of any eligible horizontal retention. There is frequently no "principal balance" concept for most EHRIs, particularly when the EHRI is comprised in

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[17] We note that our proposed "securitization value" concepts could be used in this test, by expressing the test as, "So long as the residual securitization value is projected to equal at least 5 percent of the sum of (A) the aggregate projected fair value of the all other ABS interests in the issuing entity other than the eligible horizontal retention and (B) the residual securitization value of the eligible horizontal retention, the retained risk would be satisfactory."

substantial part of excess spread. The more appropriate concept would seem to be to include the remaining fair value of the EHRI.

(C) The "Look-Back" Disclosures

In § __.4(d)(1)(vi), the Reproposed Rules specify that, prior to the closing date of a (new) securitization transaction, a sponsor that has previously effected any securitization transactions utilizing eligible horizontal retentions must disclose the number of instances during the five year period ending on a date not more than 60 days prior to that closing date (which we call the "look-back" period) on which the actual payments to the holder of the eligible horizontal retention exceeded the cash flow previously projected to be paid to such holder in respect of its eligible horizontal retention on such payment date.

We understand that the Agencies believe that the disclosure of variations between projected and actual performance will provide a material incentive for securitizers to take care in their preparation of those projections. We think that is a worthwhile goal. However, as explained further below, we believe there are a number of problems with the proposed look-back disclosures.

Payments being Counted. The Closing Date Projected Cash Flow Rate, like the Closing Date Projected Principal Payment Rate, measures for a particular payment date the cumulative amount of payments projected to be made for all payment dates from the closing date through such payment date. Accordingly, it would seem appropriate that the look-back disclosure requirement would focus on the cumulative amount of payments made to the holder of the eligible horizontal retention. However, the specification in § __.4(d)(1)(vi) instead is formulated as a measure of the "cash flow projected to be paid to the sponsor on such payment date."

We do not understand why this test has been selected. Whether the amount that was projected to be paid on any specific payment date was exceeded or not does not seem to be the relevant consideration. What we think should be measured, instead, is the "cumulative cash flow projected to be paid to the sponsor through such payment date."

Non-Compliance to be Reported. We commented above in Part III.B.1.b(ii)(A), entitled "—Maintenance of Original Enhancement Level," that the appropriate test for the projections should be whether the projected fair value (or the residual securitization value) of the eligible horizontal retention has dropped below 5 percent of the sum of (A) the aggregate fair value of all ABS interests in the issuing entity other than the eligible horizontal retention and (B) the projected fair value (or projected residual securitization value) of the eligible horizontal retention. We believe the same test should be the basis for the look-back disclosure requirement – the securitizer should be required only to disclose those instances when the value in fact dropped below that level.

(iii) Horizontal Cash Reserve Accounts

The Reproposal permits HCRAs to be used as a form of horizontal risk retention, subject to conditions that include (A) a limitation on the investment of funds placed in an HCRA to

either United States Treasury securities with maturities of one year or less or deposits in one or more insured depository institutions that are fully insured by federal deposit insurance, and (B) what seems to be a requirement that amounts will be distributed from the account for just two purposes: either to make payments to investors when other funds are insufficient or (if the calculation and certifications are provided) to make distributions to the holder of the residual interest.

(A) Permitted Investments

We think the very limited array of investment options will be viewed unfavorably by both sponsors and investors. The securitization industry has developed a standard set of high quality, low risk investment alternatives for funds held in collection accounts, reserve accounts, spread accounts and the like. Virtually every transaction will have a list of these permitted investments, which include prime money market funds, commercial paper issued by specified types of issuers, and other similar investments.

We acknowledge that these lists of permitted investments are typically based in large measure upon specified levels of debt ratings, and we understand that the Commission does not wish to endorse or propose permitted investments based upon ratings levels. We understand that the Commission may want to ensure that funds in an HCRA are not invested in speculative types of investments. But we think the Commission can permit a much more standard range of permitted investments without creating either of those problems, as we suggest below.

In addition to the general problem of having limited choices, we wish to point out specific issues with the two choices that have been provided. First, the recent budget and debt ceiling standoff in Congress highlights the potential downside of investing in Treasury securities. Second, the requirement that investments in depository institutions be limited to fully insured funds is simply impractical. The size of an account that may be federally insured is just $250,000, and an HCRA could easily be funded with tens of millions of dollars. To require a new insured account to be opened for every $250,000 in the HCRA would create an administrative nightmare for the trustee or other party administering the HCRA.

We believe that a standard for investments can be developed that is more flexible than the proposed limited set without sacrificing credit quality. We note, for example, that the Commission has proposed an amendment to the definitions of "eligible security" and "first tier security" in Rule 2a-7 under the Investment Company Act of 1940, as amended (the "Investment Company Act") to comply with the Dodd-Frank Act's mandate to remove references to credit ratings from regulations.[18] One possible formulation might be to add the following as a new clause (iii) in § __.4(c)(2):

[18] "References to Credit Ratings in Certain Investment Company Act Rules and Forms," SEC Rel. No. 33–9193; IC–29592; File No. S7–07–11 (March 3, 2011); 78 Fed. Reg. 12896 (Mar. 9 2011).

[or] (iii) in investments specified by the parties to the transaction documents that present minimal credit risks and the issuers of which have the highest capacity to meet their short-term funding obligations.

(B) Use of Funds

Although the draft regulatory language is not entirely clear to us, § __.4(c)(3) seems to be predicated on the view that funds from an HCRA would be used only to make payments to investors or to make distributions to the holder of the HCRA. Further, any distribution other than amounts due on ABS interests cannot be made unless the payment rate calculations and certification are provided.

Assuming this is the Agencies' view, we respectfully maintain that it is inconsistent with the permitted uses of funds from cash reserve accounts in many current securitization transactions. It is often the case that funds from the cash reserve account can be used to pay specified critical expenses of a securitization transaction, such as fees of various service providers (servicer, trustee, custodian and the like) or to pay other "operating expenses" of the securitization. In most instances, those types of expenses will have a higher priority in the cash flow waterfall for the transaction than will payments to investors – indicating that investors understand that this use of funds is important to the integrity and ongoing operation of the transaction.

We believe that § __.4(c)(3) should be reformulated to contemplate the use of funds in an HCRA for payments of critical expenses, and see no policy reason to forbid such a use. So long as those expense payments are made for specified priorities (other than distribution to the holder of the HCRA in its capacity as such), and are disclosed to investors, they should be permitted. Further, so long as such payments are senior in the cash flow waterfall to amounts owed to holders of third party ABS interests, or are made to parties who are not affiliated with the securitizer, no calculations or certifications should be required.

(iv) Revolving Structures

The eligible horizontal retention provisions appear to have been designed for use with static pools of assets. But there are a number of securitization transactions that utilize revolving or dynamic features, in which assets are added to the issuing entity after the closing date. For example, many sponsors of retail assets such as auto loans and leases, equipment loans and leases and student loans have established warehouse facilities. These transactions typically would not constitute master trusts, so the provisions of § __.5 would not be available to them. (We note, though, that the horizontal interest provisions also seemingly need to accommodate master trust structures, as § __.5(f) expressly permits the use of EHRIs in master trusts.)

There are a number of difficulties in seeking to apply the projection and certification requirements to eligible horizontal retentions in revolving structures, including:

- On the closing date of the issuance of ABS interests, the issuing entity will not own all of the assets that it will eventually own. Indeed, for a warehouse facility where the sponsor

is permitted to determine when and how many assets it wishes to add from time to time, there may well be no assets in the issuing entity on the closing date. But, in any event, the sponsor will not know what the composition will be of its securitized assets at any particular time in the future.

- The securitizer will not necessarily know when the amortization period will commence. For one thing, it is common in warehouse facilities for the revolving period to be extended on, say, an annual basis, in conjunction with the renewal of the commitments of the lender(s). For another, securitizers typically have the ability to use collections either to add new assets to the facility or to pay down the ABS interests owned by lenders to the extent necessary to maintain compliance with the "borrowing base" in the facility.

- To the extent that losses are taken into account, the loss profile for a pool of receivables may well depend on the composition of the pool. For example, it is commonly known that retail auto loans tend to have default rates that vary with the age of the loans. In a pool of newly-originated prime auto loans, the highest loss rates will typically be during the "middle period" of the pool, beginning about twelve months after origination and continuing for perhaps another 18 months. Before and after that middle period, the loss rates tend to be lower.

These uncertainties make it difficult and highly speculative to prepare projected Payout Rates for revolving pools of receivables. One possible way to harmonize the eligible horizontal retention requirements of § __.4 with the uncertainties of securitization transactions using revolving structures would be to specify that the projections, certifications and related disclosures are to be prepared in conjunction with the first transfer of receivables into the transaction, based on the assumption that no further receivables would be added and the pool would immediately begin to amortize in accordance with the transaction documents. In this situation, we believe that new projections and disclosures should be required thereafter only upon an increase in the maximum permitted amount of ABS interests,[19] and then only if the holders of the ABS interests so request.

(v) Self-Adjusting Horizontal Option

As described in the preceding several sections, we believe that the projection, certification and disclosure provisions associated with the eligible horizontal retention raise a number of problems. But compliance with those provisions is currently the sole means by which a securitizer can hold an eligible horizontal retention.

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[19] The reason we use the term "maximum permitted amount of ABS interests" is that we are attempting to distinguish between the ordinary draws on a revolving facility to utilize existing commitments, which we believe should not require a new set of projections, certification and disclosures, and an increase in the commitments of the lender(s), which we think is a more significant event that should give the lender the right to request a new set.

We believe that an additional option should be offered for horizontal risk retention. We note that the seller's interest option in § __.5 is based on measurement of the *actual* seller's interest that is in effect on each measurement date, with the retention being satisfactory if it is at least 5 percent on each such date. We think that, similarly, there should be an option that looks to the *actual* horizontal retention being held at any given time. We propose a "self-adjusting horizontal option" that would be structured (i) to require actual risk retention of a target risk retention percentage (*e.g.*, 5 percent) at inception and on each monthly measurement date and (ii) to prohibit payments on the eligible horizontal retention at any time that it was below the target percentage when other ABS interests were outstanding. These arrangements would be required to be set forth in the operative documents for the securitization transaction.

We think this self-adjusting horizontal option would be much easier to apply for securitization transactions with revolving structures, although we believe it should also be available to securitization transactions for static pools. It also aligns investors' interests with the sponsor's interest, in that this option does not permit the sponsor to receive cash flows when the retained risk is below the target percentage, unless all more senior ABS interests have been repaid.

We have set out in Appendix C a proposed set of rules that would give effect to the self-adjusting horizontal option. Of note, we propose there that the value of the eligible horizontal retention could be established using either a fair value approach or the securitization value approach that we described in Part III.B.1.b(i)(B) above, entitled "—Permitting an Alternative to Fair Value."

Because the self-adjusting horizontal option would be based on the actual value of the retained interest, we think that projections of Payout Rates would not be required. Further, if the sponsor used the securitization value methodology, we think that the lower level of disclosures suggested above for securitization value would be appropriate.

(vi) Alternative Eligible Horizontal Residual Interest Proposal

The Agencies have requested comment on an alternative provision relating to the amount of principal payments received by an EHRI. Under this alternative, the sponsor would be prohibited from receiving a cumulative amount which exceeded the sponsor's proportionate share of payments made to holders of the ABS. The proportionate share would be determined in accordance with the closing date fair value calculations mandated by the Reproposed Rules.

We have serious concerns regarding this alternative. Initially, we note that it has the same problem that we identified above in Part III.B.1.b(ii)(A), entitled "—Maintenance of Original Enhancement Level," which is that this alternative would effectively "lock in" the percentage of risk retention that the sponsor would be required to hold, even if that percentage were to be well above 5 percent. We see no indication in the Dodd-Frank Act or pertinent legislative history that the Congressional goal was to require risk retention to be maintained at a level potentially well above 5 percent.

We think that this alternative could particularly disadvantage highly-rated sponsors that use securitization to fund a portion of their assets, given that those sponsors typically retain a greater portion of the junior ABS interests issued by their issuing entities. Those sponsors do so for the reason that the relatively high interest rates demanded by investors in the more subordinated ABS interests are not attractive to them. The sponsors prefer not to issue those higher-yielding classes, but instead to retain their investment in that portion of the cash flow (and the risk of nonpayment, since the senior ABS interests issued to third parties would have first claim on all cash flow from the receivables). This structure means that the risk retention by such sponsors is noticeably higher than what other sponsors provide—a benefit to investors in ABS originated by those highly rated sponsors. By insisting that highly-rated sponsors must be locked in to an artificially high closing date risk retention percentage and be barred from receiving prepayments and other residual cash flow which would reduce that percentage to any extent, the Reproposed Rules would reduce their motivation to securitize their assets. The effect could be to increase such a sponsor's cost of funding, which could adversely affect the customers or other obligors of such sponsors – without providing any concomitant benefit from investors' perspective.

Another problem, which would be particularly sensitive in connection with equipment lease ABS, relates to the right of the residual interest to receive collections in respect of the residual value of the underlying equipment. Those residual cash flows may come from prepayment of the securitized receivables, from casualty insurance proceeds, or from equipment remarketing proceeds upon expiration or early termination (rather than disposition after an event of default) of the related contract. Investors and rating agencies often view the likelihood of collecting these equipment residuals as low, and therefore do not give an issuing entity credit for those cash flows in the transaction structure. In other words, equipment residuals are an extra asset included in the deal that is not part of the modeling related to repayment of investors. Although residual collections may be applied to cover certain losses that have otherwise occurred, if there are no losses to cover, then they can flow directly to the holder of the residual interest.

With equipment leases, these sorts of equipment residuals can represent significant value. Particularly if some large equipment residuals are received early in the transaction, the result under this alternative could be to "impound" those amounts because paying them out would cause the residual holder to receive a disproportionately large share of payments. If the investors and the rating agencies are willing to let these amounts flow to the residual holder—on the basis that they have not relied on these amounts in connection with rating or investment decisions—we do not understand why the Agencies should forbid that payment.

Finally, if this alternative were implemented, it seems to us that it could have a perverse effect on investor protection. Sponsors who knew that they would have to wait to receive "excess" payments would be motivated to structure ABS offerings with risk retention much closer to the regulatory 5 percent minimum. Hence, the alternative may result in diminished investor protection—the opposite of what the Dodd-Frank Act has sought to achieve. It also would produce misalignment between investor and sponsor objectives.

For the reasons set forth above, we recommend that the Commission not include the alternative provision in the Final Risk Retention Rules.

2. Revolving Master Trusts and Seller's Interests

The Reproposed Rules include a specific retention option for revolving master trusts in § __.5, which can be satisfied if the sponsor or one or more wholly-owned affiliates of the sponsor retains a seller's interest representing at least 5 percent of the unpaid principal balance of all outstanding ABS interests issued by the issuing entity. The 5 percent seller's interest requirement may be reduced to a lower percentage if qualifying horizontal residual interests are held by the sponsor or a wholly-owned affiliate of the sponsor or if an eligible excess funding account has been funded. The discussion set forth in the Commentary as the "Commission Economic Analysis" (the "Commission Economic Analysis") states that "[t]he definitions of a seller's interest and a revolving master trust are intended to be consistent with current market practices."[20] The cost/benefit analysis with respect to this portion of the Reproposed Rules is premised on the notion that the seller's interest and revolving master trust requirements are aligned with current market practice and assumes that "[m]aintaining current practice will be transparent and easy for the market to understand and will preserve current levels of efficiency and maintain investor's [sic] willingness to invest in the market."[21] Given the significant risk retention represented by seller's interests in the current market, this option provides, in theory, an appropriate framework for risk retention requirements for revolving master trusts. Unfortunately, the seller's interest option as proposed is not consistent with existing market structures and, as such, should be modified if it is going to provide credit for seller's interests in existing master trusts.

Revolving master trusts have been used for over 20 years to provide an efficient issuance structure for securitizations of credit card receivables, floor plan loans, home equity lines of credit, servicer advance facilities and other asset types comprised of both revolving and non-revolving assets. Existing issuing entities currently have many series, classes and tranches of outstanding securities structured to meet the requirements of investors and rating agencies. Given the volume of outstanding securities issued by revolving issuing entities and the variation in form of issuers and issuance, it is extremely difficult to accommodate current market practices in a highly prescriptive set of rules.

Sponsors of revolving master trusts generally maintain significant risk retention in multiple forms. A seller's interest is commonly retained and gives the holder exposure to a share of losses on the portfolio which is generally pro rata or subordinated to the exposure borne by holders of investor ABS interests. The holder of the seller's interest is also generally entitled to the excess spread on the asset pool, which is the interest at greatest risk in these transactions. This excess spread residual interest is the interest that most clearly reflects the benefits of good

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[20] 78 Fed. Reg. at 58013.

[21] *Id.*

portfolio performance and the burdens of poor portfolio performance. Many revolving master trusts have reserve accounts, spread accounts or cash collateral accounts funded by the sponsor from the initial proceeds of the transaction and/or over time from excess spread which provide protection against losses for investor ABS interests. In addition, many issuers retain subordinated ABS interests while selling more senior ABS interests to third-party investors. Generally, sponsors or depositors maintain significant risk retention in their master trust transactions.

As a result of recent changes in GAAP, most credit card securitizations that were off balance sheet for accounting purposes prior to the financial crisis came back on balance sheet around the beginning of 2010.[22] Securitizations of credit card receivables generally no longer achieve off-balance sheet treatment for the securitized assets and the performance of the assets remains a part of the sponsor's overall financial performance.[23] The general objective of the risk retention requirement in the Dodd-Frank Act was to require a securitizer to retain a material portion of the credit risk for any asset that such securitizer sells to a third party. Transactions that remain on balance sheet reflect continued ownership of the assets by the sponsor.

Despite the significant forms of risk retention present in existing revolving master trust transactions and the alignment of interests with respect to the performance of the asset pool, under the Reproposed Rules most, if not all, revolving master trusts would get no credit for their seller's interest or other forms of risk retention. In addition, existing revolving master trust agreements effectively prohibit compliance with the seller's interest requirements.[24] The discussion below attempts to highlight the reasons why the Reproposed Rules would not give effect to existing forms of risk retention in revolving master trust transactions, and provides comments regarding how the Reproposed Rules could be modified to accommodate prudent features of existing market structures.

a. Definitions

(i) Seller's Interest

Although the Reproposed Rules address a number of concerns raised in comments on the Original Proposed Rules, we believe the Reproposed Rules still fail to address the most fundamental problem, which is that the seller's interest has been defined in a way that could

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[22] *See* Accounting Standards Codification Topic 860, Transfers and Servicing (ASC 860, commonly called FAS 166); and FASB Accounting Standards Codification Topic 810, Consolidation (ASC 810, commonly called FAS 167).

[23] *See* Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention, October 2010, page 69 ("Based on regulatory data reported to the agencies, commercial banks consolidated approximately $437 billion of loans, $326 billion of which were securitized credit card receivables, as a result of the accounting charges [sic] that became effective in 2010.").

[24] Request for Comment 28(a), 78 Fed. Reg. at 57946.

preclude usage of the seller's interest as a risk retention option by most if not all revolving master trust transactions. "Seller's interest" is defined in § __.5(a) as:

> an ABS interest or ABS interests: (1) Collateralized by all of the securitized assets and servicing assets owned or held by the issuing entity other than assets that have been allocated as collateral only for a specific series; (2) That is *pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all distributions and losses with respect to the securitized assets prior to an early amortization event (as defined in the securitization transaction documents); and (3) That adjusts for fluctuations in the outstanding principal balance of the securitized assets in the pool.

Most significantly, clause (2) of the definition is inconsistent with the terms of seller's interests in the current market.

As discussed in our comments with respect to the Original Proposed Rules, for credit card securitizations a seller's interest is generally allocated collections and losses equal to (a) 100 percent minus (b) the amount allocated to investors. For series or tranches of investor ABS interests in a revolving period, the allocation of collections and losses is generally pro rata based upon the outstanding principal 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 limited amortization, scheduled amortization or accumulation period, as well as during an early amortization 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 principal amount of the relevant investor ABS interests at the end of the revolving period as the numerator and the aggregate amount of principal receivables in the issuing entity as the denominator. Using a fixed numerator for the allocation of principal collections provides for a faster repayment of principal to the investor ABS interests than would occur with a pro rata allocation. Allocating principal collections on a pro rata basis during a principal repayment period would result in the repayment of an ever-declining percentage of principal over an extended time frame. Because the allocation of principal collections to the investor ABS interests using a percentage with a fixed numerator is disproportionately large, the allocation to the seller's interest is correspondingly reduced and the payments to the seller's interest are effectively time-subordinated.

It should be noted that, because revolving 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 investor ABS interest is not in its revolving period, the seller's interest will not be allocated all distributions on a pro rata basis so long as the investor ABS interests are being repaid.

The requirement in clause (2) of the seller's interest definition that the seller's interest be *pari passu* with respect to all distributions prior to an early amortization event is inconsistent with standard master trust allocation percentages. We urge the Commission to address this significant inconsistency with current market practice in the Final Risk Retention Rules to allow

sponsors to take credit for their seller's interests. For many credit card master trusts, this problem could be addressed by replacing the phrase "prior to an early amortization event" with the phrase "prior to the end of the revolving period for such series." Another alternative would be to require that allocations to the seller's interest not be senior to allocations to each series, rather than requiring that they be *pari passu*.

If the seller's interest definition is not changed to accommodate the common approach to allocating principal collections, issuers would likely be unable to amend existing master trust agreements to conform to the proposed seller's interest definition because the necessary amendments would be materially adverse to the interests of holders of investor ABS. If the numerator of the allocation percentage for principal collections continued to float during a period when principal was being repaid prior to an early amortization event, the repayment of principal would be slowed down. An amendment to master trust agreements which would implement a delay in the repayment of principal to investor ABS interests could require the consent of 100 percent of the investor ABS interests; this would be extremely difficult, if not impossible, to obtain. Existing programs may have outstanding securities with maturities extending out more than ten years. For future transactions, while the allocation percentages for investor ABS interests could perhaps be revised, the extended repayment period would introduce greater risk and uncertainty for investors and would likely require greater credit enhancement. Such restructuring could be commercially unfeasible. In any event, restructuring future transactions in a manner that would be clearly disadvantageous to investor ABS interests seems undesirable from a public policy perspective. We respectfully submit that the risk retention rules should not be structured to shift greater risk to investors.

In addition to a minimum seller's interest test, most master trusts have a minimum aggregate principal receivables test which requires the aggregate principal balance of the pool to be at least equal to the sum of the numerators used to allocate principal to the investor ABS interests at any given point in time. In other words, the issuer is required to maintain a minimum principal receivables balance that is based on the fixed numerators described in the discussion of fixed/floating allocations, rather than allowing receivables in the pool to decline as investor interests in those receivables are reduced. This test supports the accelerated repayment of the investor ABS interests during amortization or accumulation periods and causes the seller's interest to grow with each payment to the investor ABS interests. Accordingly, throughout the period of repayment of investor ABS interests the face amount of the seller's interest increases resulting in additional risk retention.

The seller's interest in some structures is explicitly subordinated to the investor ABS interests. Collections allocated to the seller's interest may be made available to the investor ABS interests to cover required payments before being paid to the seller's interest and losses may be absorbed by the seller's interest prior to being absorbed by the investor ABS interest. A subordinated seller's interest represents a greater degree of risk retention than a *pari passu* seller's interest. It therefore seems appropriate to recognize a subordinated seller's interest as a qualifying seller's interest for risk retention purposes. To address this issue, the requirement of

clause (2) could be revised to be parallel with the language of § __.5(h)(2)[25] and to say "that is *pari passu* or subordinate to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all losses with respect to the securitized assets." We also propose that the value of a subordinated seller's interest should be measured on a face value basis rather than a fair value basis because of the complexity of determining the fair value of a subordinated seller's interest.[26]

(ii) Revolving Master Trust

A "Revolving master trust" is defined in § __.5(a) as "an issuing entity that is (1) A master trust; and (2) Established to issue on multiple issuance dates one or more series, classes, subclasses, or tranches of asset-backed securities all of which are collateralized by a common pool of securitized assets that will change in composition over time." Clause (1) of the definition appears somewhat circular and it is unclear what it is intended to add. More importantly, however, we note that current market practice for issuance out of revolving structures encompasses the use of limited liability companies, limited partnerships and corporations as the issuing entities. As a technical matter, the phrase "established to issue" in clause (2) is more limiting than it needs to be. Therefore, we recommend that the defined term "revolving master trust" be replaced with the term "revolving issuing entity," clause (1) be removed and the phrase "established to issue" in clause 2 be replaced with "issues or plans to issue."

The requirement in clause (2) of the definition of "revolving master trust" that all of the asset-backed securities of a revolving master trust be collateralized by a common pool of securitized assets would preclude issuance entities with multiple segregated asset pools from relying on the seller's interest option. A single master trust with multiple segregated asset pools would be left without a viable option for complying with the risk retention requirements if this restriction remains in the Final Risk Retention Rules.

b. General Requirements

The general retention requirement for revolving master trusts in § _.5(b) would require the sponsor to retain a seller's interest of not less than 5 percent of the unpaid principal balance of all outstanding investors' ABS interests issued by the issuing entity. Section _.5(c)(2) clarifies that the seller's interest may be retained by one or more wholly-owned affiliates of the sponsor, including one or more depositors of the revolving master trust. We appreciate the

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[25] Clause (2) of § __.5(h) is one of the conditions that must be satisfied in order for the seller's interest to be permitted to fall below 5 percent following the commencement of early amortization, and it states that: "(2) The terms of the seller's interest continue to make it *pari passu* or subordinate to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all losses with respect to the securitized assets[.]"

[26] In the discussion of the general use of a principal balance based valuation of the seller's interest rather than use of fair value, we note that the Agencies state that "the fair value determination would create additional complexity and costs, especially given the frequency of measurement periods." 78 Fed. Reg. at 57944.

inclusion of this provision, which allows a depositor that is distinct from the sponsor to be the holder of the seller's interest at all times without a requirement for the sponsor to be the initial holder. However, the general hedging, transfer and financing prohibitions in § _.12 allow a transfer of a retained interest to an "entity that is and remains a majority-owned affiliate of the sponsor." Indeed, the Commentary, when referencing this aspect of § __.5, seems to suggest that the affiliation requirement would be the same in § __.5 as for all other sections.[27] A majority-owned affiliate of the sponsor would be a consolidated reporting entity. In some circumstances, the depositor to a revolving issuing entity has been a majority-owned affiliate of the originator/sponsor but not a wholly-owned affiliate. We therefore suggest that the phrase "wholly-owned" in § __.5(c)(2), § __.5(d) and § __.5(f) be replaced by "majority-owned" consistent with the general standard as reproposed, and to accommodate certain transactions in the current market.

In the Commentary, the Agencies express the view that the measurement of the seller's interest based on face value rather than fair value is appropriate because they believe that sponsors of revolving master trusts do not issue "senior interest-only bonds or premium bonds."[28] The discussion in the Commentary goes on to say that the Agencies expect to include in the Final Risk Retention Rules a prohibition against use of the seller's interest approach for any revolving trust that has issued senior interest-only bonds or premium bonds.[29] The terms "senior interest-only bonds" and "premium bonds" are not defined. We assume that the intent is to encompass bonds that monetize the excess spread from a transaction, and we believe that such securities are not commonly issued by revolving issuing entities. However, we are concerned that a broad interpretation of the term "premium bonds" could encompass securities that are issued from time to time by revolving issuing entities. In particular, "premium bonds" could include investor ABS interests that are priced slightly above par at closing due to movements in interest rates. For example, in a so-called "re-opening transaction" a sponsor may issue additional notes of a particular series, class or tranche of ABS interests after the date of the initial issuance generally on the same terms and conditions as the originally issued ABS interests but at a premium to the par value at which the original ABS interests were issued due to movements in interest rates during the interim period. Re-opening transactions occur from time to time often because a potential investor may be subject to internal investment criteria that include a minimum size for a class or tranche of securities that might not be met if the class or tranche purchased were limited in size to the securities to be purchased by the new investor. To avoid this problem, the investor may request that an outstanding class or tranche of securities be re-opened so that the investor's securities will be part of a larger class or tranche. The motivation behind a re-opening transaction is not to monetize excess spread but to satisfy investor demand for participation in such a larger class or tranche. Clarification thus should be provided in the

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[27] *See* fn. 54, 78 Fed. Reg. at 57943, which cross-references the discussion of affiliation in Part III.D.2 of the Commentary. The referenced discussion endorses a majority-owned affiliate concept.

[28] 78 Fed. Reg. at 57944.

[29] *Id.*

Final Risk Retention Rules, including in any prohibition on the use of the seller's interest option for any revolving trust that issues premium bonds, that premium bonds do not include bonds issued at a premium due to movements in interest rates relative to the coupon on the security.

If the Reproposed Rules define "premium bonds" to include bonds sold at a premium to par in connection with a re-opening or other fixed rate bonds sold at a premium to par due to rate fluctuations, we strongly recommend that the Commission provide explicit "grandfathering" for past issuance of such bonds. Doing so will avoid the situation in which a revolving issuing entity is not allowed to utilize the seller's interest due to its prior issuance of premium bonds, even though that issuance was entirely permissible, and the adverse consequences for risk retention were unknown, at the time it occurred.

c. Measuring and retaining the seller's interest

Unlike most other forms of risk retention recognized under the Reproposed Rules which must satisfy the relevant retention requirement only at the time of initial issuance, § __.5(c)(1) requires the 5 percent seller's interest requirement to be met at the closing of each issuance of ABS interests and at every seller's interest measurement date specified under the securitization transaction documents (but no less than monthly) until no ABS interest in the issuing entity is held by any person not affiliated with the sponsor. We believe that the requirement to measure the seller's interest at every measurement date should be clarified to require that measurement dates are not required to occur more frequently than once a month for purposes of the risk retention rule. In addition, the requirement should be modified to contemplate and permit explicitly the existence of a reasonable "cure period" consistent with the period specified in the relevant transaction documents within which the failure of the seller's interest to meet its required level may be remedied prior to triggering an early amortization event. Typically, an issuing entity can add assets within a specified time frame to meet the minimum seller's interest requirement and only if such entity fails to do so in the specified time frame will an early amortization event occur. Given the constant fluctuations in the size of a seller's interest, we recommend that the Final Risk Retention Rules provide for a similar cure period following each monthly measurement date.

The measurement requirement in § __.5(c)(1) applies only to the 5 percent seller's interest requirement in § __.5(b), but, because the 5 percent seller's interest requirement can be reduced under the provisions of § __.5(e) and § __.5(f), it is unclear whether each monthly measurement would require a measurement of the offsetting interest in the pool wide excess funding account or the EHRI or alternative horizontal interest described in those subsections. An eligible horizontal residual interest meeting the standard requirements set out in § __.4 or a horizontal interest meeting the special requirements set out in § __.5(f) (which we refer to as a "<u>specialized horizontal interest</u>"), if in the form of an interest other than a residual interest, should be required to be measured only upon original issuance and at any point when the outstanding amount is either increased or reduced as a result of principal payments.

d. Multilevel trusts

The inclusion of the provisions of § __.5(d) regarding multi-level trusts is helpful and responsive to concerns regarding credit for the seller's interest held by a legacy trust that issues a collateral certificate to an issuance trust. As discussed below, similar consideration should be given by the Commission to crediting any EHRI, specialized horizontal interest or HCRA at the legacy trust level which supports the collateral certificate.

e. Offset for Pool-level Excess Funding Account

The Reproposed Rules provide for a dollar-for-dollar reduction of the 5 percent seller's interest requirement for amounts held in an excess funding account if it is funded to maintain a minimum seller's interest requirement, and is *pari passu* to each investor ABS interest with respect to the allocation of losses. It is unclear why the Reproposed Rules include a requirement that a cash funded excess funding account should be *pari passu* with respect to losses. Losses are not allocated to a cash account that by its nature does not generate any losses, unlike a pool of receivables or other financial assets. This condition would not be consistent with the way transactions allocate losses and would result in credit not being given for amounts in excess funding accounts.

The excess funding account provision also would require that, in the event of early amortizations, amounts in the excess funding account must be paid out in the same manner as distributions on the securitized assets. For transactions that separate principal collections from interest and fees (or finance charge) collections, the amounts in the excess funding account are generally applied as principal collections. The Final Risk Retention Rules therefore should provide clarification that amounts paid out of an excess funding account may be applied as principal collections or, if no distinction is made between principal and other collections, as collections.

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f. Combined Retention

(i) Combined Retention at Trust and Series Level

Section _.5(f) allows for a reduction in the seller's interest risk retention requirement below 5 percent to the extent that, for all series of ABS interests issued by the revolving master trust, the sponsor or wholly-owned affiliate of the sponsor retains a corresponding percentage of the fair value of all ABS interests issued in each series held in the form of either an EHRI meeting the standard requirements set out in § _.4 or a horizontal interest meeting requirements

set out in §__.5(f). Unfortunately, neither the standard eligible horizontal interest nor the specialized horizontal interest, as reproposed, accommodates subordinate investor ABS interests for revolving issuing entities as currently structured.

Section __.5(f) would require the sponsor or wholly-owned affiliate of the sponsor to retain a specific percentage of the horizontal risk retention in every series issued by the revolving master trust in order to be able to reduce such sponsor's 5 percent seller's interest requirement by a corresponding percentage. This requirement would not give credit for certain forms of horizontal residual interests. In some cases a subordinated series provides credit enhancement for all other series. It is structured not as a subordinated class of the other series, but instead as a standalone series that provides enhancement to some or all of the other outstanding series. In addition, although the Reproposed Rules have incorporated a provision (§ __.5(d)) giving credit for seller's interests held at legacy master trusts that issue collateral certificates, the Reproposed Rules do not have a corresponding provision to provide credit for a horizontal residual interest or horizontal cash reserve account providing enhancement for a collateral certificate. In our view, the Final Risk Retention Rules should give credit for standalone subordinated series and horizontal residual interests and horizontal cash reserve accounts held at legacy trusts.

The proposal that the reduction in the seller's interest requirement be based upon the lowest percentage that a horizontal residual interest represents for any series does not give credit for significant risk retention retained by sponsors of revolving issuing entities. The permitted reduction for a sponsor that holds a 4 percent interest in a $2 billion series and a 2 percent interest in a $100 million series would be capped at 2 percent of the $2 billion series, even though the sponsor retains a significantly greater interest in the revolving issuing entity's pool of assets. Over the last several years, securitizers of credit card receivables have retained most of the junior tranches of their transactions and, accordingly, have accumulated significant risk retention in their revolving issuing entity's assets. In years prior to the financial crisis, credit card securitizers sold many though not all of their subordinate securities. The decision whether or not to sell subordinated securities, in the absence of a risk retention requirement, would be based upon a cost/benefit analysis factoring in the market coupon to be paid on the securities and the capital consequences of selling or retaining the securities, as well as market demand at the time of issuance. This would produce different outcomes at different times depending upon market appetite for subordinated securities and evolving capital standards. For so long as a sponsor is retaining a horizontal residual interest, such sponsor has a specific continuing exposure to the common pool of securitized assets collateralizing the ABS interests. We suggest that the Commission give credit for horizontal residual interests retained by a sponsor or affiliate on a proportionate basis, based on the horizontal residual interests held by the sponsor or qualifying affiliate on any measuring date relative to all investor ABS interests issued by the revolving issuing entity which are then outstanding.

As described above, the Reproposed Rules would allow a reduction of the 5 percent seller's interest requirement for EHRIs that meet the requirements of § __.4 or for specialized horizontal interests that meet the requirements described in § __.5(f). As noted by the Agencies in the Commentary, the residual interests held by sponsors of revolving master trusts typically do not meet the requirements of the proposed definition of EHRIs in § __.4 because, among other

things, those requirements would limit the rate of payment to the sponsor to the rate of payments made to the holders of senior ABS interests. As discussed more fully in Part II.B.1.b.(ii) of this comment letter, entitled "—The Payout Rates," the cashflow projection tests of § __.4 require a comparison of total payments to the retained horizontal residual interest, including interest payments, against principal payments to holders of senior ABS interest. For revolving structures under which interest payments to all classes of securities are made during the revolving period but principal payments are made only after the end of the revolving period, the cashflow projection test would always be failed. The option in § __.5(f) providing credit for eligible horizontal residual interests meeting the requirements of § __.4 therefore is of no value for revolving issuing entities under the current terms of § __.4.[30] Revolving issuing entities would therefore need to look to the specialized horizontal interest as described in § __.5(f).

Under § __.5(f) a specialized horizontal interest is an ABS interest that satisfies the following requirements:

> (1) whether certificated or uncertificated, in a single or multiple classes, subclasses, or tranches, the horizontal interest meets, individually or in the aggregate, the requirements of § __.5(f);
>
> (2) each series distinguishes between the series' share of the interest and fee cash flows and the series' share of the principal repayment cash flows from the securitized assets;
>
> (3) the horizontal interest's claim to any of the series' share of the interest and fee cash flows for any interest payment period is subordinated to all accrued and payable interest and principal due on the payment date to more senior ABS interests in the series for that period, and further reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving master trust for that period, to the extent that such payments would have been included in amounts payable to more senior interests in the series; and
>
> (4) the horizontal interest has the most subordinated claim to any part of the series' share of principal repayment cash flows.

The proposed inclusion in clause (3) of the requirement that the horizontal residual interest's claim to any part of the relevant series' share of interest and fee cash flows for any interest payment period be subordinated to all accrued and payable interest *and principal* due to more senior ABS interests in the series for that period is inconsistent with the provisions of the transaction documents for most revolving issuing entities with separate interest and principal cash flow waterfalls. Interest and fee cash flows (or "finance charge collections") are generally applied to pay accrued and payable interest on the ABS interests and not applied to repayments of principal in finance charge "waterfalls" (except to the extent finance charge collections are

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[30] *See also* the discussion in Part III.B.1.b.(iv).

applied with respect to defaulted or charge-off amounts and recharacterized as principal collections). We note that the summary description of the specialized horizontal interest requirements included in the Commentary refers only to the payment of interest and not principal.[31] This is a very significant discrepancy. Conforming the text of the Final Risk Retention Rules to the language used in the Commentary in this respect, in our view, would address an issue that, if not addressed, would preclude revolving issuing entities with separate principal and finance charge collection waterfalls from availing themselves of this option. We note that clause (2) of § __.5(f) requires that finance charge and principal collections be kept separate. When principal collections and finance charge collections are separated and applied in separate waterfalls, as is the case for most credit card securitizations, finance charge collections generally are not used to pay principal. We believe that the Agencies should address this inconsistency by removing the reference to "principal due" in clause (3).

Section __.5(f)(3) also states that the horizontal residual interest's claim to finance charge collections must be "further reduced by the series' share of losses, including defaults on principal of the securitized assets collateralizing the revolving master trust for that period." If this requirement was intended to mean that the horizontal residual interest may not receive any of its series' share of finance charge collections prior to the finance charge collections being used to cover losses, the option is inconsistent with the waterfalls for many existing revolving issuing entities. Typically, in the finance charge waterfall for a credit card securitization, finance charge collections are applied to make interest payments to each class of outstanding securities in descending order of seniority before being applied with respect to loss amounts allocated to the series for the current and prior periods. Finance charge collections applied in the waterfall with respect to losses allocated to the series generally would be paid to the holder of the seller's interest, the seller's interest would be reduced by a corresponding amount and the investors' interest in receivables would be reinstated to the extent of those reimbursed losses Alternatively, if any series (which could be the series from which the subordinated interest was issued or any other series) is in an amortization or accumulation period during which principal is being repaid, the finance charge collections applied to losses may be allocated to the amortizing series in reduction of that series' outstanding principal amount. If the intent of the language in clause (3) of § __.5(f) that would require the horizontal interest's claim to cash flows to be "reduced by the series' share of losses" is to prohibit payments of interest to retained subordinated securities prior to the application of finance charge collections to losses, such requirement would disqualify most retained subordinated interests in credit card securitization transactions. This result, coupled with the proposed requirement that a specified percentage of qualifying horizontal residual interest be held in each series of ABS interest in order for any credit to be provided against the

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[31] *See* 78 Fed. Reg. at 57945. The second bullet point describing this proposal says:

> "The sponsor's claim to any of the series' share of interest and fee proceeds each period pursuant to the horizontal residual interest is subordinated to all interest due to all ABS interests in the series for that period. . ."

It does not mention principal due to all ABS interests.

seller's interest requirement, would mean that the offset for horizontal residual interests would be of no benefit to those transactions, at least so long as the disqualifying interests remain outstanding. Restructuring future subordinated interests to conform to the proposed requirements in clause (3) of § __.5(f) could have adverse ratings and other implications for holders of such interest. In circumstances in which the class of subordinated ABS interests would otherwise be held in part by the sponsor and in part by third party investors, it may be significantly more difficult to find investors if the ABS interests are structured to comply with these restrictions. It should also be noted that structuring to comply with the restrictions could adversely affect the fair value of the retained interest.

Clause (4) of § __.5(f) would require the horizontal interest to have "the most subordinated claim to any part of the series' share of principal repayment cash flows." While revolving issuing entity transactions have subordination provisions designed to protect the senior ABS interests, including provisions that generally require principal payments to senior ABS interests to be made prior to principal payments to subordinated ABS interests in descending order of seniority, many credit card securitization programs now utilize de-linked issuance trust structures that allow a sponsor to issue subordinated tranches of ABS interests with maturities that may be shorter than the maturities of certain more senior tranches. In a de-linked program, tranches of ABS interests are issued on multiple issuance dates with varying maturities. Subordinated ABS interests are entitled to receive principal payments on scheduled principal payment dates while more senior ABS interests remain outstanding so long as sufficient subordination remains available to provide required credit enhancement to the more senior ABS interests. While the claim of a horizontal residual interest would continue to be subordinate to any claim of more senior ABS interests, the subordinated horizontal interest could be receiving principal payments while senior interests are not yet receiving principal payments. We think that this type of structure should be accommodated in the Final Risk Retention Rules, and that it would be possible to do so by modifying clause (4) to read "the horizontal interest has the most subordinated claim to any part of the series' share of principal repayment cash flows due to any ABS interest on the payment date."

Section __.5(f) provides that the offset for horizontal interests will be determined based on the fair value of those interests rather than on the face value which is the measurement used for the seller's interest. Fair value calculations are complex and in many instances inherently subjective, especially where no equivalent securities are trading in the market. We recognize that an excess spread residual interest that has no outstanding principal amount cannot be valued at face value; therefore, it seems appropriate for those interests to be valued at fair value. Given the complexity of the fair value determination with respect to an excess spread residual interest and the potential liability associated with the disclosures that would be required in connection with fair value calculations, we recommend that a sponsor be allowed to elect not to perform and disclose a fair value determination for an excess spread residual interest but still be allowed to elect to offset the seller's interest retention requirement for a retained subordinated security or cash reserve account if such interest, along with the excess spread residual interest, represents a first loss position. If the sponsor elects to forego any offset to the 5 percent seller's interest requirement with respect to that excess spread residual interest, the sponsor should still be able to offset any other specialized horizontal interest, valued in accordance with the provisions of the

Final Risk Retention Rules, which, together with the excess spread residual interest, represents a first loss position in the series. Under our suggested approach, this relief would be available if the sponsor or its affiliate holds both the excess spread residual interest and the subordinated note horizontal interest, but chooses to obtain the offset only for the subordinated residual interest.

For subordinated notes, because the Reproposed Rules would require ongoing measurement of the seller's interest, we believe that the Final Risk Retention Rules should provide clarification that a sponsor does not need to re-determine the fair value of any horizontal residual interest that is being relied on to reduce the 5 percent seller's interest requirement after the initial determination, until principal payments are made with respect to that security. The fair value determination with respect to the retained horizontal residual interest in the form of a subordinate security, and the other investor ABS interests that would be necessary to determine the percentage that the fair value of the retained interest represents of the fair value of all relevant ABS interests, would present a significant burden for revolving issuing entities which would not exist for other transaction structures if the Final Risk Retention Rules were to require a re-determination of the fair value of each ABS interest on each measurement date. Fair value determinations can fluctuate significantly based on changes in interest rates and other external factors. Therefore, clarification should be provided in the Final Risk Retention Rules that any fair value calculation for a horizontal residual interest should be required to be performed only at original issuance and at any point when the outstanding amount is increased or reduced as a result of principal payments.

We appreciate the fact that the Agencies intended to provide offsetting credit for retained excess spread residual interests as well as subordinated classes of securities. The description of the specialized horizontal interest in the Commentary appears to be focused on describing an option that gives credit for a subordinated claim to a residual interest. Although this seems to be an appropriate recognition of the risk retained by sponsors in the form of excess spread residual interests, we ask that the requirements relating to specialized horizontal interests in § __.5(f) be drafted in a way that also accommodates subordinated classes or tranches of notes.

Section __.5(f) does not specifically mention any option to hold the eligible horizontal residual interest or specialized horizontal interest in the form of a horizontal cash reserve account as permitted under § __.4(c). Revolving issuing entity transactions generally include cash reserve accounts as credit enhancement. As a result, the Final Risk Retention Rules should provide dollar for dollar offsetting credit for amounts in those accounts which are available to cover losses or make interest or principal payments to senior ABS interests.

(ii) Vertical Retention

The Commentary states that "[t]he agencies are proposing to maintain the seller's interest as the specific risk retention option for master trusts."[32] Later in the Commentary the Agencies

[32] 78 Fed. Reg. at 57942.

note that, although they have considered allowing vertical forms of risk retention to be combined with the seller's interest option, the Agencies are not proposing to allow sponsors to meet their risk retention requirement in this manner.[33] If the language cited above was intended to preclude reliance by revolving issuing entities on the vertical option or any of the other retention options not set forth in § __.5, we believe that such language would be unduly restrictive. Although it would be extremely difficult for the sponsor of a revolving issuing entity with multiple series, classes or tranches of investor ABS interests outstanding currently to obtain a vertical slice of each such interest, given the problems we believe are associated with the ways in which the Reproposed Rules would limit the usefulness of the seller's interest and horizontal residual interests for revolving master trusts, vertical retention could be the only viable risk retention option and is of value to sponsors of revolving issuing entities as a potential last resort for compliance. In addition, for new structures going forward, the vertical retention option might be adopted as the least intrusive with respect to existing industry practices, again assuming that the current technical problems we have identified with respect to the seller's interest option and the horizontal residual interest option are not addressed in the Final Risk Retention Rules. Therefore, we believe that the Final Risk Retention Rules should clarify that the vertical option and any other means of satisfying risk retention obligations that may be available based upon the assets included in a revolving issuing entity or otherwise under other provisions of the Final Risk Retention Rule should explicitly be made available for revolving issuing entity transactions.

(iii) Representative Sample

As discussed in Part III.B.3.a of this letter, entitled "—Representative Sample," the representative sample retention option that was included in the Original Proposal was removed from the Reproposed Rules, but in our view should be restored in a functional form in the Final Risk Retention Rules. We note that certain revolving issuing entities have relied on the representative sample option for compliance with the FDIC Securitization Rule. A properly constructed representative sample option and the option to retain a participation interest in the pool of assets should be alternative forms of risk retention for revolving issuing entity transactions.

g. Disclosure

(i) Disclosure to potential investors a reasonable period of time prior to the sale of the ABS (and, upon request, to Commission and bank regulators)

The disclosure and record maintenance provisions of § __.5(g) of the Reproposed Rules would require a sponsor relying on the seller's interest option to disclose within "a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction," the value of the seller's interest at the closing of the securitization transaction expressed both as

[33] 78 Fed. Reg. at 57945.

a percentage of the investors' ABS interests and as a dollar amount.[34] The face amount of the seller's interest is always fluctuating to reflect changes in the size of the pool of assets as a result of the inclusion of new balances and repayments of principal on outstanding pool assets. At any time, the seller's interest generally equals the portion of the unpaid principal balance of the pool of assets in excess of the unpaid principal amount of the investors' ABS interests (less cash set aside in a principal funding account for their repayment). Clause (3) of the proposed seller's interest definition acknowledges this, and would require the seller's interest to adjust for fluctuations in the outstanding principal balance of the securitized assets in the pool. For this reason, the requirement that the sponsor must disclose on a date that is a reasonable period of time prior to the sale of the asset-backed securities the dollar amount of the seller's interest, and the percentage of the ABS interests that such interest will represent, at the closing is technically a condition that cannot be satisfied.

The Final Risk Retention Rules, in our view, should allow sponsors to disclose to potential investors the dollar amount and percentage of ABS interests represented by the seller's interest as of a date that is the most recent monthly measurement date. This disclosure should be permitted to be made on a *pro forma* basis and should allow the issuer to give effect to the ABS interests to be issued on the closing date and any additions or removals of assets scheduled to take place on or prior to the closing date based on balances in the applicable accounts on the relevant measurement date.

h. Early Amortization of all outstanding series

Although the Reproposed Rules generally would require a sponsor to maintain the 5 percent seller's interest (as may be offset by amounts in the excess funding account and EHRIs or specialized horizontal interests), §__.5(h) would permit the seller's interest to fall below the otherwise required level after an event of default triggers early amortization. The phrasing of this permissive language raises an interpretive issue that does not appear to have been addressed in the Reproposing Release. Revolving issuing entity transactions with securities issued in note form often include events of default which, if triggered, allow for acceleration of the notes so that they can become immediately due and payable and also allow for liquidation of the collateral to satisfy repayment obligations. These transactions in note form also have early amortization events that, if triggered, end the revolving period, may end the reinvestment in new assets and require principal payments on the notes to commence. In transactions that have both events of default and early amortization events, the list of early amortization events generally includes the occurrence of an event of default along with other events. The language of §__.5(h) specifically references "an event of default" that "triggers early amortization"; however, we do not believe the Agencies intended to limit the relief solely to the circumstance where early amortization commenced solely as the result of an event of default. We therefore recommend that the language be revised to say "after an early amortization event triggers early amortization".

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[34] *See* 78 Fed. Reg. at 58029.

In addition, we ask that clarification be provided in the Final Risk Retention Rules with respect to the condition in clause (3) of §__.5(h), which requires, in order for a sponsor to be entitled to relief from the 5 percent seller's interest requirement after the commencement of the early amortization period, that "[t]he terms of any horizontal interest relied upon by the sponsor pursuant to paragraph (f) to offset the minimum seller's interest amount continue to require the interests to absorb losses in accordance with the terms of paragraph (f) of this section." A horizontal interest by definition is a first loss interest in a series. If pool performance deteriorates, the horizontal interest should (and is intended to) absorb losses until it is completely written off; however, if the horizontal interest has performed its function of absorbing losses before losses are allocated to more senior interests and such interest is written down to zero, the condition of clause (3) cannot be satisfied. Early amortization may have been triggered by adverse pool performance; accordingly, although it is appropriate that the horizontal interest be required to absorb losses prior to senior interests, the relief provided in §__.5(h) should not be taken away when a horizontal interest is written down to zero and no longer able to absorb losses.

i. Grandfathering

The Agencies propose to require sponsors that rely on the seller's interest option to comply with respect to all of the outstanding investor ABS interests after the effective date of the Final Risk Retention Rules, without regard to whether the investor ABS interests were issued before or after the Final Risk Retention Rules' effective date. Essentially, there is no "grandfathering" for existing revolving issuing entities that rely on the seller's interest option. In the Commentary, the Agencies acknowledge that some master trust securitizations could need time to achieve compliance and state that "the agencies propose to recognize a sponsor's compliance with risk retention requirements based on the sponsor's actual conduct."[35] This is a vague standard, especially in light of the virtual impossibility of compliance with the Reproposed Rules for most revolving issuing entities as currently structured.

As discussed above, the Commission Economic Analysis indicates that the Agencies believed that, with the seller's interest option and revolving master trust provisions of the Reproposed Rules, they were "aligning the requirements with current market practices," "[m]aintaining current practice" and codifying current market practice.[36] The cost/benefit analysis for this portion of the Reproposed Rules is premised on those assumptions, which, from our perspective, are flawed.

As we have described in detail above, the proposed definition of "seller's interest" is inconsistent with current market standards, and revolving issuing entities, and their sponsors may be unable to amend their respective program documents to conform to the seller's interest option as proposed because such an amendment would be disadvantageous to holders of ABS interests.

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[35] 78 Fed. Reg. at 57946.

[36] *See id.* at 58013.

Moreover, as also discussed above, neither the proposed offset for pool-wide excess funding accounts nor the reduction for EHRIs or specialized horizontal interests is structured in a way that is consistent with current market practices. Although the issues with respect to each of the risk retention options for revolving issuing entities that are included in the Reproposed Rules are technical in nature and, we believe, could be addressed easily in the Final Risk Retention Rules, if such issues are not addressed sponsors of revolving issuing entities face an unsolvable problem that could render large and complex, yet efficient, funding vehicles inoperable, and cause the sponsors to have facilities that are out of compliance with the Reproposed Rules absent some form of relief.

Attempting to conform transaction documents on a going-forward basis for new issuance would result in new series of tranches of investor ABS interests which are less favorable to the investors than those issued prior to implementation of the Final Risk Retention Rules, and therefore less desirable. Sponsors would generally need relief from the proposed requirements if imposed with respect to outstanding securities. We urge the Commission to address the technical issues that we have discussed with respect to the Reproposed Rules in order to avoid placing issuers and investors in a position from which they have no clear path to compliance. Granting case-by-case exceptions is not an efficient or adequate solution for a problem that will generally apply to all revolving issuing entities.

We note that in implementing the FDIC Securitization Rule, which included a precondition requiring compliance with a risk retention requirement, the FDIC included a provision grandfathering existing revolving trusts or master trusts.[37]

Given that there may be no viable option for compliance with the Reproposed Rules by existing revolving issuing entities, and that the Agencies were attempting to codify current market practice, we believe that it would be appropriate for existing revolving issuing entities to be grandfathered if the Final Risk Retention Rules go into effect as currently reproposed, rather than be put in the position of violating rules with which such entities cannot comply without undue hardship and market disruption.

3. Representative Sample and Participation Interests

a. Representative Sample

In the Reproposed Rules, the Agencies do not propose to include the representative sample option as a form of risk retention, but request comment on whether the option should be retained.[38] We appreciate that many commenters, including the Committees in the Original ABA Comment Letter, were critical of the representative sample option included in the Original Proposal and were concerned that, as originally proposed, the option was not workable.

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[37] 12 C.F.R. § 360.6(d)(2).

[38] Request for Comment 31, 78 Fed. Reg. at 57947.

However, we believe now that the representative sample option, if properly structured, would be a workable and useful option for certain asset classes (such as retail auto loans, auto leases and student loans) and should be included in the menu of risk retention options available to sponsors.

We note that a representative sample is one form of risk retention currently permitted to be used by financial institutions under the FDIC Securitization Rule[39] and that financial institutions are using this form of risk retention in structuring transactions that comply with that rule. The FDIC Securitization Rule does not elaborate on what would be considered a "representative sample," leaving it to financial institutions to determine if their structures comply with the FDIC's rule. Our understanding is that market participants currently using this risk retention option interpret it as permitting financial institutions to hold assets similar in quality and other important characteristics on their balance sheet in unsecuritized form at a level equal to 5 percent of what they securitize so that there is no "cherry-picking."

In our view, the representative sample option in the Original Proposed Rules was problematic in large measure because it overlaid quantitative and characteristics requirements on top of a truly random sample structure. The FDIC's approach is working because of its simplicity. However, we recognize that the Agencies may want something more than the FDIC approach, and we think it would be reasonable to include a representative sample option with some additional requirements. In that regard, we recommend that the Commission include a representative sample option based on the following requirements:

- the sponsor would select from its unsecuritized assets a "designated pool" (as described in the Original Proposed Rules) that comprises the assets that will go into each of the representative sample and the securitized pool;

- the sponsor must randomly split the designated pool into the 5 percent representative sample and the 100 percent securitized pool, using a statistically valid methodology; and

- the sponsor must disclose in its offering document (a) the methodology used by the sponsor for selecting the random sample and (b) the composition of the representative sample, using all of the same pool stratifications (statistical information) as are included in the offering document with respect to the securitized pool.

We believe that the foregoing approach would address investor concerns that sponsors might "game" the system to put their better-performing receivables into the representative sample. The process of selecting a designated pool and then splitting it randomly, together with

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[39] "Prior to the effective date of regulations required under new Section 15G of the Securities Exchange Act. 15 U.S.C. 78a et seq.. added by § 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. the documents shall require that the sponsor retain an economic interest in a material portion. defined as not less than five (5) percent, of the credit risk of the financial assets. This retained interest may be either in the form of an interest of not less than five (5) percent in each of the credit tranches sold or transferred to the investors or in a representative sample of the securitized financial assets equal to not less than five (5) percent of the principal amount of the financial assets at transfer." 12 C.F.R. § 360.6(b)(5)(A).

disclosure of the sampling methodology and the material characteristics of the representative pool should be sufficient.

In addition, given the rather simple statistical exercise involved, we believe that the further burdensome requirement of an agreed-upon procedures report from an independent accounting firm that was included in the Original Proposed Rules should not be included in the Final Risk Retention Rules. If the Agencies nonetheless believe that more assurance is needed that the representative sample is representative of the securitized assets at the time of the selection of the sample, then the Final Risk Retention Rule could include a requirement that the sponsor review the representative sample (in a manner designed to provide reasonable assurance that the randomly selected assets are representative of the designated pool) and provide disclosure about the nature of such review.

Although we are less troubled by including the requirement from the Original Proposed Rules that the assets be serviced by the same entity using the same servicing standards as are required for the securitized assets, we do not believe it is workable to require that every employee of the servicer be unable to identify the owner of the assets being serviced. In particular, cash flows from, and periodic servicing reports on, the representative sample will need to be distributed to the sponsor, while cash flows from, and the related servicing reports on, the securitized pool will need to be distributed to the trustee for the securitized pool.

We recognize that, prior to the adoption of the FDIC Securitization Rule, securitizations were not structured to include a representative sample. That is logical because before the adoption of the Dodd-Frank Act and the FDIC Securitization Rule, there simply was no requirement that securitizers retain a percentage of the credit risk of the securitized assets. Market participants for several asset classes, however, now are using the representative sample risk retention option under the FDIC Securitization Rule and we believe that is good reason for the Commission to include a representative sample option in the Final Risk Retention Rules.

b. Participation Interests

We also take this opportunity to urge the Commission to include in the Final Risk Retention Rules the option of the sponsor to retain a 5 percent participation interest in the asset pool backing an issuance of asset-backed securities, as we discussed in our Supplemental ABA Comment Letter to the Commission. The Supplemental ABA Comment Letter responded to an invitation from representatives of several of the Agencies to discuss the use of participation interests as a risk retention method and to submit suggested language for the rule. Our suggested language followed the terminology used in the FDIC Securitization Rule, which addresses participations in loans as well as securitizations.

In our view, allowing the sponsor to hold a 5 percent participation interest in the asset pool perfectly aligns the interests of investors and sponsors, inasmuch as they will proportionally share in any profits and losses. Moreover, because the servicer would service the "assets" and not the participation interests, we believe that this option does not raise any concern that assets retained by the sponsor would be serviced differently from assets owned by the securitization trust. This option also has the advantage of being easily administered and monitored, and (like

the representative sample option) would eliminate the need to make the cash flow projections required in connection with the eligible horizontal retention interest option or the fair value calculations required for use of the vertical interest option.

As we noted in our Original ABA Comment Letter and in the suggested language for the participation interest option included in our Supplemental ABA Comment Letter, we laid out for the Commission two ways in which this option could be structured: the sponsor could sell a 95 percent participation interest to the issuing entity and retain a 5 percent participation interest in each asset or the sponsor could sell 100 percent of the assets to the issuing entity and receive a 5 percent participation interest in the asset pool from the issuing entity as part of the consideration for the sale. In any event, the creation of participation interests is not a complicated or difficult process (participation interests are frequently used by financial institutions in connection with asset sales as a way to transfer beneficial, but not legal, ownership of the assets). A single agreement can be used to create a separate 5 percent participation interest in multiple assets just as easily as a pooling and servicing agreement can create a 5 percent participation interest in the asset pool.

Although we believe that participants would like the flexibility of using either of the participation interest approaches outlined in our Supplemental ABA Comment Letter and briefly described above, we believe that it would also be acceptable to limit the use of participation interests to the second approach (conveyance of 100 percent of the assets to the issuing entity, which would issue a 5 percent participation interest in the asset pool to the sponsor). Doing so should alleviate concerns that we understand have been expressed regarding treatment of the ownership of the assets in connection with a bankruptcy or insolvency of the sponsor in a situation in which the first type of participation interest was used. In addition, the second approach would, we believe, largely resolve the securities law issue[40] inherent in the sale of a 95 percent participation interest to the issuing entity. Accordingly, on reflection, we believe that it would be reasonable if the Final Risk Retention Rules adopted just the second approach. This approach would allow the sponsor to transfer 100 percent of the assets to the issuing entity and receive from the issuing entity a 5 percent participation interest, which would be retained by the sponsor (or an affiliate) in accordance with the provisions of the Final Risk Retention Rules in respect of hedging and transfers.

4. Asset Backed Commercial Paper Conduits

Although there are a number of concerns expressed in the Original ABA Comment Letter regarding changes needed to the Reproposed Rules as they relate to asset-backed commercial paper (the "ABCP"), we wish to emphasize two issues that we discussed in our original letter.

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[40] Under Regulation AB, if an asset being securitized is itself a security then additional registration requirements apply to that securitized asset. The Commission has indicated its view that loan participations that are securitized should generally be viewed as separate securities. *See, e.g.*, Asset Backed Securities, Securities Act Release No. 8518, 70 Fed. Reg. 1506, 1529, n. 173 (Dec. 5, 2005).

a. Most sponsors of ABCP conduits are not "securitizers" under the Exchange Act or "sponsors" under the Reproposed Rules

Section 15G(b) of the Exchange Act gives the Commission the statutory authority to impose risk retention rules with respect to "securitizers" of asset-backed securities, but most financial institutions that sponsor ABCP conduits are not "securitizers" as defined by Section 15G(a)(3) of the Exchange Act. Section 15G(a)(3) defines "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." Similarly, the base risk retention requirement set forth in § __.3 of the Reproposed Rules applies to "sponsors" of securitization transactions, but most financial institutions that sponsor ABCP conduits are not "sponsors" as defined in § __.2 of the Reproposed Rules.[41] The definition of "sponsor" in § __.2 is similar to the definition of "securitizer" in Section 15(G)(a)(3), but the difference is that § __.2 does not contain the first prong of the Section 15(G)(a)(3) definition.

In either case, most sponsors of ABCP conduits do not fall within the ambit of either Section 15G(b) of the Exchange Act or § __.3 of the Reproposed Rules. The bank sponsor providing liquidity and credit support to most ABCP conduits does not issue ABCP. In addition, bank sponsors of ABCP programs with multiple originator-sellers do not typically sell or transfer assets to the issuer. Therefore, we do not believe that Section 15G(b) by its terms authorizes the imposition of the base risk retention requirement set forth in § __.3 of the Reproposed Rules with respect to most sponsors of ABCP conduits.

b. The definition of "ABCP" should include ABCP with maturities of up to 397 days

With respect to the requirement in the Reproposed Rules that an eligible ABCP conduit issue commercial paper with maturities of no longer than nine months, we repeat our argument from the Original ABA Comment Letter that the definition of "ABCP" should be revised to include asset-backed commercial paper with an initial maturity of up to 397 days. Most ABCP investors are money market funds subject to Rule 2a-7 under the Investment Company Act, which prohibits money market funds from acquiring securities (including ABCP) with maturities of longer than 397 days. If the nine month tenor limit in the Reproposed Rules is not extended, there would be an inconsistency between the requirement under Rule 2a-7 and the Reproposed Rules. More importantly, there will likely be a movement towards issuances of longer-dated ABCP going forward, given that two new liquidity requirements under Basel III will become effective in 2015: the liquidity coverage ratio ("LCR") and the net stable funding ratio ("NSFR"). LCR is a short-term (30-day) liquidity stress test that will require banks that are obligated to fund under a liquidity facility to cash-collateralize such obligation. NSFR is a long-

[41] Section __.2 of the Reproposed Rules defines a "sponsor" as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."

term (1-year) liquidity stress test that will penalize banks that hold liabilities with maturities of shorter than one year. Working together, these two liquidity stress tests will likely drive ABCP conduits to issue commercial paper with maturities of longer than one year.

5. Commercial Mortgage Backed Securities - Operating Advisor

We wish to comment on two issues related to the Operating Advisor ("OA") framework in § __.7 of the Reproposed Rules. Appendix D contains our proposed changes to the text of § __.7(b)(6), which would give effect to our comments below.

a. The control event trigger should take into account appraisal losses to notionally reduce the principal amount of the eligible horizontal residual interest

Based on comments received on the Original Proposal, the Agencies revised the OA's consultation requirement in § _.7(b)(6)(iv) to apply only to special servicers, and only once the eligible horizontal residual interest held by third-party purchasers in the transaction has a principal balance of 25 percent or less of its initial principal balance.[42] Therefore, as reproposed, the OA's consultation rights would not be triggered until realized losses have reduced the third party purchaser's interest by 75 percent. We believe the practical implication of this high threshold will be that the OA would, in most transactions, not have a consultative role in the workout of loans in special servicing, which we believe would greatly reduce its ability to act as an independent check on the power of third-party purchasers to manipulate cash flows through special servicing. Furthermore, given the length of time it takes for losses to be realized (as a result of foreclosure proceedings or negotiated workouts), we believe that there could be long delays before the OA has consultative rights despite high delinquencies in the pool and "appraisal reductions." In general, an appraisal reduction describes the process by which the value of the bonds are reduced on a notional basis in reverse sequential order in an amount equal to the excess of (a) the stated principal balance of the mortgage loan over (b) the excess of (1) the sum of (x) some percentage (typically, 90 percent) of the appraised value of the related mortgaged property as determined by one or more appraisals of the property and (y) all escrows, letters of credit and reserves in respect of the mortgage loan over (2) the sum of (x) all unpaid interest due on the mortgage loan, (y) all principal and interest advances and servicing advances on the mortgage loan not reimbursed, and (z) all currently due and unpaid real estate taxes and assessments, insurance premiums and ground rents, unpaid special servicing fees and all other amounts due and unpaid with respect to such mortgage loan. Such appraisal reductions are typically used in CMBS transactions to reduce the value of the B-piece buyer's securities (which may cause it to lose its control rights earlier than would be the case if reductions were based solely on losses to the B-piece buyer's securities).

To address this issue, we encourage the Commission to revise the regulatory text of § _.7(b)(6)(iv) so that appraisal losses are taken into account when measuring the value of the third

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[42] *See* § __.7(b)(6)(iv).

party purchaser's investment. In other words, the OA's consultative role would be triggered when the principal balance of the eligible horizontal residual interest, after giving effect to appraisal reductions, is 25 percent or less of its initial principal balance. This is also consistent with current market practice in CMBS securitizations.

b. The OA's independence requirements should prohibit financial conflicts with the special servicer

We agree with the point made in the Commentary that an independent OA is a key factor in providing a check on third-party purchasers and special servicers, thereby protecting investors' interests.[43] Consistent with this view, we agree that the OA should not be affiliated with other parties to the securitization transaction.[44] Likewise, we agree that the OA should not, directly or indirectly, have any financial interest in the securitization transaction other than in the fees from its role as OA.[45] To further safeguard the OA from conflicts of interest, however, we recommend that the OA be prohibited from having any direct or indirect financial interest in, or financial relationship with, the special servicer. We believe that preventing such financial ties is in keeping with the spirit of the independence requirement and would help to mitigate investor concern that an OA may elect not to recommend the removal of a special servicer because of a conflict of interest resulting from a direct or indirect financial relationship. For example, if the OA maintains an active business relationship with the special servicer outside of the securitization, investors may call into question the willingness of the OA to recommend the removal of the special servicer. The perception of such a conflict of interest results in the breakdown of confidence in the validity of the OA, and such perception could undermine the protections afforded by the OA.

6. Open Market Collateralized Loan Obligations

a. Overview

We believe that the position taken in the Reproposal on risk retention in the context of open market CLOs should be reconsidered. Although we appreciate the reasons articulated in the Commentary regarding the need for risk alignment in these transactions, open market CLOs present a legal and financial model very different from the structures that Congress intended to regulate. These differences also already strongly align the interests of the asset manager with those of the CLO and its investors.

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[43] *See* 78 Fed. Reg. at 57955.

[44] *See* Reproposed Rules, § __.7(b)(6)(i)(A).

[45] *See* Reproposed Rules, § __.7(b)(6)(i)(B).

Open market CLOs rely on the services of an asset manager that is almost always a registered investment adviser and thus a fiduciary.[46] Under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), these asset managers owe their clients a duty of undivided loyalty and utmost good faith. The asset managers are subject to strict rules relating to conflicts of interest and full and fair disclosure to clients and prospective clients, and must operate in accordance with a strict code of ethics. Registered investment advisers are the only category of securitization sponsor whose obligations run solely to the securitization and who have no pre-existing stake in the financial assets to be securitized. Moreover, their role in the context of open market CLOs is no different from the role of the asset manager in any other private fund structure, including debt funds, private equity funds, hedge funds and venture capital funds. That role is to select and manage investments in accordance with fund restrictions and with a goal toward maximizing the return to the fund and its investors consistent with agreed risk parameters.

While traditional securitizers have an obligation under the federal securities laws to provide *disclosures* about the securitized assets, they have no obligation to consider the interests of the investors with respect to the *selection* of those assets. In other words, they can securitize poor quality assets as long as they provide appropriate disclosures—which will presumably affect the price at which investors are willing to buy the securities, but places on investors the burden of making effective judgments about asset quality in light of those disclosures. By contrast, the asset manager of an open market CLO that is a registered investment adviser generally has both statutory and contractual duties of care in connection with the management of the portfolio, including the selection of assets. The asset manager can be replaced if it does not act in accordance with its obligations to the vehicle or if the portfolio is badly mismanaged. When doing its job properly, the asset manager of an open market CLO provides the sort of objective analysis and due diligence regarding the assets that the Agencies seek to foster.

In addition, the financial interests of asset managers are generally already aligned with those of investors. The fee structures used in CLOs borrow heavily from those used in a broad variety of other private funds — the asset manager receives a senior fee at the top of the waterfall that is intended to allow it to cover its expenses, but all fees that reflect meaningful economic return, such as the subordinated fee and the incentive fee, are received only if the CLO performs well. In some cases, investors that are generally sophisticated entities acquiring in a private placement may also require asset managers to hold a portion of the equity tranche, but such requirements are tailored to the capital structure of the asset manager so as not to jeopardize its ability to enter into the transaction or continue its business. These investments have historically been far smaller than the amount of risk retention that has been proposed. Moreover, this investor involvement reflects three important features of this market: first, investors at all levels of the risk spectrum (*i.e.*, from the senior-most class of notes to the equity tranche) are actively

[46] Title IV of the Dodd-Frank Act required many previously exempt investment advisers to register by eliminating the exemption for investment advisers that did not have more than 15 clients (with each private fund being treated as a separate client). As a result, most managers of CLOs registered when the Commission's related rules took effect.

engaged in structuring the fund, selecting the asset manager, negotiating the investment parameters and setting manager compensation; second, investors are sophisticated market participants that exercise meaningful power with respect to fund structuring to protect their interests; and third, there are longstanding private solutions to risk alignment in this market that are more nuanced and balanced than what can be achieved through a regulatory mandate.[47]

The asset manager does not own the assets prior to their inclusion in the CLO, is not involved in originating the assets, and is not in the chain of title. As a result, the term "risk retention" would be inaccurate with respect to these managers—any requirement placed on the asset managers of CLOs would require them to acquire risk that they do not otherwise have. Because they are generally capitalized in a manner consistent with providing advisory services rather than acquiring assets, we understand that many will not be able to satisfy a "risk retention" requirement and may need to exit the business or consolidate with a larger entity that can provide needed capital. We do not believe that a regulatory determination that results in a smaller, more concentrated market with higher barriers to entry and fewer options for investors is consistent with Congressional or Commission goals.

b. What is an open market CLO?

An open market CLO is a fund structure in which an actively managed, diversified pool of loans is purchased in the secondary market by an asset manager and financed by issuing debt securities at varying risk levels. The risk tranching is achieved by creating a payment priority structure under which more senior notes receive payment ahead of junior notes, and senior notes are "overcollateralized" by being supported by the entire pool of assets.[48] Typical CLO structures are contractually required to invest all or substantially all of their assets in senior secured corporate loans; have very specific investment criteria that prevent significant concentrations in any single industry or obligor; include limits on loan maturity to support timely payments of the notes through cash flows on the loans rather than sales; have investment criteria that consider loan quality, anticipated recovery rates for categories of loans and interest payment

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[47] We recognize that there are other types of funds that are similar to open market CLOs, such as CDOs that invested in mortgage-backed securities and did not perform well during the financial crisis. CDOs of mortgage-backed securities or other structured products, however, often involved the securitization of an existing portfolio of assets rather than an open market selection process. Balance-sheet CLOs, where the sponsor securitizes a fixed pool of loan assets held on its balance sheet as a way to finance the loan portfolio, reduce its balance sheet, manage its risk exposure or for other reasons, took a similar approach. The incentives are very different between an open market CLO in which the asset manager selects assets for the fund in the open market and a structured fund established to finance or transfer risks of a pre-existing asset pool.

In addition, the manager in a CLO can perform credit analysis on each of the underlying assets; in an ABS CDO, given the myriad of credits included in the transaction, the manager may not be able to look through to the underlying exposures. In other words, CLOs support a more comprehensive credit analysis than what is generally possible with ABS CDOs.

[48] For example, a senior tranche might represent 70 percent of the capital structure of the CLO but have first priority with respect to 100 percent of its assets.

obligations of the vehicle; and include coverage tests that protect the most senior note classes by requiring collections to be diverted to repay their principal if the overcollateralization that supports them falls below specified levels. Asset managers are restricted from trading if collateral quality and coverage tests are not satisfied, and generally cannot trade in a way that causes any test that is not satisfied (for instance, because of the deterioration of loan quality of existing loans) to become further out of compliance.

An asset manager enters into an asset management agreement with the CLO under which it agrees to manage the loan portfolio in accordance with an agreed standard of care, subject to the investment restrictions, and in compliance with all applicable laws, including the Investment Advisers Act. The CLO vehicle is a separate legal entity with its own board of directors. The asset manager must disclose to the CLO vehicle any conflicts of interest and must obtain consent when required under the statute. The asset management agreement typically provides for the asset manager to be terminated if it does not follow investment guidelines or if the portfolio suffers excessive loss. Thus, investors have remedies if the portfolio is being significantly mismanaged.

Generally the asset manager receives a senior management fee that is paid out at the top of the waterfall, a subordinate fee that is paid after interest on all tranches of notes other than any equity tranche, and an incentive fee that is payable only if the returns on equity reach an agreed hurdle. The fee is thus structured so that substantial portions of it are earned only if the CLO performs well. Although the incentive fee is tied to return for equity investors, a typical CLO will not have cash flows that support the incentive fee unless all classes of interests in the CLO have performed at or above expectations. As the name indicates, the incentive fee is designed to provide incentives for the asset manager to manage the portfolio to the best of its ability.

c. Asset managers in open market CLOs are the only market participants that have a fiduciary duty to their clients

The managers of open market CLOs typically are registered investment advisers, and thus have statutory fiduciary and other duties to their clients and are subject to significant regulatory oversight.[49] Among other things, registered investment advisers:

- have a fundamental obligation to act in the best interests of their clients and to provide investment advice in their clients' best interests;
- owe their clients a duty of undivided loyalty and utmost good faith;
- must eliminate or disclose (and obtain client consent[50] with respect to) all conflicts of interests with their clients;

[49] Although older legal decisions in the context of managed funds have limited the reach of those duties to the funds themselves, rather than the investors in those funds, more recent decisions suggest that fund investors are increasingly being recognized as benefitting from those duties. *See, e.g.*, U.S. v. Lay, 612 F.3d 440 (6th Cir. 2010).

- have a duty to provide full and fair disclosure of all material facts to their clients and prospective clients;
- are restricted with respect to principal trades and cross trades; and
- are required to maintain and operate pursuant to a code of ethics that emphasizes the above obligations.

The fiduciary and other obligations of investment advisers under the Investment Advisers Act to act in the best interests of their clients create a powerful legal obligation that is not present in other securitizations. In our view, the regulatory status of these asset managers strongly supports treating them differently from other securitization sponsors.[51] Moreover, as discussed above, we believe that other core aspects of these vehicles—including the lack of a pre-existing financial stake in the assets—makes risk retention inappropriate in this context.

d. The asset manager in an open market CLOs is not a "securitizer"

In response to the Original Proposal, a number of commenters argued that the asset manager in an open market CLO is not a "securitizer" as defined under Section 941 of the Dodd-Frank Act. That section defines the 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.[52]

The asset manager of an open market CLO falls into neither of these categories. The "issuer" of the securities is the vehicle itself, typically a corporation or other legal entity formed outside the U.S. specifically for the purpose of acquiring and securitizing assets. There is no person that organizes and initiates the CLO by selling or transferring assets, either directly or indirectly, to the issuer.

We realize that the Agencies have interpreted the language of the statute to encompass the asset manager of an open market CLO, but we believe that interpretation is contrary to both the commonly understood meanings of the relevant terms and the overall purpose of the risk retention requirement. The Agencies state:

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[50] Such consent must be provided by the board of directors of the CLO.

[51] We recognize that regulated entities do not always act in accordance with their legal obligations. We believe, however, that regulatory policy cannot be devised around the possible breach of existing obligations.

[52] Dodd-Frank Act, Section 941(b); Securities Exchange Act Section 15G(a)(3).

> The CLO manager typically organizes and initiates the transaction as it has control over the formation of the CLO collateral pool, the essential aspect of the securitization transaction. It also indirectly transfers the underlying assets to the CLO issuing entity typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets.[53]

We do not agree that the actions of the asset manager with regard to the CLO constitute an indirect transfer of the assets to the CLO by the asset manager. First, to "transfer" an asset requires that the transferor own the asset. An indirect transfer may involve the use of an intermediate owner between the original transferor and the issuer, but the transferor is still in the chain of title. This is not the case for an asset manager in an open market CLO. Second, the asset manager cannot "transfer" the assets by selecting the assets for the CLO and assisting[54] the CLO in acquiring those assets. The asset manager and the CLO are both on the wrong side of the transfer to be said to have transferred the assets—the CLO is the transferee, or the recipient, of the transferred assets, and accepts the transferred assets, but it does not transfer them. Nor does the asset manager, who acts for the CLO in its capacity as transferee. Finally, Congress could have included as a securitizer not only the person that transfers assets to the issuer but the person that *causes* the assets to be transferred to the issuer. This construction appears elsewhere in the Dodd-Frank Act and in numerous other statutory and regulatory provisions.[55] The difference between performing an action and causing it to be done is well understood, and Section 941 encompasses only transferring the assets, not causing them to be transferred.

The issue goes beyond the matter of statutory construction of the term "securitizer," however. Section 941 is about credit risk *retention.* In other words, the securitizer is expected to retain—*i.e.*, continue in possession of—a portion of the credit risk of the securitized assets. But the asset manager of a CLO cannot retain risks it does not possess at the outset. Nor is the structure of an open market CLO comparable to securitizations of assets that are, in fact, transferred to the securitization by their owners. Unlike typical securitizations in which the assets remain in the vehicle until they are paid in accordance with their terms or default, thus ensuring that the transferor of the assets retains the risk of the specific assets transferred, in an open market CLO the underlying assets are actively traded. As a result, holding an interest in the

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[53] 78 Fed. Reg. at 57962.

[54] We note that the asset manager does not "direct" the CLO to acquire the assets—the asset manager acts as the agent for the CLO pursuant to an asset management agreement, but it acts under the direction of the CLO—a separate legal entity with its own board of directors or other governing body.

[55] For example, in Section 765(c) of the Dodd-Frank Act, addressing conflicts of interest in connection with security-based swaps, the statute provides:

> In adopting rules pursuant to this section, the Securities and Exchange Commission shall consider any conflicts of interest arising from the amount of equity owned by a single investor, *the ability to vote, cause the vote of, or withhold votes entitled to be cast* on any matters by the holders of the ownership interest, and the governance arrangements of any derivatives clearing organization that clears swaps, or swap execution facility or board of trade designated as a contract market that posts swaps or makes swaps available for trading. (*emphasis added*)

pool does not function to cause the retention of risk in the assets, but rather to create exposure to the management strategy for the pool. This is an important distinction. For example, if the asset manager for a CLO was replaced for any reason, any interests it held in the CLO would increasingly not reflect risk exposure to the assets it had selected, but instead to the assets chosen by the replacement manager (who would not have organized and initiated the transaction, and thus would not be subject to a risk retention requirement).

We recognize that collateralized debt obligations are listed within the definition of "asset-backed security" in Section 941(a) of the Dodd-Frank Act. However, we believe that this reference can be read consistently with an appropriate reading of the term "securitizer" by recognizing that there are multiple types of transactions that fall under the "collateralized debt obligation" designation.[56] These include balance sheet CDOs and static pool CDOs that relate to monetizing or reallocating the risk of a particular pre-existing pool of assets. Such transactions are appropriately captured within the Reproposed Rules, and do have sponsors that transfer assets to the securitization. Open market CLOs do not present the same issues, because the asset manager has no pre-existing stake in the assets that form the pool. We consider them to be a separate category of transaction that unfortunately shares a name with more classic securitization structures.[57]

e. A narrow exception from risk retention for open-market CLOs should be created

We recognize that any exclusion for open market CLOs needs to be sufficiently narrow so that other classes of assets for which risk retention is appropriate—including balance sheet CLOs—are not able to avail themselves of it, and so that transactions such as balance sheet CLOs remain subject to the risk retention rules. We believe an appropriately narrow exclusion can be crafted that can achieve this, subject to the following conditions:

1. The asset manager must be a registered investment adviser;

2. All US investors must be qualified purchasers or knowledgeable employees, consistent with reliance on the Section 3(c)(7) exemption from investment company status under the Investment Company Act;

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[56] Moreover, the statutory language does not specifically refer to "collateralized loan obligations," but does specifically refer to other transaction types that might fall under the broad "collateralized debt obligation" nomenclature—"collateralized bond obligations," "collateralized debt obligations of asset-backed securities" and "collateralized debt obligations of collateralized debt obligations."

[57] An open market CLO is a managed fund that issues debt. It does not have the traditional defining aspects of a securitization, in that it is not designed to legally isolate assets from the insolvency risk of the originator of those assets. In that regard, neither true sale opinions nor nonconsolidation opinions are typically rendered in open market CLOs. Balance sheet CLOs, however, are traditional securitizations that would have such structuring and opinions.

3. The pool assets are permitted and expected to be traded by the asset manager on behalf of the issuer in accordance with contractually agreed restrictions;

4. The asset management agreement establishes a standard of care that requires the asset manager to employ a degree of skill and care no less than it uses for its own investments and consistent with industry standards for asset managers that are acting on behalf of comparable clients; and

5. The investment adviser effects agency cross trades on behalf of its advisory client only in accordance with §275.206(3)-2 of the Commission's rules under the Investment Advisers Act.

The first condition ensures that the asset manager is subject to the Investment Advisers Act and the supervision of the Commission. The second is intended to confirm that the investors in the vehicle have the sophistication to be able to negotiate appropriate terms. The third condition establishes the intention to have a managed vehicle rather than a static pool. The fourth is intended to confirm that the asset manager has contractually committed to a robust standard of care that will require it to conduct appropriate due diligence on the assets. The fifth, while applicable even if not specified, clarifies that agency cross-trades will continue to be permitted to the extent the asset manager complies with existing regulations.

IV. General Exemptions

A. Student Loans

As of July 1, 2010, no new federal government-guaranteed loans have been originated under the Federal Family Education Loan Program under Title IV of the Higher Education Act ("FFELP"). All such federal government guaranteed loans are now originated directly by the U.S. government through its Federal Direct Loan Program. However, all rules and regulations pertaining to previously originated FFELP loans remain in full force and effect. Although a substantial percentage of FFELP loans have been previously securitized, a substantial amount of these loans still exist on the balance sheets of financial institutions and numerous state and nonprofit agencies (including those still financed through the U.S. Department of Education's sponsored Straight-A conduit program). In addition, outstanding FFELP securitizations have recently been subjected to restructurings and new issuances of FFELP backed student loan ABS (often as a way to refinance those loans previously pledged under the Straight-A conduit program, which is due to expire in January 2014).

An exemption for FFELP loan securitizations from the risk retention requirements would be appropriate under Section 941(c)(1)(G)(ii) of the Dodd-Frank Act, which requires that the regulations provide for "a total or partial exemption for the securitization of an asset issued or guaranteed by the United States or any agency of the United States" as the Agencies determine appropriate in the public interest and for the protection of investors. As noted above, FFELP permitted eligible lenders to originate loans that were reinsured by the federal government. Under FFELP, federally insured loans provided a guaranty of 97 to 100 percent (depending on the date of origination) 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. As noted in the Commentary, the policy driving the adoption of risk retention rules is based principally on the notion that originators will develop safer and sounder credit underwriting standards going forward for loans for which they will need to retain "skin in the game." That is clearly not the case with FFELP loans, given that the federal government has terminated the program, and all such underwriting and servicing guidelines are now federally mandated.

Other types of federally insured or guaranteed loans are designated in the Reproposed Rules as entirely exempt from the risk retention requirements, even though they are just partially guaranteed. Section __.19(b)(1) exempts securitization transactions that are "collateralized solely by residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed (in whole or in part) as to the payment of principal and interest by the United States or an agency of the United States." As the Agencies note in the Commentary, the Department of Veterans Administration guarantees between 25 percent and 50 percent of lender losses in the event of residential borrower defaults, and the Department of Agriculture also guarantees a sliding amount against loss of up to 90 percent of the original loan amount for single family Rural Development loans.[58] Although these types of loans are only partially guaranteed, the Reproposed Rules would exempt securitizations of such loans from risk retention requirements. In our view, it would be appropriate to provide the same exemptive treatment to securitizations backed exclusively by FFELP loans under the Final Risk Retention Rules.

We recognize that the Agencies have proposed a new rule that reduces the burden of risk retention for FFELP securitizations. However, we believe that the new rule as reproposed does not reduce the level of required risk retention in a manner that is consistent with other asset classes' risk retention requirements. Under § __.15(b), a pool that consists in part of "qualifying" commercial loans, commercial real estate loans or auto loans and in part of non-qualifying loans of the same asset class would be allowed to utilize a reduced rate of risk retention that reflects the blended nature of the pool. In contrast, § __.19(e)(2) permits no reduction in the risk retention requirement for mixed pools of FFELP loans. Although the risk retention for a securitized pool in which the FFELP loans are all 100 percent guaranteed will be zero, a mixed pool consisting of, say, 99 FFELP loans that are 100 percent guaranteed and 1 FFELP loan that is 97 percent guaranteed would require risk retention of 3 percent of the entire pool. As discussed, this result is not consistent with the treatment of risk retention applicable to other asset classes. In addition, if one assumes that a federal guarantee makes an asset-backed security "riskless," then imposing a 3 percent (for 97 percent-guaranteed FFELP loans) risk retention requirement for mixed guarantee percentage pools can result in securitizations where the required risk retention is far in excess of the actual percentage "at risk." In the foregoing "99 and 1" pool example, just 3 basis points of the entire principal balance would be at risk, but the

[58] 78 Fed. Reg. at 57970.

risk retention requirement would be 300 basis points.[59] This result does not seem to us to be in keeping with the spirit of the risk retention requirement in the Dodd-Frank Act.

We believe an exemption would be appropriate under Section 941(c)(1)(B)(ii) due to the negligible credit risk of such a pool of loans. That section provides for a downward adjustment of the 5 percent risk retention requirement if prescribed underwriting criteria are met "that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan." We believe that this approach is more in keeping with the risk retention analysis presented under the Reproposed Rules, and therefore urge the Commission to give it careful consideration.

B. Safe Harbor for Foreign Securitization Transactions

We appreciate the Commission's thoughtful consideration of comments (including our comments set forth in the Original ABA Comment Letter regarding the proposed safe harbor for certain foreign securitization transactions, and the modifications made to the Original Proposal in response to those comments. However, as explained below, we believe more should be done to make the safe harbor workable for U.S.-based issuers and investors and for the efficient and sound operation of the global ABS markets.

The principal concerns expressed in the Original ABA Comment Letter related to the differential treatment of U.S.-based issuers and foreign issuers based on differences in the risk retention legal requirements imposed by different jurisdictions. With respect to U.S.-based issuers placing securities entirely outside the U.S., we expressed our concern that such U.S.-based issuers would be disadvantaged in global markets, and suggested that the simplest and fairest approach to dealing with this differential treatment would be 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.

In the Reproposal, the Agencies have generally characterized our suggestion and similar suggestions by other commenters as proposals to establish a "mutual recognition framework." The Agencies have declined to pursue this approach in the Reproposal, citing concerns with finding comparability between different securitization legal frameworks and questioning whether it would be practicable to construct a mutual recognition framework that would comply with Section 15G of the Exchange Act. While we continue to believe it would be well worth the effort to pursue a workable mutual recognition framework, we acknowledge that it may be difficult for the Agencies to formulate a workable mutual recognition framework within the time frame contemplated for adoption of the Final Risk Retention Rules. Nonetheless, we expect that

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[59] If all 100 FFELP loans in this pool were the same size, then 99.0 percent of the pool would be fully guaranteed, and the remaining 1.0 percent of the pool would be 97.0 percent guaranteed. The result is that just 3.0 percent of that remaining 1.0 percent, or .03 percent (3 basis points) would be at risk. But § __.19(e)(2) would require risk retention equal to 3.0 percent of the entire principal balance of the pool.

the disparate regulatory treatment of U.S.-based and foreign issuers in different jurisdictions with respect to risk retention ultimately may have long-term negative consequences for U.S.-based issuers and investors and the establishment of an efficient and sound global securitization market. Accordingly, we urge the Commission, following the adoption of the Final Risk Retention Rules if not before, to join with the other Agencies to engage in a dialogue with their counterparts in other jurisdictions, including the European Union, to identify ways to rationalize and conform risk retention regulatory regimes or to establish a mutual recognition framework.

We recommend that the Commission clarify in the Final Risk Retention Rules that ABS interests initially sold by a foreign issuer in an "offshore transaction" in compliance with the issuer safe harbor under Rule 903 of Regulation S under the Securities Act would not be considered as having been sold to a "U.S. person" for purposes of the eligibility calculations under the foreign securitization transaction safe harbor, subject to whatever conditions the Commission deems necessary or appropriate to prevent U.S. flowback. Absent such clarification, foreign ABS issuers intending to rely on the issuer safe harbor under Rule 903 may face uncertainty regarding the application of the Final Risk Retention Rules to their transactions and practical difficulties in ascertaining compliance with the foreign securitization transaction safe harbor requirements.

C. Sunset on Hedging and Transfer Provisions

We are pleased to see that the Agencies added several "sunset" provisions to the Reproposed Rules, and we agree with the point made in the Commentary that "the primary purpose of risk retention – sound underwriting – is less likely to be effectively promoted by risk retention requirements after a certain period of time has passed and a peak number of delinquencies for an asset class has occurred."[60]

Generally speaking, there are two types of sunset provisions in the Reproposed Rules: a "minimum holding period" and an "outside limit." There are two different minimum holding periods in § __.12(f):

- for non-residential mortgage ABS, the latest of (i) the date by which the underlying assets in the securitization transaction have amortized down to 33 percent of the closing date principal balance, (ii) the date by which the total unpaid principal obligations under the ABS interests issued in the securitization transaction have paid down to 33 percent; and (iii) two years after the closing date; and

- for RMBS, the later of (i) five years after the closing date and (ii) the date on which the underlying mortgage loans have amortized down to 25 percent of the closing date principal balance.

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[60] 78 Fed. Reg. at 57978.

We have one technical comment on these minimum holding periods, which is to note that the concept of "principal balance" for non-residential mortgage ABS is problematic for leases, which do not have a principal balance. We suggest that this phrase be changed to "principal balance or securitization value," and we note that we have offered a definition of "securitization value" in Part II.B.1b.(i)(B), entitled "—Permitting an Alternative to Fair Value."

In addition to the minimum holding periods, two asset classes have the benefit of outside limits on the transfer and hedging requirements:

- for residential mortgages, § __.12(f)(2)(ii) specifies an outside limit of seven years; and

- for commercial mortgages, § __.7(b)(8)(ii)(A) specifies an outside limit of five years on the requirement that the initial third-party purchaser retain the risk retention (although the transferee must continue to observe the hedging limitation).

We do not understand why there is no outside limit for asset classes other than residential and commercial mortgages.

Perhaps the Agencies believe that no outside limit is necessary because securitizations of other asset classes will amortize relatively rapidly (*e.g.*, within five years), thus obviating the need for outside limits. For typical securitization structures in many asset classes, that belief would be accurate. But it is not an inviolate rule. We can identify a number of transaction structures and asset classes where the amortization of the ABS interests or the underlying assets will likely not have reached the 33 percent level within, say, five years, such as:

- student loans
- aircraft leases
- shipping container leases
- railcar leases
- structured settlements of personal injury awards, lottery winnings and other assets

We think that non-mortgage asset classes are just as deserving of an outside limit on risk retention as are residential and commercial mortgages. We also suggest that the outer limit be no longer – and perhaps shorter – than the five-year outside limit for commercial mortgages, as we do not believe there is any compelling evidence of underwriting deficiencies in non-mortgage classes preceding (or following) the financial crisis.

Finally, we think that the outside limit should apply in a limited sense to revolving issuing entities, which generally will not get any benefit from the minimum holding period concept (because their assets will not amortize, other than in early amortization). We understand that risk retention that is held on an entity-wide basis for a revolving issuing entity cannot be transferred, as that would effectively reduce the risk retention for all outstanding series. However, to the extent that the risk retention consists of a horizontal interest in a series of that revolving issuing entity, we think that the holder should be entitled to transfer or hedge that series interest after the occurrence of an outside date.

D. Exception from Transfer Restrictions for Transfers of Lines of Business or Significant Portions Thereof

We suggest the addition of an exception in the Final Risk Retention Rules that will allow the transfer of interests representing retained risk in the limited circumstance in which the securitizer decides to exit the business to which the securitization relates or, in the case of revolving assets, to transfer the account relationships to a purchaser that will then originate all new receivables on the accounts. Although in some circumstances an entire legal entity may be sold, in which case we believe that the securitizer would still be considered to be holding the retained risk, in other cases this will not be feasible. For example, a bank might decide to sell the affinity card portion of its credit card business while retaining the remainder of its credit card business as well as commercial lending and other banking operations. If the bank is not permitted to sell the seller's interest in its credit card securitizations to the purchaser of the affinity card business, it may be impossible to sell that business. This is particularly a concern for revolving structures, where the receivables supporting the seller's interest change over time as new receivables are originated and other receivables are paid off in designated accounts. We are not aware of any way to subdivide the seller's interest to reflect interests only originating before or after a specified point in time, and note that any such efforts may also negatively affect the tax structure of the issuing vehicle.

We consider it highly unlikely that any securitizer would decide to dispose of an entire line of business, or a significant portion thereof, in order to transfer its retained interests in its securitizations. Moreover, we would expect that any purchaser would carefully value those retained interests in making a purchase decision. For revolving assets, we believe that transfers of retained interests should be permitted in connection with a disposition of all of the account relationships related to the applicable securitized receivables, so long as the acquirer holds the retained interests on the same terms as they were held by the original securitizer. For non-revolving assets, we believe that transfers of retained interests should be permitted in connection with the transfer of all or substantially all of the assets of a discrete line of business, again so long as the acquirer holds the retained interests on the same terms as they were held by the original securitizer. We believe such exceptions may be important in allowing financial institutions to execute critical strategic decisions and will not undermine Congressional goals.

V. Other Topics

A. Reduced Risk Retention Requirements and Underwriting Standards for ABS Backed by Qualifying Commercial, Commercial Real Estate, or Automobile Loans

The Reproposed Rules include a provision allowing the use, in connection with issuances of ABS backed by commercial loans, commercial real estate loans and automobile loans, of "blended pools" that include both qualifying assets that meet the criteria specified in the Reproposed Rules and non-qualifying assets. Under the "blended pool" exemption, subject to certain additional conditions, the Agencies would reduce the 5 percent risk retention requirement

by the same amount as the ratio of the combined unpaid principal balance of qualifying loans to the total unpaid principal balance of all of the securitized loans backing the ABS.[61] In the Reproposal, the Agencies note that commenters on the qualified residential mortgage standards, like those of the asset classes for which blended pools would be allowed, urged the Agencies to provide this relief to pools of qualifying and non-qualifying residential mortgage loans. The Agencies requested comment on whether the "blended pool" exemption should be available for residential mortgage loans and, in particular, whether certain portions of Section 15G of the Exchange Act would preclude the Agencies from doing so.[62]

We do not believe that Section 15G, taken as a whole, precludes the Agencies from making this exemption available for asset-backed securities secured by pools of residential mortgage loans. In our view, a literal reading of paragraph (c)(1)(B)(i)(II) of Section 15G would be inappropriate, as there clearly are inconsistencies among various paragraphs of that section. For example, one paragraph (*see* paragraph (c)(2)(A) and (B)) would allow the Agencies to adopt rules permitting a lower percentage of risk retention for "lower risk" assets, while another paragraph (*see* paragraph (c)(1)(B)(i)(I)) would require a minimum of 5 percent risk retention for *any* assets other than qualifying residential mortgages.

In addition, the general exemptive powers of the Agencies set forth in paragraph (e) of Section 15G provide broad authority to adopt regulations that include exemptions from the statutory requirements, so long as such an exemption improves access of consumers to credit and is in the public interest. We do not believe a proper reading of the exemptive authority is that the Agencies may adopt rules that include exemptions from the general 5 percent risk retention requirement but not for other paragraphs of Section 15G.

Moreover, we do not see the purpose to be served by requiring a sponsor to enter into multiple transactions, one collateralized solely by qualifying residential mortgages and the other collateralized solely by non-qualifying residential mortgages, where an investor in both transactions would have the same overall level of protection that the investor would have had had the sponsor been allowed to effect a single transaction with a blended pool. The sponsor could, in fact, take the senior class of securities issued in each of these transactions and use them as collateral in a re-securitization. Because each of the underlying transactions would have individually satisfied the risk retention requirements, no additional risk retention would be required in the re-securitization transaction. The investor who buys the securities issued in the re-securitization would, in effect, hold an economic interest in a blended pool of qualifying- and non-qualifying residential mortgages. If each underlying transaction included both a senior class and a subordinated class, the sponsor could likewise re-securitize the subordinated classes. In effect, the rules would require the sponsor to enter into three or four securitizations in order to achieve the same result that the sponsor of a securitization backed by a blended pool of qualifying and non-qualifying commercial real estate loans could achieve in a single transaction.

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[61] Reproposed Rules, § __.15, 78 Fed. Reg. at 58038-9.

[62] Request for Comment 85, 78 Fed. Reg. at 57987.

In our view, the additional costs, inefficiencies and complexities of multiple transactions that would result if the Commission proceeds to adoption would do little (if anything) to advance the interests of investors or, to the extent that higher costs are passed along to them or otherwise affect the availability of credit, consumers.

In proposing the blended pool exemption for other asset classes, the Agencies posit that such blended pools:

> should promote liquidity in the relevant securitization markets without harming the goals of risk retention requirement *[sic]*. The agencies understand that a lender may not be able to originate, or a sponsor aggregate, an entire pool of qualifying assets within a reasonable amount of time to promote efficient securitization. The agencies believe that the proposal to apply a 0 percent risk retention requirement to qualifying assets would likely enhance the liquidity of loans underwritten to the qualifying asset underwriting standards, thereby encouraging originators to underwrite more qualifying assets of high credit quality.[63]

Clearly, the same goals would be served, in our view, by allowing blended pools of qualifying residential mortgages and non-qualifying residential mortgages. Furthermore, we agree with the Agencies that the enhanced loan-level disclosures proposed by the Commission should address investors' concerns about not having sufficient information to assess the quality of the qualifying and non-qualifying assets securing the asset-backed securities.[64]

Accordingly, we urge the Commission to make the blended pool exemption available for pools of qualifying and non-qualifying residential mortgage loans.

B. Securitizations of Servicer Advance Receivables In Revolving Master Trusts

Servicers of residential mortgage loans that are collateral for residential mortgage securities are required under the terms of the related servicing agreements to make advances ("servicer advances") of delinquent principal and interest payments, delinquent property taxes and assessments and delinquent property insurance premiums, in each case to the extent that the related borrower is obligated to pay, but has failed to pay, the same, and of other costs necessary to preserve or realize upon the value of the underlying mortgaged properties. Servicer advances provide continuity of payment to the investors in RMBS and increase the amount realized in respect of defaulted loans. Servicer advance receivables ("SARs") represent the contractual right of servicers of residential mortgages to be reimbursed for servicer advances.

The servicing agreement typically entitles the servicer to be reimbursed for its servicer advances, prior to holders of the related RMBS, out of any collections or proceeds received in respect of the mortgage loan or property in respect of which the servicer advance was

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[63] 78 Fed. Reg. at 57986.

[64] *Id.* (*see* footnote 130 and the accompanying text).

made. Under most servicing agreements, servicer advances may also be reimbursed from any collection on the entire mortgage loan pool, to the extent not recoverable from the proceeds of the related mortgage loan or property. The servicer is not, however, entitled to receive interest on any servicer advance such servicer has made.

As mortgage delinquencies and defaults have increased in recent years, servicers have been required to fund correspondingly increased amounts of servicer advances. Funding these increased amounts has presented significant liquidity challenges to servicers. To meet their liquidity needs, servicers have sought financing facilities to fund these obligations. To address lender and investor concern regarding the insolvency risk of the servicer, the financing facility has typically been structured as a securitization.

SARs are generated on a continuous basis, do not have scheduled repayments and in some cases are repaid in short order. As collateral for a securitization transaction, SARs are thus best suited to revolving structures. A servicer will typically structure, and act as the sponsor of, a financing facility (a "servicer advance facility" or an "SAF") that will include SARs from multiple servicing agreements.

Over time, the revolving master trust has evolved as the primary structure for SAFs. Servicer advance facilities are structured with trust-level credit enhancement that is retained by the servicer/sponsor or one of its affiliates. This enhancement is in the form of equity in the master trust, which equity is subordinated to all investor interests issued by the master trust (the "Trust Equity Interest"). Some SAFs include cash reserve accounts that are available to pay current interest shortfalls on the investor interests of the related series and cover ultimate principal losses that would otherwise be borne by the related series. SAFs may issue multiple series comprised of one or more classes of bonds, including senior bonds and subordinate bonds. SAFs do not issue senior interest-only bonds or premium bonds.

Revolving master trusts are currently used to finance a variety of assets, including credit and charge card receivables, motor vehicle dealer floorplan loans, SARs, trade receivables and insurance premium finance receivables. Although there are common elements among all revolving master trusts, each asset class has unique structural features. But the points we make in this section with respect to SARs apply as well in virtually all respects to securitizations of trade receivables and in certain respects to securitizations of insurance premium finance loans.

1. Servicer Advance Facility Background and Structure

A typical SAF structure involves the transfer of SARs arising under a mortgage servicer's mortgage loan servicing portfolio to a special purpose entity ("SPE depositor"), which is organized to be "bankruptcy-remote" from the related servicer. The SPE depositor further transfers the SARs to a statutory trust or other issuer entity, which then issues one or more series of revolving notes or term bonds backed by the SARs. As servicer advances are made by the servicer, the related SARs continue to be transferred by the servicer to the SPE depositor and by the SPE depositor to the issuing entity. To the extent existing servicer advances are reimbursed, and provided that the SAF is in its revolving period, the servicer advance reimbursements (net of

the issuing entity's expenses, including interest payments on the investor interests issued under the related SAF) are used to purchase new SARs.

An SAF issuing entity may issue one or more series of investor interests backed by the pool of SARs owned by the issuing entity. Each series (and each class within each series) is backed by the entire pool of SARs owned by the issuing entity and requires different levels of credit enhancement. A series may be comprised of a single class of investor interests or may include senior and subordinate investor interests. SAFs, however, have not issued any interest-only securities or any premium securities.

Credit enhancement is created in an SAF by over-collateralization, pursuant to which the principal amount of all of the investor interests issued under each series will be less than the principal amount of the SARs owned by the issuing entity, sometimes supplemented by one or more series-dedicated reserve funds. The over-collateralization in an SAF is represented only by the Trust Equity Interest. The Trust Equity Interest is typically held by the SPE depositor, which is typically a wholly-owned subsidiary of the servicer.

Because servicer advances are reimbursed at their face amount, without interest, SAFs do not have separate allocations of interest collections and principal collections. Instead, all collections received in respect of the SARs during a collection period are aggregated and applied to pay the then-due obligations of the issuing entity pursuant to a priority of payments (referred to as the "payment waterfall") on each monthly payment date. A simple version of a typical payment waterfall would apply collections according to the following priorities:

- third-party expenses of the issuing entity (for example, indenture trustee fees and expenses and statutory trust trustee fees and expenses),
- interest on the investor interests issued under each series,
- required deposits to reserve accounts,
- required principal payments on any series that is amortizing,
- principal repayments on variable funding notes necessary to maintain the requisite level of overcollateralization and purchase price payments for newly arising SARs, and
- if any collections remain following the payment in full of those amounts, those remaining collections would be distributed to the owner of the Trust Equity Interest.

Unlike most credit card and floorplan master trusts, collections and losses on the SARs are not first allocated to each series and then run through a series-specific payment waterfall. Nor is there any specific allocation of collections or losses to the Trust Equity Interest; rather, the absolute seniority of the investor interests in the waterfall, coupled with the requirement to maintain the required level of overcollateralization, is what ensures that the Trust Equity Interest takes the first-loss risk in the transaction. If the overcollateralization declines below the required minimum level and all series enter early amortization, then all payments on ABS interests will be

made to investor interests until those are repaid, and only thereafter will the Trust Equity Interest be entitled to any distributions. The effect of this system is that the Trust Equity Interest is fully subordinated to investor interests.

2. Risk Retention Options And SAFs Under The Reproposal

The general risk retention option offered to revolving master trusts is the "seller's interest" as provided in § __.5(c). SAFs, however, do not have a "seller's interest." The Trust Equity Interest, as noted above, is fully subordinated to the payment of all expenses of the issuing entity, including payments of principal and interest on the investor interests issued by the issuing entity. Clause (2) of the definition of "seller's interest" in the Reproposal requires the "seller's interest" to be "*pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all distributions and losses with respect to the securitized assets prior to an early amortization event." Because the Trust Equity Interest is subordinated, it does not satisfy the "*pari passu*" requirement of clause (2) of the definition of "seller's interest" and, therefore, is not a seller's interest. There are no other interests created under SAFs that satisfy the definition of "seller's interest."

SAFs are not structured as multi-level trusts as contemplated by the provisions of § __.5(d). As a result, the risk retention options provided for in § __.5(d) are not applicable to SAFs.

The provisions of § __.5(e) permit some portion or all of the risk retention requirement relating to a revolving master trust to be satisfied to the extent of funds held in an "excess funding account." However, clause (1) of § __.5(e) describes an excess funding account as being "funded in the event of a failure to meet the minimum seller's interest requirements." Because SAFs do not, as noted above, have "seller's interests," they would not be able to utilize the risk retention option provided by § __.5(e).

To the extent that § __.5(f) requires eligible horizontal residual interests or specialized horizontal interests to be held at each individual series level of the revolving master trust, as currently structured SAFs would not, as discussed below, satisfy the requirements of § __.5(f). Aside from series-specific cash reserve accounts used by some series, SAFs are structured with credit enhancement at the trust level, which benefits all series.

3. Comments to Risk Retention Rules Concerning SAFs Structured as Revolving Master Trusts

The Commentary indicates that the Agencies recognize that some revolving master trusts have "subordinated seller's interests" that "perform a loss-absorbing function that is analogous to a horizontal interest."[65] The Commentary does not provide a great deal of detail regarding the

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[65] 78 Fed. Reg. at 57943.

nature of those interests that the Agencies believe constitute subordinated seller's interests. [66] As a result, we are not certain whether to present the Trust Equity Interest as an example of a subordinated seller's interest for which a new subsection of § __.5 should be drafted or to present it as a different form of horizontal interest to be dealt with inside § __.5(f), which applies to specialized horizontal interests.[67]

As described above, due to its subordination in the payment waterfall, the Trust Equity Interest performs such a loss-absorbing function in an SAF. Because the Trust Equity Interest functions as a horizontal residual interest across all series, we recommend the adoption of rules permitting Trust Equity Interests to satisfy the servicer/sponsor's risk retention requirement, either as a subordinated seller's interest or as another form of permitted horizontal interest.

As noted above, one or more series of investor interests issued by an SAF may include a cash reserve account that is available to pay accrued interest on the investor interests if the monthly collections on the underlying SARs are insufficient to pay such interest in a given month. These cash reserve accounts are also available to pay any losses on the notes if there is ever an event of default under the SAF. However, prior to an event of default, amounts in the cash reserve accounts are only used to cover interest shortfalls on the notes in the related series; therefore, if any principal were to be due prior to the event of default, the reserve accounts would not meet the requirement in the Reproposed Rules that "[a]mounts in the account shall be released to satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an[y] amount due on any ABS interest." Because these cash reserve accounts perform loss-absorbing functions for their related series, and cash reserve accounts are permitted to offset, on a dollar-for-dollar basis, the amount of an eligible horizontal residual interest (§ __.4(c)), we urge the Agencies to adopt a risk retention rule permitting SAFs structured as revolving master trusts to satisfy or offset the sponsor's risk retention requirement on a dollar-for-dollar basis to the extent of any cash reserve account that otherwise satisfies the requirements of § __.4(c).

In the event that the Agencies were to seek to revise the provisions of § __.5(f) to enable servicers to utilize the specialized horizontal interest for SAFs, we believe several changes would be necessary in order for the final rules to be viable for these entities. Section __.5(f) permits both eligible horizontal residual interests and specialized horizontal interests to satisfy the risk retention requirements for a revolving master trust. Although unclear in § __.5(f), the Commentary indicates that these horizontal interests must be issued in connection with each series of the revolving master trust. SAFs do not currently issue or create specific equity

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[66] For example, we are not certain whether the Agencies believe that a subordinated seller's interest must have its own allocation of collections and losses on the securitized assets. As we describe above, a Trust Equity Interest typically does not have its own allocation of collections or losses.

[67] We note that the Trust Equity Interest is issued at the issuer or trust level and is not a separate interest in any specific series. As § __.5(f) requires a horizontal interest to be issued with respect to specific series, the Trust Equity Interest could not satisfy that requirement. Accordingly, we recommend that the Commission recognize the Trust Equity Interest as a horizontal interest that underlies all series.

interests for each series. Instead, as described above, the Trust Equity Interest supports all series, increasing as new series are issued and new SARs are added. Therefore, we urge the Commission to make it clear that, for revolving master trusts, separate equity interests do not need to be created for each series and a Trust Equity Interest that supports all series will qualify as a risk retention option for revolving master trusts.

We propose the following alternative to accommodate current SAF revolving master trust structures:

- A sponsor satisfies its risk retention requirements with respect to a securitization transaction for which the issuing entity is a revolving master trust if the sponsor retains a Trust Equity Interest of not less than 5 percent of the unpaid principal balance of all outstanding investors' ABS interests issued by the issuing entity after the effective date of the rule and prior to any early amortization date for the entire trust.

- A Trust Equity Interest is any equity interest in the revolving master trust that is subordinated, by operation of cash flow mechanisms or otherwise, to the payment of all outstanding investors' ABS interests, which interest may be certificated or uncertificated and may or may not have a stated principal balance.

- The 5 percent Trust Equity Interest may be reduced or offset, dollar-for-dollar, by any series-specific cash reserve account that satisfies the requirements of § __.4(c).

- The specialized horizontal interest may be used by revolving master trusts that distinguish between each series' share of collections but that do not have separate interest and principal collection allocations.

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We thank you again for the opportunity to comment on the Reproposed Rules. We hope that our comments assist the Commission in its efforts, together with the other Agencies, to develop a set of risk retention rules that will recognize and give appropriate credit to the ways in which securitizers retain significant risk in the performance of their securitizations.

Appendix A

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Appendix B

Proposed Securitization Value Methodology

"Securitization value" means, with respect to a securitization transaction, the value of the securitized assets and any funds in a horizontal cash reserve account and it has the meaning specified in the related transaction documents, provided that such value shall be no greater than the sum of (1) the present value of the cash flows from the then-existing securitized assets, discounted at an annualized rate that is at least equivalent to the sum of (A) the weighted average annualized rate at which interest accrues on third party ABS interests and (B) an annualized rate sufficient to cover the costs of compensation for any service providers who are paid from such cash flows (such as servicers, trustees, custodians and agents) and (2) the amount of funds in any horizontal cash reserve account, and provided, further, that if the securitized assets are interest-bearing and the weighted average interest rate on the securitized assets is at least equal to the sum of (1)(A) and (B), the principal balance of such assets may (but need not) be used as the securitization value of such assets.

"Eligible horizontal retention" means an eligible horizontal residual interest, a self-adjusting horizontal interest[68] or a horizontal cash reserve account or a combination of the foregoing.

"Residual securitization value," with respect to a securitization transaction, means the amount by which the securitization value exceeds the fair value of all ABS interests other than the eligible horizontal retention.

"Third party investor interest" means an ABS interest that is not an eligible horizontal retention or other residual interest in the securitized assets and that (i) has been acquired by a party who is unaffiliated with the sponsor or (ii) has been acquired or retained by the sponsor or any affiliate of the sponsor but with an interest rate and other terms that reflect an arms-length arrangement. If a third party investor interest is interest-bearing and its interest rate was established on an arms-length basis, its fair value shall be presumed to be its outstanding principal balance, notwithstanding subsequent changes in interest rates.[69]

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[68] We discuss the concept of a "self-adjusting horizontal interest" in Part III.B.1.b(v) and define the term in Appendix C.

[69] We think the sponsor should be entitled to treat the principal balance of a third party ABS interest as its fair value.

Appendix C

Self-Adjusting Horizontal Option

"Self-adjusting horizontal interest" means, with respect to any securitization transaction, an ABS interest (the "subject interest") in the issuing entity:

(1) That is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition;

(2) With respect to which, as of any calculation date, the fair value or the residual securitization value equals at least the target percentage of the sum of (A) the aggregate fair value of all ABS interests in the issuing entity other than such subject interest(s) and (B) the residual securitization value of such subject interest(s).

"Target percentage," with respect to a securitization transaction, means a specified percentage that is greater than zero and not greater than 5 percent, which percentage remains in effect as long as any third party investor interests are outstanding.

"Calculation date" means each measurement date specified in the transaction documents (but not less than monthly) and each date on which ABS interests are issued (or, in each case, on the cutoff date related to such measurement date or issuance date, so long as such cutoff date is not more than two months earlier).[70]

[70] We have included a "cutoff date" concept in our definition of "calculation date." That is because most mortgage, auto and student loan sponsors reconcile the status of their receivables no more frequently than monthly; they cannot ascertain the precise status of their entire pool of receivables (whether they have been paid on time, whether a default or repossession has occurred, and so on) on a real time basis. It often takes ten or more, and perhaps as many as 30, days following the end of the month for a full accounting of a pool of receivables to be generated. Reporting in securitization transactions of such sponsors is virtually always delivered 10 to 30 days after month end, which means that up to two months of "grace" is required after the cutoff date. (For example, if a sponsor that required 30 days after calendar month end to produce its reports wanted to effect issuance of an ABS interest on October 28, its most recent available report would be August 31.) Hence, we think it is appropriate to incorporate that paradigm into the calculation date.

Appendix D

Proposed Changes to Operating Advisor Provisions

(6) Operating Advisor. The underlying securitization transaction documents shall provide for the following:

(i) The appointment of an operating advisor (the Operating Advisor) that:

(A) Is not affiliated with other parties to the securitization transaction;

(B) Does not directly or indirectly have any financial interest in (i) the securitization transaction other than in fees from its role as Operating Advisor, or (ii) the special servicer; and

(C) Is required to act in the best interest of, and for the benefit of, investors as a collective whole;

(ii) Standards with respect to the Operating Advisor's experience, expertise and financial strength to fulfill its duties and responsibilities under the applicable transaction documents over the life of the securitization transaction;

(iii) The terms of the Operating Advisor's compensation with respect to the securitization transaction;

(iv) When the principal balance of the eligible horizontal residual interest ~~has a principal balance of~~(taking into account the application of any appraisal reductions) is 25 percent or less of its initial principal balance, the special servicer for the securitized assets must consult with the Operating Advisor in connection with, and prior to, any material decision in connection with its servicing of the securitized assets, including, without limitation:

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