Milbank

Client Alert

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RISK RETENTION AND RATING AGENCY REGULATION UNDER THE DODD-FRANK ACT

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") was enacted. This client alert is part of a series of client alerts Milbank is releasing on particular aspects of the Act of importance to our clients. This client alert focuses on particular provisions that will affect asset-backed securitizations, specifically the Act's provisions regarding risk retention and rating agency regulation.

1. **Risk Retention**

   a. **Amendment to 1934 Act.** The Act adds a new Section 15G to the Securities Exchange Act of 1934 (the "Exchange Act") that requires specified government agencies to "jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party."

   An asset-backed security is defined as "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." The following are explicitly included within such definition of asset-backed security:

   (i) a collateralized mortgage obligation;

   (ii) a collateralized debt obligation;

   (iii) a collateralized bond obligation;

   (iv) a collateralized debt obligation of asset-backed securities;

   (v) a collateralized debt obligation of collateralized debt obligations; and

   (vi) a security that the Securities and Exchange Commission (the "SEC") determines to be an asset-backed security for purposes of such section.

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An asset-backed security "does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company."

A securitizer is "an issuer of an asset-backed security" or "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."

b. **Regulation standards include risk retention.** As with many other provisions of the Act, the effect of the risk retention provision is difficult to predict until regulations are issued. However, the Act does state that the regulations must require a securitizer to retain at least five percent of the credit risk for any asset that is "transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer" (unless the assets that collateralize the asset-backed security consist entirely of qualified residential mortgages). The risk retained by a securitizer may be less than five percent if the originator of the asset meets "underwriting standards to be established by the Federal banking agencies in regulations 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." In addition, the regulations may provide for "the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator." An originator is a person who, "through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security" and "sells an asset directly or indirectly to a securitizer." A securitizer will be prohibited "from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset."

Credit risk is not defined in the Act, nor does the Act itself describe how a securitizer might retain credit risk. However, the Act provides that the regulations must specify the permissible forms of risk retention, and a minimum duration for that retention.

The relevant agencies are directed by the Act to provide for enough flexibility to account for differences between different types of asset-backed securitizations, including different classes of assets. The following are examples of these directives:

(i) The regulations must identify asset classes with separate rules for securitizers of different classes of assets.

(ii) The regulations may provide for a total or partial exemption of any securitization.

(iii) The regulations must provide for a total or partial exemption for a securitization of an asset issued or guaranteed by the United States or any agency of the United States (excluding the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation); or a security issued or guaranteed by any State of the United States, any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act, or a security defined as a qualified scholarship funding bond in section 150(d)(2) of the Internal Revenue Code of 1986.

(iv) The Federal banking agencies and the SEC are given the authority jointly to adopt or issue exemptions, exceptions, or adjustments to the rules laid out in Section 15G.

Certain institutions and programs are exempted by the Act from the risk-retention requirements. These include:

(i) Any "loan or other financial asset made, insured, guaranteed, or purchased" by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

(ii) Any "residential, multi-family, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset," which is insured or guaranteed by the United States or an agency of the United States (excluding the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation).

(iii) Any "qualified residential mortgage" if these mortgages are the only asset that collateralizes an asset-backed security and the asset-backed security is not collateralized by tranches of other asset-backed securities. The term "qualified residential mortgage" is to be defined jointly by the Federal banking agencies, the SEC, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." The term is to be defined no more broadly than the definition of "qualified mortgage" under section 129C(c)(2) of the Trust in Lending Act, as amended by the Consumer Financial Protection Act of 2010.

c. **Timing.** The regulations issued under the risk-reduction provisions of the Act will become effective two years after the date on which final rules are published in the **Federal Register**, with respect to securitizers and originators of asset-backed securities, or one year after publication, with respect to securitizers and originators of asset-backed securities backed by residential mortgages. The relevant agencies are required to issue their regulations within 270 days of the enactment of the Act, *i.e.*, by April 18, 2011.

d. **Conflicts of interest of securitization parties.** The Act amends the Securities Act of 1933 (the "Securities Act") to add a Section 27B that prohibits, for one year after the date of the first closing of the sale of an asset-backed security, an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security from engaging "in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity." This prohibition does not apply to "risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship." It also does not apply to "purchases or sales of asset-backed securities made pursuant to and consistent with...commitments...to provide liquidity for the asset-backed security, or...bona fide market-making in the asset-backed security." This prohibition will take effect on the day final rules are issued by the SEC with respect to the prohibition, which is also required within 270 days after enactment of the Act.

2. **Rating Agency Regulations**

a. **Rating agency liability as experts.** The Act repeals Rule 436(g) under the Securities Act, which had established a safe harbor for certain rating agencies. Rule 436(g) provided that ratings assigned by a nationally recognized statistical rating organization (an "NRSRO") were not considered a part of a registration statement prepared or certified by an "expert," within the meaning of Sections 7 and 11 of the Securities Act, and therefore NRSRO consent was not required to include such ratings in Securities

Act registration statements and related prospectuses. Absent the Rule 436(g) safe harbor, the consent of an NRSRO would be required in order to include or incorporate by reference that NRSRO's actual or expected ratings (or any portion of a report or opinion of that rating agency) in a registration statement, prospectus or prospectus supplement.

Despite the fact that SEC disclosure rules and regulations may require a registration statement or prospectus to include actual or expected ratings in some cases, some NRSROs have stated that they do not intend to provide their consent without further internal review. As a result, the market for asset-backed securities registered with the SEC subject to Regulation AB was temporarily shut down. In response to these market developments, on July 22, 2010, the Office of Chief Counsel of the Division of Corporation Finance of the SEC issued a "no-action" letter allowing, for six months, an issuer to omit rating information required under Items 1103(a)(9) and 1120 of Regulation AB from a prospectus relating to an offering of asset-backed securities under Regulation AB. Securities that are registered with the SEC and are not asset-backed securities under Regulation AB will not benefit from the no-action letter.

Please see our Client Alert dated July 30, 2010 for more information regarding the repeal of Rule 436(g).

b. **Regulation of Rating Agencies.** The Act contains several provisions that impose additional regulation on NRSROs, including amendment to the Securities Exchange Act of 1934 to increase "consistency, quality and transparency" of the credit-rating process, and to reduce the impact of conflicts of interest on credit ratings. As in the case of its risk-retention provisions, the Act describes the types of requirements that are to be imposed, but leaves it to the regulatory process to establish the details of these requirements.

(i) **Consistency and quality.** The Act includes several provisions designed to encourage NRSROs to generate their ratings in a consistent manner and with higher quality, including the following:

(a) NRSROs are required to "establish, maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the [SEC] may prescribe."

(b) In adopting these policies, procedures, and methodologies, NRSROs are required to consider information about an issuer that the NRSRO has, or receives from a source other than the issuer or underwriter, that the NRSRO "finds credible and potentially significant to a rating decision."

(c) The SEC is to require that each NRSRO establish, maintain and enforce written policies and procedures that "assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument."

(d) The SEC is to require that each NRSRO "clearly define and disclose the meaning of any symbol used by the [NRSRO] to denote a credit rating" and apply any such symbol "in a manner that is consistent for all types of securities and money market instruments for which the symbol is used." However, an NRSRO may use distinct sets of symbols to denote credit ratings for different types of securities or money market instruments.

(e) NRSROs are required to establish procedures to receive complaints by employees and

users regarding ratings, models, methodologies, and compliance with laws, policies, and procedures.

(f) Regulations will also extend to the quality of rating agency employees, as the SEC is required to issue rules that are reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings "meets standards of training, experience, and competence necessary to produce accurate ratings for the categories of issuers whose securities the person rates" and "is tested for knowledge of the credit rating process."

(ii) **Transparency.** Many aspects of the NRSRO ratings process will be required to be made public, such as the following:

(a) The SEC will require that each NRSRO "publicly disclose information on the initial credit ratings determined by the [NRSRO] for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different [NRSROs]."

(b) NRSROs must publish information about the assumptions and data the NRSRO relied on, including servicer reports used to conduct surveillance of a credit rating, an assessment of the quality of the information relied on, and disclosure about the limitations, uncertainty, and volatility of the rating and any conflicts of interest of the NRSRO.

(c) The SEC will require public notification of the NRSRO's policies, procedures, and methodologies and material changes to those policies, procedures, and methodologies.

(d) The SEC will make publicly available the findings of its periodic review of each NSRSO's adherence to its policies, procedures and methodologies and other conduct.

(iii) **Conflicts of interest.** The Act includes requirements that target conflicts of interest, such as the following:

(a) The SEC is required to issue rules to "prevent the sales and marketing considerations of an [NRSRO] from influencing the production of ratings by the [NRSRO]."

(b) The SEC will make rules that require NRSROs to review for potential conflicts of interest if an employee of such NRSRO later becomes an employee of an obligor, issuer, underwriter, or sponsor of an instrument that is rated by that NRSRO and that provide, in some cases, for the NRSRO to revise the applicable rating if a conflict of interest is found.

(c) The Act also imposes requirements on the governance of NRSROs that largely attempt to reduce conflicts of interest.

(iv) **Oversight.** The Act requires the SEC to monitor various aspects of the NRSROs'

implementation of their policies, procedures, and methodologies, and expands the SEC's authority to take certain actions against the NRSROs in connection with their ratings. For example, the Act provides the following:

(a) The SEC must review at least annually each NRSRO's adherence to its policies, procedures, and methodologies, conflicts-of-interest management, and other specified aspects of its conduct.

(b) The SEC will have the ability to revoke the registration of an NRSRO with respect to a particular class or subclass of securities based on whether it has "adequate financial and managerial resources to consistently produce credit ratings with integrity."

(c) Within the SEC, an Office of Credit Ratings is established to regulate the production and application of the NRSROs' policies, procedures, and methodologies.

(d) The Act provides for the amendment of various laws to replace certain references to investment-grade ratings or other descriptions of credit ratings with references to standards of credit-worthiness adopted by a relevant governmental authority. These amendments are effective two years after the Act is enacted.

(v) **Timing.** The SEC is required by the Act to issue its rating-agency regulations within one year of the enactment of the Act, *i.e.*, by July 22, 2011.

(vi) **Possible further changes.** The SEC is required to study, within two years after the Act is enacted, the desirability and feasibility of establishing a system under which NRSROs would be assigned responsibility for determining the initial credit ratings of structured finance products, rather than the issuer, sponsor, or underwriter selecting the NRSRO, and NRSROs would be paid by a party other than the issuer. After completing the study, the SEC has the authority to issue rules requiring that such a system be established.

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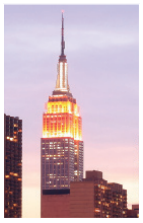

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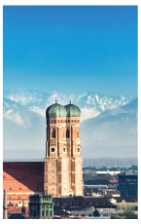

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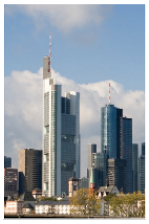

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