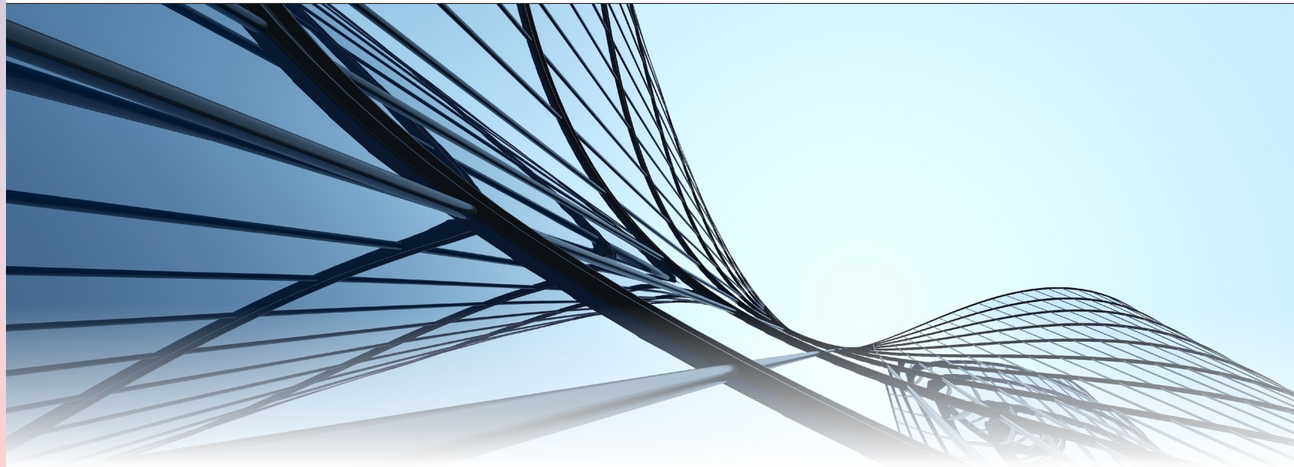
STRUCTURED FINANCE SPECTRUM

ALSTON & BIRD

SUMMER 2024

In this issue

Editor's Note



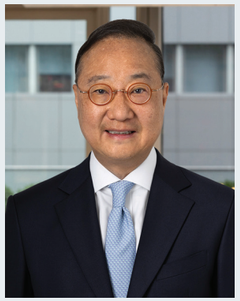
The dog days of summer are truly upon us. I hope everyone is staying cool and enjoying what's left of the season. It's hard to believe that we are more than halfway through 2024. "Certainty" is a lawyer's best friend, but I'm afraid certainty seems to have become a distant pen pal nowadays. The financial landscape remains unpredictable and, in some ways, unfamiliar, with many variables unanswered at this point in the cycle. I think I speak for all of us when I say it would be nice to see some certainty in the marketplace.

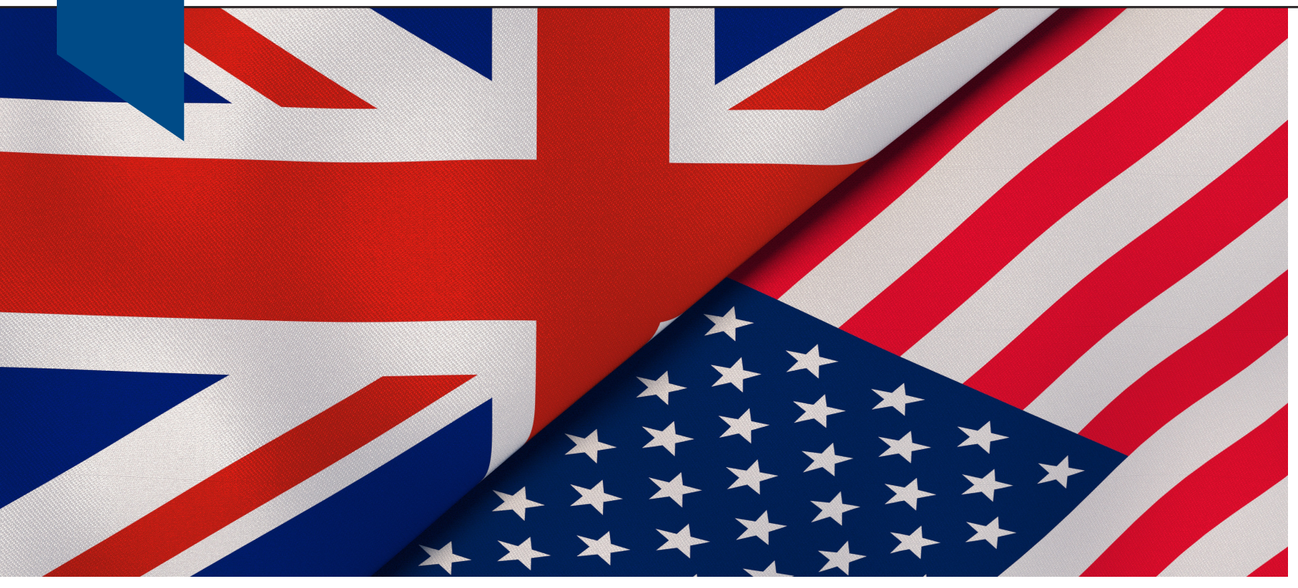
Jon Ruiss
Partner, Finance

Now for the good news! I am excited to present to you the summer edition of the *Spectrum*. This issue focuses on various regulatory matters across the board. You might even decide that our old friend "Certainty" could be back for a visit. The articles in this issue seek to clear up some of the fogginess we have all been experiencing for the past six months. Our Finance team prides itself on being a trusted partner to our clients and colleagues and, as the guest editor for this season's edition, I am proud to say that my colleagues have thought long and hard about what our friends want to know about today's market. We hope that our insights will help you all come to an informed decision about what's best for your business in these uncertain times.

I hope the rest of summer is a nice respite as we gear up for the end of the year!

In July, we welcomed partner Boong-Kyu (B.K.) Lee to the Structured & Warehouse Finance Team in New York. B.K. has over 20 years of experience representing issuers, underwriters, and U.S. and international financial institutions in public and private ABS offerings. He advises clients on structured finance and M&A transactions involving credit card receivables, data center revenues, automotive loans, pharmaceutical royalties, student loans, peer-to-peer loans, and solar assets. Our team is thrilled to add B.K.'s experience across these active asset classes. His background also includes counsel related to whole-business securitizations, resecuritizations, advanced derivative products, CDO and CLO transactions, tender offers, and restructurings.





The New United Kingdom Securitization Regime and What It Means for the United States

On April 30, 2024, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) published new UK securitization rules to replace the existing onshored EU securitization regulation, commencing November 1, 2024. These changes are part of the UK government's "Smarter Regulatory Framework" initiative, which aims to replace retained EU laws with UK-specific regulations for financial services.

Since Brexit, the UK securitization regime has fundamentally consisted of the "grandfathered" EU regime. This has meant that U.S. sell-side entities have largely been able to structure their transactions to comply with the EU and UK regimes as one. Beginning in November, this will no longer be possible. Three separate (U.S., UK, and EU) regimes will need to be complied with if deals are being marketed to U.S., UK, and EU investors.

The new UK rules represent a flexible shift from EU regulations, introducing targeted policy changes and setting the stage for future adjustments. They aim to provide a more tailored and efficient regulatory framework for the UK securitization market while maintaining alignment with key EU principles when beneficial. U.S.-based entities involved in UK securitizations, or marketing U.S. securitizations to UK investors, will need to understand and adapt to the new UK rules to ensure compliance and optimize their engagement in the UK market because this two-way traffic is set to increase in the coming years.

Application and Transition

The new UK rules will take effect on November 1, 2024. Transitional provisions largely allow existing securitizations to remain under current rules (the exception being when a UK institutional investor delegates its due diligence obligations to a non-UK-authorized alternative investment fund manager). Pre-2019 securitizations continue under pre-2019 regulations.

Impact on U.S.-based entities

U.S. sell-side entities will need to ensure that they are prepared to comply with the new UK rules for any transactions that will close on or after November 1, 2024 and that will be marketed to UK investors. Similarly, U.S. investors investing in UK securitizations that will close on or after November 1, 2024 will also need to be prepared to comply with their own obligations under the new rules.

> UK investors may continue to ask for reporting on the specified templates as a belts-and-braces approach to ensure they meet their due diligence obligations.

Framework Composition

The new UK rules are found in three places:

1) **Securitization Regulations 2024.** These statutory instruments (the Securitisation Regulations 2024 and the draft Securitisation (Amendment) Regulations 2024) provide the legislative framework for securitization activities in the UK, designating certain activities such as acting as an original lender, originator, sponsor, or securitization special purpose entity (SSPE) as requiring regulatory oversight.
2) **FCA Rules.** Firm-facing rules set out in the FCA's rulebooks. These can be found in the FCA's Policy Statement PS24/4. Apply to UK-based entities such as FCA-authorized firms, unauthorized manufacturers, sellers to retail clients, third-party verifiers of simple, transparent, and standardized securitizations, and securitization repositories.
3) **PRA Rules.** Firm-facing rules set out in the PRA's rulebooks. These can be found in the PRA's Policy Statement PS7/24. Apply to PRA-authorized UK entities involved in securitization markets, such as banks, insurers, or pension funds. Trustees or managers of UK occupational pension schemes must follow the securitization regulations for due diligence obligations, monitored by the pensions regulator.

Impact on U.S.-based entities

U.S. entities that engage in securitization activities involving UK markets must ensure compliance with the new UK rules if they interact with UK-based investors, entities, or structures. This includes adhering to FCA or PRA rules if the entities act as originators, sponsors, or SSPEs with UK involvement.

U.S.-based investors in UK securitizations will need to be mindful of the disclosure and due diligence requirements set by the FCA and PRA to ensure their investments are compliant with UK regulations.

If a U.S. entity is involved in selling securitization positions to retail clients in the UK, it must comply with the relevant FCA rules.

Changes and Policy Updates

The current rules are, for the most part, being preserved. However, some updates to the current regime are:

- **Due Diligence and Reporting.** A principles-based approach to disclosure requirements, simplifying the process for UK investors and allowing more flexibility compared with the EU's requirement for template reporting (which has come to be known in the market as "Article 7 reporting" or "ESMA reporting").

- **Delegation of Due Diligence.** UK institutional investors can delegate due diligence obligations to another investor, which may or may not be a defined "institutional investor," provided that the UK institutional investor retains the responsibility for compliance with the due diligence requirements when the delegate is not a UK institutional investor.
- **Sole Purpose Test.** The new rules liberalize the test for determining if an originator operates solely for securitizing exposures, allowing for a more flexible approach compared with the EU rules.
- **Risk Retention.** The 5% retention of risk for the lifetime of the deal remains. Retention requirements can now be based on the purchase price rather than nominal value, aligning with current EU rules.
- **Change of Risk Retainer upon Insolvency.** Allows for the transfer of retained risk to a new retainer in cases of insolvency.
- **Hedging Against Retained Risk.** Permits hedging the credit risk of retained exposures if it does not benefit the retainer differently from other investors.
- **Disclosure Timing.** Specifies that draft transaction documents should be available before pricing or commitment, and final documents within 15 days of closing, simplifying requirements for secondary market investors.

Impact on U.S.-based entities

A major update for U.S. sell-side entities is that reporting in a specified format on "Article 7 templates" or "ESMA templates" will no longer be required when selling to UK investors. Article 7 reporting has been a headache for U.S. sell-side entities because—since a European Commission ruling in October 2022—U.S. deals have not been able to market to EU buyers without doing this reporting (and the UK has followed suit). UK investors will now be able to invest in U.S. securitizations when this reporting is not being done (though they will still need to ensure disclosure is provided at a high level, just not in the specified templates). EU investors still require the reporting, though. It may be that in the future the EU relaxes this requirement, but in the meantime, UK investors may continue to ask for reporting on the specified templates as a belts-and-braces approach to ensure they meet their due diligence obligations. Further, UK investors may continue to ask for Article 7 reporting to be done to make their loans more marketable to European lenders for syndication or sale on the secondary market.

Similarly, the more flexible "sole purpose test" will be a welcome introduction for U.S. market participants, many of whom have had to spend considerable time and expense proving that an entity passes the more rigid EU sole purpose test.

U.S. entities will need to understand and align their risk retention strategies with the new UK rules if they engage in securitizations that include UK assets or investors. Fortunately, the overarching 5% retention rule is being retained.

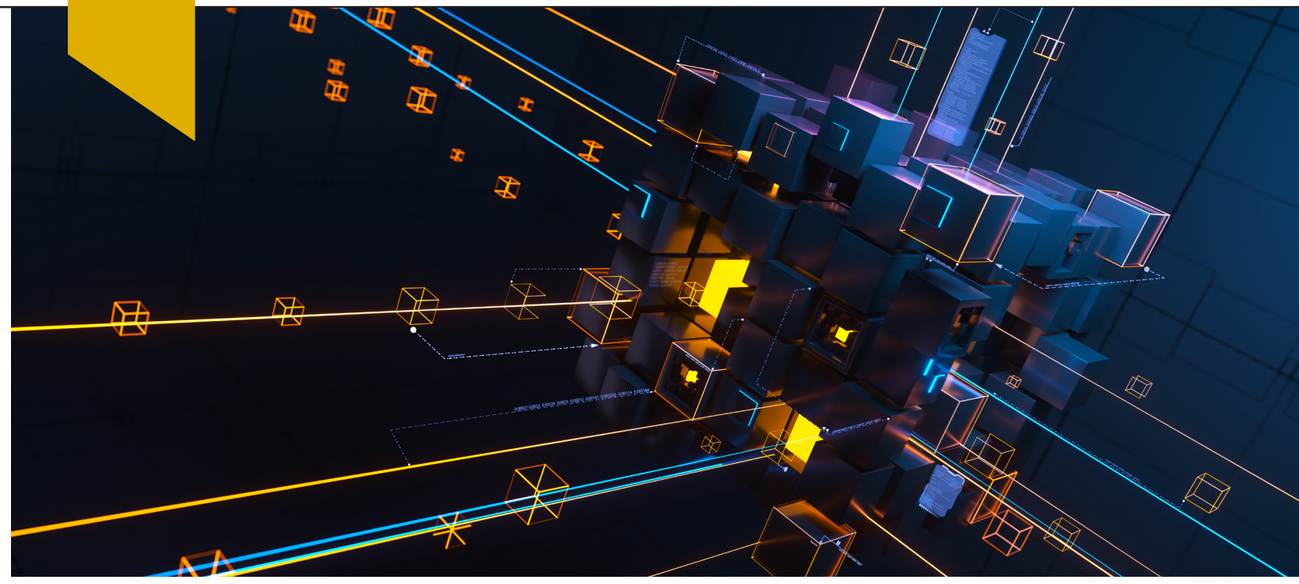
For U.S.-based originators or sponsors, the allowance for hedging retained risk prior to securitization could provide more flexibility in managing credit risk, but they must ensure such hedging complies with both UK and, potentially, U.S. regulations.

Future Changes

The FCA and PRA plan to consult on additional changes in late 2024 or early 2025, particularly on the definitions and reporting requirements for "private" and "public" securitizations. The potential changes aim to streamline disclosure requirements for private securitizations. Additionally, feedback from initial consultations, including suggestions for "L-shaped" risk retention, may be considered for future policy updates. Moving securitization rules to regulators' rulebooks is expected to facilitate quicker and easier policy changes in the UK.

Impact on U.S.-based entities

U.S. firms engaged in UK securitizations or marketing securitizations to UK investors should stay informed on future consultations and changes to ensure ongoing compliance. U.S. entities must also be aware of any new UK policies that may impact their obligations, especially if they involve UK investors or originate transactions that include UK assets. ■



Electronic HELOCs and Blockchain Technology: Considerations Under the Uniform Commercial Code Amendments (2022) for Warehouse Lenders

Recently, there has been a surge in home equity line of credit (HELOC) originations as homeowners look to find cheaper financing in the rising-interest-rate environment—cheaper relative to unsecured lines of credit. Homeowners, while continuing to grapple with the pandemic's impact on home prices and cost of living expenses, are also keen to take advantage of this increased equity that has been afforded to them. This surge in HELOC originations has in turn fueled a similar uptick in warehouse financing of HELOC loan products.

In an effort to bring quick and effortless financing options to consumers, some HELOC originators are utilizing fully automated and digital underwriting and origination processes, including partnering with Fintech companies to use blockchain technology. Inevitably, this has created some unique concerns of first impression and questions for warehouse lenders and their counsel.

We review some of these concerns and questions relating to electronic HELOCs (eHELOCs) and how eHELOCs compare with paper mortgage notes and electronic mortgage notes (eNotes), with a look to the future to see how the 2022 amendments to the Uniform Commercial Code (UCC) may alter the legal and technology landscape for eHELOCs. Finally, we discuss additional specific collateral issues and considerations related to eHELOCs.

Perfection and Negotiability

To understand and analyze the perfection issues surrounding eHELOCs, a trip through the basics of perfection in the context of mortgage finance is a good place to start. A security interest in a traditional mortgage loan and the associated paper promissory note can be perfected in two ways under Article 9 of the UCC: (1) by filing a UCC financing statement; and (2) by

possessing the paper promissory note, which is typically done through a document custodian. These methods of perfection are fairly straightforward because the collateral in question is a signed writing that orders or promises payment of money (i.e., a paper promissory note) and is thus an instrument under Article 9 of the UCC, which states that writing "includes printing, typewriting, or any other intentional reduction to tangible form."

An eNote, on the other hand, is not a writing, so it is not an instrument under Article 9 of the UCC and therefore not susceptible to be perfected by physical possession (it still can be perfected by filing a UCC financing statement because it is a payment intangible). Similarly, an eNote is not a negotiable instrument under Article 3 of the UCC since it is not a writing. Although eNotes cannot take advantage of the negotiability rules of Article 3 of the UCC or the nontemporal perfection afforded to physical promissory notes pursuant to Article 9 of the UCC, eNotes can, by their terms, opt in to being governed by the federal Electronic Signatures in Global and National Commerce Act (ESIGN)—ESIGN only relates to an eNote that is "secured by real property"—and Uniform Electronic Transactions Act (UETA).

> An eNote is not a negotiable instrument under Article 3 of the UCC since it is not a writing.

Under ESIGN and UETA, eNotes nonetheless enjoy the same negotiability rules under Article 3 of the UCC as long as they would be negotiable instruments had they been in writing. Under ESIGN and UETA, such an opted-in eNote is a "transferable record," in which a person may have "control." The controller is deemed to be the holder of such transferable record and is analogous to a "holder" of a negotiable instrument under Article 3 of the UCC. A controller who otherwise controls the transferable record as a holder in due course (as the term is defined in Article 3 of the UCC) holds the transferable record free from prior claims and defenses, subject to certain exceptions. Importantly, a controller with a holder in due course status takes rights in the transferable record free of any prior perfected security interest.

A "holder in due course" means the holder of an instrument if both:

1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
2) the holder took the instrument (1) for value; (2) in good faith; (3) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series; (4) without notice that the instrument contains an unauthorized signature or has been altered; (5) without notice of any claim to the instrument described in Section 3-306; and (6) without notice that any party has a defense or claim in recoupment described in Section 3-305(a).

Electronic registries, such as the MERS eRegistry, were developed to manage the controller status as relating to eNotes in accordance with the requirements of ESIGN and UETA and consequently, the MERS eRegistry provides procedures and policies for maintaining control for purposes of ESIGN and UETA. Also, to be clear, eNotes opting in to ESIGN and UETA still cannot take advantage of the nontemporal perfection under Article 9 of the UCC because they are mere payment intangibles that can only be perfected by filing a UCC financing statement under Article 9 of the UCC.

Unlike mortgage notes, eHELOCs (and HELOCs in general) are typically evidenced by a revolving credit agreement, categorizing them as "payment intangibles" under the UCC. Consequently, the only way to perfect a security interest in HELOCs and eHELOCs is by filing a UCC financing statement. Additionally, because eHELOCs are not considered negotiable promissory notes, even if they were in written form, the ESIGN and UETA opt-in features do not apply. This means eHELOCs do not benefit from the rules of negotiability, including the protections offered to a holder in due course, that a negotiable eNote would enjoy. As a result, warehouse lenders and investors in eHELOCs are limited, compared with lenders and investors in traditional paper promissory notes and negotiable eNotes, because such lenders and investors do not receive the protections afforded by nontemporal priority security interests and negotiability advantages that are available to paper promissory notes and negotiable eNotes.

> The only way to perfect a security interest in HELOCs and eHELOCs is by filing a UCC financing statement.

There are currently eRegistry systems that use blockchain technology to track and assign "control" to lien holders. These eRegistries are functionally similar to the regime MERS uses in tracking eNotes, but blockchain technology can also now be used to ensure protection for the owners of the loans (and their lenders and investors). Purveyors of these eRegistries tout benefits for warehouse lenders and investors such as lower prices for registration and automated processes and reconciliation. The practicality of this system cannot be denied. An eRegistry combined with blockchain technology creates a one-stop shop for lenders by essentially cutting out the burdens of shipping collateral to document custodians. However, it is important to note that eHELOC originators typically stand up such eRegistries themselves. While MERS is a service provider that technically acts independently, the one-stop shop of an eHELOC origination platform poses its own risks. The warehouse lender must essentially underwrite the financing with the strength of the originator's eRegistry system as a consideration. The fact remains, though, that perfection must arise through control, and control can only be attained via the eRegistry system in use.

We offer a word of caution to warehouse lenders because these blockchain eRegistries are similar to MERS eRegistries but cannot currently create the nontemporal priority security interest and negotiability afforded to paper promissory notes and negotiable eNotes. The rollout of the 2022 amendments to the UCC will change this, and blockchain eRegistries will be able to provide the nontemporal priority security interest and negotiability status to warehouse lenders and investors without involving ESIGN and UETA. However, given the growing pains experienced when MERS rolled out its eRegistry, some lenders may not want to be the beta testers for systems like these.

Article 12 and the Introduction of the Controllable Electronic Record

In the summer of 2022, the American Law Institute and the Uniform Law Commission approved the Uniform Commercial Code Amendments (2022) that introduced a new Article 12 to govern the transfer of property rights in a newly defined property type—a controllable electronic record (CER). In addition, significant changes to Article 9 of the UCC were also introduced to allow a security interest in CERs to be perfected by control, which would give lien priority over a security interest perfected by filing a UCC financing statement. A CER is defined to be "a record stored in an electronic medium that can be subjected to control" under Article 12 of the UCC. This definition is purposefully broadly drafted and, other than certain expressly excluded categories of collateral, should cover wide-ranging electronic records, such as an eHELOC, whether or not they use blockchain technology.

CER is a reference to the actual electronic record, which itself can be an asset (such as non-fiat crypto currencies and nonfungible tokens). CERs can be tethered or linked to other distinct property rights, such as a payment obligation under a HELOC, and control over the CER could affect the rights of

third parties with respect to the tethered property right. The amended Article 9 of the UCC specifically refers to two new collateral subcategories, which are CERs that are tethered to types of payment obligations: "controllable accounts" and "controllable payment intangibles." These are "accounts" and "payment intangibles" that are evidenced by (or tethered to) a CER. Note that, to be a "controllable account" or a "controllable payment intangible," the underlying account debtor will need to agree to pay the person in control of the "controllable account" or "controllable payment intangible" at the time such "controllable account" or "controllable payment intangible" is created.

Before the implementation of the 2022 amendments, the only way to perfect a security interest in eHELOCs was by filing a UCC financing statement. In addition, given that eHELOCs are not negotiable electronic instruments, purchasers of eHELOCs could not take advantage of the negotiability rules under ESIGN and UETA, including the "take free" rights afforded to a holder in due course. With the 2022 amendments, eHELOCs benefit from the nontemporal priority perfection rules and negotiable rules (similar to those currently enjoyed by paper negotiable promissory notes) and the negotiable rules (similar to those currently enjoyed by negotiable eNotes) under ESIGN and UETA. Thus, under Article 12 of the UCC, a qualifying purchaser of an eHELOC in the form of a controllable payment intangible could take it free of property claims and, under the amended Article 9 of the UCC, a secured party can perfect its security interest in an eHELOC in the form of a controllable payment intangible by control, which perfection would have priority over a secured party that has perfected by means other than control.

As for eHELOCs utilizing blockchain technology, the foregoing benefits will allow eHELOCs to achieve the same levels of protection for the warehouse lender that are afforded to paper mortgage notes, all while being able to take advantage of the automated electronic origination, registration, perfection, and assignment afforded by the use of a blockchain-based registry or multiple blockchain-based registries that can seamlessly interact with each other.

Representations and Warranties and Other Collateral Package Issues

One key aspect to consider when financing eHELOCs is the content of the collateral package itself.

The representations and warranties concerning the loans themselves are often overlooked but are nonetheless important pieces of the financing. Many warehouse lender forms contain voluminous sets of such representations and warranties. With collateral such as eHELOCs, the standard representation set will not do much to protect a lender or address the specific nature of HELOCs generally. For example, certain carveouts need to be made for multi-lien protections because eHELOCs can range from first lien down to third liens. These types of carveouts need to be addressed (and priced accordingly) when ensuring lender protection. Moreover, the lender should ensure the originator or counterparty can give representations addressing the revolving term of a HELOC, compliance with draws, and amortization. Finally, warehouse lenders will want to make sure that the proper appraisals were conducted for the origination of the eHELOC.

> This is where the rubber meets the road with negotiating scheduled representations.

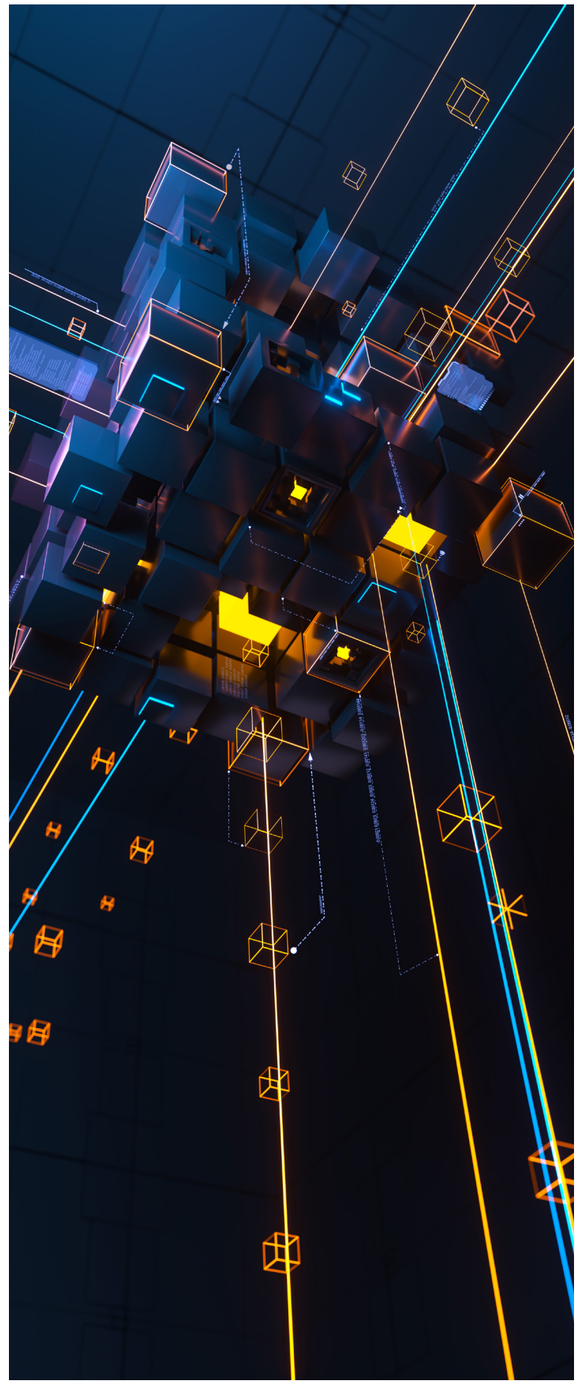
Of course, a lender can always be choosy and add additional eligibility criteria within the eHELOC product to account for the risks associated with higher combined loan-to-values and nonperforming loans.

Another consideration is where these representations and warranties originate. With more and more companies acquiring eHELOCs from originators via flow purchases or single pool purchases, lenders should consider creating the appropriate look-through back to the originating entity. This is where the rubber meets the road with negotiating scheduled representations. When acquiring loans from originators, it may seem as if investors are also "purchasing" the representations that come along with those eHELOCs. However, lenders should be wary about what types of representations the originator is giving in the underlying deal and whether the counterparty is willing to be at risk for new or additional representations needed to meet the lender's standards. A full review of those representations should lead the lender to engage in negotiating for the proper standard of protection. While this type of review is not novel when financing loans acquired from the originator, the importance of such review is underscored by the fact that dealing with a more exotic type of collateral (such as eHELOCs) can result in material gaps when making representations about what is actually present when it comes to the collateral itself. Ultimately, the lender will have to negotiate the best protections it can achieve and in doing so, the representations offered by the underlying originator should also be vetted.

Conclusion

eHELOCs present important operational and legal considerations that will become more and more relevant as the warehouse finance market continues to adapt to the use of new forms of electronic collateral. When the 2022 amendments become widely adopted, the marketplace will begin to offer systems that utilize their benefits, which will permit warehouse lenders to enjoy some of the traditional ownership and security interest protections they have grown used to with physical collateral and eNotes. While other considerations remain at play, the 2022 amendments may provide some comfort to those lenders who have stayed out of the eHELOC sphere due to such collateral concerns.

For lenders that are contemplating adding eHELOCs to their lending programs, it is important to lean on counsel with experience working with this asset class, given the market standards for these assets continue to evolve. For counsel, it remains critical to bridge the gap between the important protections our warehouse lender clients need and their desire to remain competitive and innovative in the warehouse finance market. ■



FHFA Approves Closed-End Second Pilot Program

Freddie Mac, a government-sponsored enterprise, was created in 1970 with the goal of expanding the secondary market of mortgages in the United States. In practice, Freddie Mac purchases mortgages from private banks and then issues securities backed by pools of these mortgages that it sells to the capital markets. According to Freddie Mac's guidelines, the purpose of Freddie Mac is to "purchase loans from lenders to replenish their supply of funds so they can make more mortgage loans to other borrowers." Currently, Freddie Mac focuses its business on single-family first-lien mortgages.

Recently, the Federal Housing Finance Agency (FHFA) announced conditional approval of an 18-month pilot program for Freddie Mac to purchase second mortgages from primary market lenders approved to sell to Freddie Mac, such as saving banks, commercial banks, and mortgage companies. A closed-end mortgage loan differs from an open-end mortgage loan in that with an open-end mortgage, a homeowner can increase their loan principal over time at their own discretion, while with a closed-end mortgage, the homeowner is provided a set amount of funds and is not allowed to increase that loan principal, regardless of how much time has passed. Second-lien mortgage loans differ from first-lien mortgage loans in that they are subordinate mortgages that are created while the original, first-lien mortgage is still in effect, with the main purpose of allowing home buyers to tap into their equity interest in the mortgaged property in the form of cash liquidity. In a closed-end second-mortgage loan, the funds are fully disbursed in the form of a one-time cash payment to the borrower when the loan closes that the borrower repays over a scheduled time, and the mortgage is recorded in a junior lien position.

Because of the junior lien position of the closed-end second mortgage, these mortgages are considered riskier because the primary mortgage has priority and is paid first in the event of default. Taking that risk into account, among other controls, the new conditional rule states that Freddie Mac may only purchase a closed-end second mortgage if it has purchased the first mortgage. This way, Freddie Mac has insight into the performance of both loans, allowing for improved risk management.

Objective of New Rule

Freddie Mac expects the pilot program to address the following main objectives:

- Many homeowners purchased or refinanced homes during a period of lower mortgage rates, and now, during a time of elevated interest rates, tapping into a homeowner's equity interest in their home through traditional cash-out refinancing has largely become a significant financial endeavor requiring a refinancing of the entire outstanding loan balance. Freddie Mac argues the new rule addresses this issue by ensuring borrowers can retain their low-interest first-lien mortgage and have a more limited exposure to today's higher market rate only through a closed-end second mortgage. This, of course, benefits homeowners by providing increased liquidity while not leading to an increased interest rate that is too high for a homeowner to keep up with. It is expected borrowers would also prefer these closed-end second mortgages as means to access cash liquidity in lieu of other borrowing options because the interest rates are still usually lower than those for many consumer or personal loans.
- According to FHFA Director Sandra Thompson, access to closed-end second mortgages will in fact benefit underserved borrowers, a core goal of the Freddie Mac program. While higher-income earners tend to have ready access to cash-out options, private lenders are more apt to overlook low-income earners or borrowers in rural areas. It's expected that Freddie Mac's entry into this market will give those often-overlooked potential borrowers the cash liquidity they are looking for at a more friendly rate than the alternative lending options they are often resigned to use.
- Freddie Mac argues that this new rule also benefits the enterprise and private market generally by (1) providing liquidity and stability in the second-mortgage market due to its credit guarantee and experience securitizing mortgage loans; and (2) creating space for smaller financial institutions to offer closed-end second mortgages. The hope is that this in turn will support the earlier-stated goal of providing access to underserved borrowers through these smaller community-based financial institutions.

Goalposts of the Pilot Program

Freddie Mac, being a government-sponsored enterprise, has strict rules regarding the mortgage products it is permitted to purchase. Some rules focus on the length of the loan's payback, the ability to securitize said pool of loans, or the eligibility of certain second mortgages. Below is a table that outlines the criteria set out for the closed-end second-mortgage program.

The new conditional rule states that Freddie Mac may only purchase a closed-end second mortgage if it has purchased the first mortgage.

Terms	Requirement	Observation
Seller Participation	Seller must be an approved and active seller/servicer to Freddie Mac.	Ability to meet the financial and counterparty standards to sell loans to Freddie Mac.
Second Mortgage	Freddie Mac will only purchase a second mortgage if it currently owns the first mortgage.	Assist with servicing and risk oversight.
Restricted Products	Certain second mortgages would be ineligible, such as land trusts and cooperative share mortgages.	Minimize additional layers of risk due to complexity and terms.
Evaluation Period	Limitations on the number and aggregate unpaid principal balance of second mortgage purchases for an initial period.	Provide an opportunity to manage risk and create the infrastructure to support possible future growth.
Loan Terms	Fixed-rate fully amortizing loan up to a 20-year term on borrower's primary residence.	Fixed and stable payment for the borrower.
Loan Acquisition: Commitments and Delivery	Second mortgages would initially be delivered through the cash window.	Help manage the market risk in the pipeline.
Pricing	Freddie Mac would initially provide "spot bids" rather than forward prices to its sellers.	Help achieve appropriate risk vs. return ratios.
Securitization	Loans would remain in portfolio for approximately six to nine months until the creation of second-mortgage non-TBA-guaranteed securities and for systems implementation.	Allow for credit risk transfer opportunities that would be evaluated in subsequent phases.

Criticisms of New Rule

Critics of the new rule have several concerns. There is concern that this program will disrupt the private securitization market. Closed-end second-mortgage loans have traditionally been originated and funded by private capital. There is also concern that entry by the government-sponsored enterprise would lessen competition in the existing private marketplace, or even completely take over private market activity.

There is also concern about exacerbating "rate lock" or the lock-in effect. Almost all the active mortgages in the United States are fixed at interest rates lower than the prevailing market rate, creating a disincentive to sell, in turn reducing supply and increasing prices for those looking to buy homes. Such higher prices in the housing market could increase overall inflation.

Critics also cite policy reasons for their disapproval of the new rule. The new rule risks widening the wealth gap because it does little for those in underserved communities hoping to buy homes, build equity, or access equity in the home they already own. For Freddie Mac to engage with those certain closed-end second mortgages, Freddie Mac must first have bought the first-lien mortgage loan. This new rule could be viewed as favoring those who already had the privilege of obtaining a mortgage during a time of lower interest rates. Many obtained such mortgages when individuals of color were statutorily prevented from obtaining these mortgages due to redlining policies. These critics highlight that, due to this, the public interest factor required for Freddie Mac's rule to go into effect would not be satisfied.

Other critics noted that the risks associated with Freddie Mac acquiring closed-end second-mortgage loans will be borne by the U.S. taxpayers should the housing market decline—a situation similar to the one that played out in the 2008 financial crisis.

The FHFA took into consideration the various comments they received from the market. However, in taking into consideration the various comments, the FHFA gave conditional pilot approval for Freddie Mac's purchase of second mortgages that limited the product to: (1) a maximum volume of $2.5 billion in purchases; (2) a maximum duration of 18 months; (3) a maximum loan amount of $78,277, corresponding to certain subordinate-lien loan thresholds in the Consumer Financial Protection Bureau's definition of qualified mortgage; (4) a minimum seasoning period of 24 months for the first mortgage before a purchase of the second; and (5) eligibility only for principal/primary residences.

The FHFA has the responsibility of closely monitoring its pilot program, making sure that the objectives of the new rule and the Freddie Mac program at large are met. The pilot program will last 18 months and will then go through another public comment period if Freddie Mac chooses to extend the pilot or to adopt the product as a regular new program, with Fannie Mae expected to follow suit should it be adopted. Both proponents and critics will be anxiously awaiting to see how the market responds to this new rule. ■

The CFPB's Enforcement Agenda After *Community Financial Services Association of America*

Since the Consumer Financial Protection Bureau (CFPB) was established in 2011, myriad entities have lodged constitutional challenges to its existence, structure, and processes. Most recently, the U.S. Supreme Court resolved challenges to the constitutionality of the CFPB's funding structure; namely, whether the CFPB's ability to draw money from the Federal Reserve violates the Appropriations Clause.

On May 16, 2024, the Court issued an opinion in *CFPB v. Community Financial Services Association of America Ltd.*, holding that the CFPB's funding statute does not violate the Appropriations Clause. The Constitution's Appropriations Clause states that "[n]o Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law." Unlike most agencies, the CFPB does not receive its funding through an annual appropriation law. Rather, the CFPB receives annual funding directly from the Federal Reserve in an amount that the CFPB director deems "reasonably necessary," limited only by an inflation-adjusted cap.

In a 7–2 decision, the Court held that, under the Appropriations Clause, an appropriation is "simply a law that authorizes expenditures from a specified source of public money for designated purposes." The Court therefore went on to find that the provision of Dodd–Frank that allows the CFPB to draw from the Federal Reserve System in an amount that its director deems "reasonably necessary" to carry out its duties is a proper appropriation mechanism.

In recent years, the CFPB has become increasingly aggressive in its enforcement, and the victory in *Community Financial Services Association* is likely to further embolden it. In light of the bureau's recent areas of focus, we anticipate increased enforcement activity in at least three specific areas following the Supreme Court's decision.

Consumer Fees

First, the CFPB continues to crack down on "junk fees" as part of an initiative it announced in 2022. Junk fees have also proven to be a priority for other federal agencies. Last year, the Federal Trade Commission (FTC) proposed a trade regulation rule on unfair or deceptive fees that would prohibit businesses from omitting mandatory fees from list prices and require disclosure of the amount and purpose of all fees. The Federal Communications Commission also proposed a rule that would prohibit cable and satellite service providers from charging early termination fees and billing cycle fees.

In just the past year, the CFPB issued an advisory opinion clarifying that consumers are entitled to obtain basic account information from large banks and credit unions without having to pay junk fees and issued a proposed rule designed to curb excessive overdraft fees. The CFPB also ordered Bank of America to pay $100 million to customers for illegally charging junk fees to consumers with insufficient funds in their accounts and entered into a $2.7 billion settlement with various credit repair companies for collecting illegal junk advance fees for their services.

Most recently, in March, the CFPB issued a final rule on credit card penalty fees. Under the new rule, card issuers' safe harbor threshold for late fees has been lowered from $41 to $8. The rule also eliminates annual automatic inflation adjustments to the $8 safe harbor amount. But within 48 hours of its publication, the rule was challenged in federal court in Texas. The U.S. Chamber of Commerce and other plaintiffs alleged that the CFPB violated the Administrative Procedure Act (APA) by, among other things, failing to reasonably and rationally analyze or explain its decisions, failing to base its decisions on substantial evidence, and basing its decision on an analysis of data that was not made available to the public. This case remains pending.

In light of the bureau's anticipated efforts to continue to address junk fees after *Community Financial Services Association*, we are likely to see more APA challenges to the CFPB's enforcement activity in this area. This is especially true in the wake of the Supreme Court's recent decision in *Loper Bright Enterprises v. Raimondo* to jettison *Chevron* deference, which will undoubtedly produce a spate of APA challenges in any event.

The Court went on to find that the provision of Dodd–Frank that allows the CFPB to draw from the Federal Reserve System in an amount that its director deems "reasonably necessary" to carry out its duties is a proper appropriation mechanism.

Buy Now, Pay Later

Second, the CFPB has focused on "buy now, pay later (BNPL) loans since the rapid expansion of the products over just the past few years. On May 22, 2024, the CFPB issued an interpretive rule treating BNPL lenders as credit card providers. This imposes obligations on BNPL lenders to provide consumers with certain legal protections and rights afforded by Regulation Z that previously only applied to conventional credit card providers, including the right to dispute charges and demand a refund after returning a product purchased with a BNPL loan.

The BNPL industry has largely been supportive of the interpretive rule. Many major players in the BNPL space have taken the position that their business practices are already in line with Regulation Z's requirements. Additionally, commentators have noted that increased regulation of BNPL loans could increase consumer confidence in these products.

To date, the CFPB's interpretative rule has not been challenged in court. That may change, however, depending on the CFPB's enforcement activity.

Credit Reporting Agencies

Finally, the CFPB has long targeted practices by consumer reporting agencies (CRAs) that the bureau is concerned act as an unfair impediment to consumers' ability to access credit and, by extension, to housing. The bureau's efforts over this past year have confirmed that it continues to view CRAs as a primary focus for enforcement.

In October 2023, the CFPB and FTC filed a joint complaint against TransUnion, alleging violations of the Fair Credit Reporting Act for failing to ensure rental screening background check information was accurate and withholding information that consumers needed to correct inaccurate information. TransUnion was ordered to pay $23 million in redress and penalties.

And last month, the CFPB proposed a rule that would remove medical debt from credit reports in most instances by eliminating the existing financial information exception that broadly permits creditors to use medical debt information for credit eligibility determinations. If the proposed rule is finalized, we are likely to see litigation challenging the bureau's move to repeal the financial information exception as arbitrary and capricious under the APA, particularly now that the Supreme Court has reduced the CFPB's (and other agencies') powers by limiting *Chevron* deference. ■

FSOC Issues Report on Nonbank Mortgage Servicing Highlighting Strengths, Vulnerabilities, and Recommendations

This article originally appeared in Of Interest, Alston & Bird's consumer finance blog, in June 2024.

What Happened?

In May 2024, the Financial Stability Oversight Council (FSOC) issued its Report on Nonbank Mortgage Servicing. The report recognizes the strengths of nonbank mortgage companies (NMCs) and their important role. However, the council warns that the vulnerabilities of NMCs are more acute due, in part, to the mortgage market shift from banks to NMCs, the increasing federal government exposure to NMCs, financial strain of nonbank originators following the end of the refinance boom, and considerable liquidity risk from NMCs funding sources. The council warns that it will continue to monitor such risks and take or recommend additional actions in accordance with its 2023 analytic framework and nonbank designation guidance, which we discussed in a prior post in *Of Interest*, Alston & Bird's consumer finance blog. The council also makes several recommendations, including asking Congress to establish a fund financed by the nonbank mortgage sector and administered by an existing federal agency to ensure there are no taxpayer-funded bailouts should a nonbank mortgage servicer fail.

Why Does It Matter?

The Dodd–Frank Act empowers the FSOC to designate a nonbank financial company subject to enhanced prudential standards and supervision by the Federal Reserve's Board of Governors by a two-thirds vote of the council. The council is composed of 10 voting members: the U.S. prudential regulators, the director of the Consumer Financial Protection Bureau (CFPB), the director of the Federal Housing Finance Agency, the chair of the Securities and Exchange Commission,

the chairman of the Commodity Futures Trading Commission, an independent member having insurance expertise, and five nonvoting members, with the Secretary of the Treasury serving as the council's chairperson.

This designation can be made upon the council's finding that: (1) material financial distress at the nonbank financial company could pose a threat to U.S. financial stability; or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to U.S. financial stability.

The council's 2023 analytic framework provides a nonexhaustive list of eight potential risk factors and the indicators that the FSOC intends to monitor, including: (1) leverage; (2) liquidity risks and maturity mismatches; (3) interconnections; (4) operational risk; (5) complexity of opacity; (6) inadequate risk management; (7) concentration; and (8) destabilizing activities. Additionally, the FSOC will assess the transmission of those risks by evaluating exposure, asset liquidation, critical function or service, and contagion. The procedural 2023 nonbank designation guidance defines a two-stage process the council will use to make a firm-specific "nonbank financial company determination" pursuant to the FSOC's analytic framework. The council also has the authority to make recommendations to regulators and Congress and to engage in interagency coordination.

The 2024 report on nonbank mortgage servicing

At the outset, the council recognizes that the NMC market share has increased significantly. According to Home Mortgage Disclosure Act data, NMCs originate around two-thirds of mortgages in the United States and owned the servicing rights on 54% of mortgage balances in 2022 compared with 2008 when NMCs originated only 39% of mortgages and owned the servicing rights on only 4% of mortgage balances. Moreover, in the 10-year period between 2014 and 2024, the share of agency (i.e., Fannie Mae, Freddie Mac, and Ginnie Mae) servicing handled by NMCs increased from 35% to 66%.

In 2023, NMCs serviced around $6 trillion for the agencies and approximately 70% of the total agency market.

The FSOC recognizes that NMCs filled a void following the 2007–2009 crisis when banks exited the market due to several factors (such as the revised capital rules on banks, making mortgage servicing rights (MSRs) less attractive, as well as perceived increased costs of default servicing resulting from the National Mortgage Settlement, the Independent Foreclosure Review, prosecutions under the False Claims Act, and private litigation.) According to the FSOC, NMCs developed substantial operational capacity and embraced technology. The council also recognizes NMCs' strength in servicing historically underserved borrowers. In 2022, NMCs originated more than 70% of the mortgages extended to Black and Hispanic borrowers and more than 60% of those made to low- and moderate-income borrowers.

While recognizing the strengths of NMCs, the report also highlights several vulnerabilities. Of the eight risk factors identified in the analytic framework, the FSOC focuses its concerns on the following four vulnerabilities:

- **Liquidity Risks and Maturity Mismatches.** As noted in the 2023 analytic framework, a shortfall of sufficient liquidity to cover short-term needs, or reliance on short-term liabilities to finance longer-term assets, can lead to rollover or refinance risk. The FSOC may measure this risk by looking at the ratios of short-term debt to unencumbered liquid assets and the amount of additional funding available to meet unexpected reductions in available short-term funds. The FSOC reports "considerable" liquidity concerns from NMCs' funding sources and servicing contracts. First, NMCs' reliance on warehouse lines of credit can result in (1) margin calls; (2) repricing or restructuring lines by raising interest rates, changing the types of acceptable collateral, or canceling lines; (3) exercising cross default provisions; and (4) the risk of multiple warehouse lenders enforcing covenants or imposing higher margin requirements at the same time. Second, NMCs face liquidity risk from margin calls on the hedges in place to protect interest rate movements while mortgages are on a warehouse line. Third, NMCs face liquidity risks from their lines of credit that are collateralized by MSRs, which can also result in margin calls. Finally, requirements to advance funds on behalf of the investor (particularly Ginnie Mae) or repurchase mortgages from securitization pools may result in liquidity strains.
- **Leverage.** As stated in the analytic framework, leverage is assessed by levels of debt and other off-balance sheet obligations that may create instability in the face of sudden liquidity restraints within a market or at a limited number of firms in a market. To assess leverage, the council may look at quantitative metrics such as ratios of assets, risk-weighted assets, debts, derivatives liabilities or exposures, and off-balance sheet obligations to equity. The report cites data from Moody's Ratings that requires an NMC to have a ratio of secured debt to gross tangible assets of less than 30% for its long-term debt rating to be investment grade. In the third quarter of 2023, 37% of NMCs met this standard and 35% of NMCs had ratios over 60%, which is considered a high credit risk. According to the FSOC, equity funding by NMCs add to leverage vulnerability.
- **Operational Risk.** As noted in the analytic framework, operational risk arises for the "impairment or failure of financial market infrastructures, processes or systems, including due to cybersecurity vulnerabilities." The report highlights that for NMCs, operational risks include continuity of operations, threats from cyber events, third-party risk management, quality control, governance, compliance, and processes for servicing delinquent loans.
- **Interconnections.** According to the 2023 analytic framework, direct or indirect financial interconnections include exposures of creditors, counterparties, investors, and borrowers that can increase the potential negative effect measured by the extent of exposure to certain derivatives; the potential requirement to post margin or collateral; and the overall health of the balance sheet. Through warehouse lenders, other financing sources, and servicing and subservicing relationships, NMCs are connected to each other. Because of such linkages, the council is concerned that financial difficulties at one core lender could affect many NMCs.

Because of these NMC vulnerabilities, the FSOC is concerned that NMCs could transmit the negative effects of shocks to the mortgage market and broader financial system through the following channels discussed in the analytic framework:

- **Critical Functions and Services.** A risk to financial stability, the analytic framework states, can arise if there could be a disruption of critical functions or services that are relied upon by market participants for which there is no substitute. The FSOC is concerned that an NMC under financial strain would not have the resources to carry out its core responsibilities, which could result in bankruptcy, borrower harm, operational harm, or servicing transfers mandated by state regulators.

The council's 2023 analytic framework provides a nonexhaustive list of eight potential risk factors and the indicators that the FSOC intends to monitor.

- **Exposures.** This refers to the level of direct and indirect exposure of creditors, investors, counterparties, and others to specific instruments or asset classes. Again, if an NMC faced financial strain that impacted the ability of the National Mortgage Settlement to execute its functions, other counterparties could be harmed, including investors and credit guarantors. The agencies could also experience high costs and credit losses and may have challenges in transferring servicing to a more stable servicer. The report notes that "servicing assumption risk may be slightly less acute (though not less costly) for the enterprises, which have more preemptive tools available to them to assist a servicer in distress than Ginnie Mae does."

- **Contagion and Asset Liquidation.** While these are two separate risks, the council grouped them together. As defined in the analytic framework, contagion is the potential for financial contagion arising from public perceptions of vulnerability and loss of confidence in widely held financial instruments. Asset liquidation is rapid asset liquidation and the snowball effect of a widespread asset selloff across sectors. The council is concerned that because MSRs are a large share of NMCs' assets, "changes in macroeconomic conditions or funder risk appetite" could depress MSR valuations, resulting in rapid liquidation and having a material impact on NMC solvency and access to credit.

Because of the federal government's financial support to Fannie Mae and Freddie Mac, and the direct responsibility for Ginnie Mae's guarantee to bond investors, the federal government has an interest in addressing servicing risks. The FSOC does not believe such risks, as identified above, are sufficiently addressed by the states or existing federal authority. First, "[n]o federal regulator has direct prudential authorities over nonbank mortgage servicers." Second, the state regulators have prudential authority, but only nine states (as of April 2024) have adopted prudential financial and corporate governance standards. To that end, the council recommends:

- State regulators adopt enhanced prudential requirements, further coordinate supervision of nonbank mortgage servicers, and require recovery and resolution planning for large nonbank mortgage servicers.
- Federal and state regulators should continue to monitor the nonbank mortgage sector and develop tabletop exercises to prepare for the failure of nonbank mortgage servicers.
- Congress should provide the Federal Housing Finance Agency and Ginnie Mae with additional authority to establish safety and soundness standards and directly examine nonbank mortgage servicer counterparties for compliance with such standards. Congress should also authorize Ginnie Mae and encourage state regulators to share information with each other and council members.
- Congress should consider legislation to provide more protections for borrowers to keep their homes.
- Congress should consider providing Ginnie Mae with the authority to expand its Pass-Through Assistance Program to include tax and insurance payments, foreclosure costs, or advances during periods of severe market stress.
- Congress should through legislation establish a fund (financed by the nonbank mortgage servicing sector) to facilitate operational continuity of servicing for servicers in bankruptcy or failure to ensure the servicing obligations can be transferred or the company is recapitalized or sold. The council recommends that Congress provide "sufficient authority to an existing federal agency to implement and maintain the fund, assess appropriate fees, set criteria for making disbursements, and mitigate risks associated with the implementation of the fund."

What Do I Need to Do?

Shortly after the report was issued, CFPB Director Rohit Chopra issued a statement, indicating that: "The Report is silent on what, if any, tools the FSOC itself should use to address these risks. That must be the next phase of our work. In line with the 2023 Analytic Framework and Nonbank Designation Guidance, we should carefully consider whether any large nonbank mortgage companies meet the statutory threshold for enhanced supervision and regulation by the Federal Reserve Board."

Given that warning, NMCs should pay careful attention to the statutory threshold for enhanced supervision and work on mitigating their liquidity and other risks. The report points out that the CSBS-enhanced prudential standards are enforceable by the states that have adopted such standards, "including through multistate examinations that include at least one state that has adopted the standards or through referrals to states that have adopted these standards." Thus, servicers should anticipate more state or multistate probes concerning liquidity and corporate governance. Now is the time to double down on managing operational risks, including continuity of operations, threats from cyber events, third-party risk management, quality control, governance, compliance, and processes for servicing delinquent loans. ■

An Update to Climate Risk Disclosures Among the SEC, CA, and the EU: Navigating Next Steps

The Securities and Exchange Commission (SEC) recently adopted new climate-related disclosure rules but due to litigation, stayed the effect of these rules. Because of the stay, many public companies are contemplating how to proceed with these rules. Given the additional regulatory requirements for California, the EU's Corporate Sustainability Reporting Directive (CSRD), the SEC's 2010 guidance, and current investor expectations, public companies would be well served to continue to put in place their climate and sustainability-related programs at a measured pace.

SEC Climate Rules

On March 6, 2024, the SEC adopted the climate risk rules it initially proposed in 2022, requiring public companies to provide certain climate-related disclosures. The new SEC climate rules require disclosure on direct and indirect greenhouse gas emissions; oversight and governance; climate-related risks that have had or are reasonably likely to materially impact the business, strategy, and outlook; and recoveries as a result of severe weather or natural conditions. On April 4, 2024, due to the increasing number of petitions filed challenging the rules, the SEC voluntarily stayed its newly adopted climate rules, pending judicial review. Although the new SEC climate rules are temporarily stayed, companies must still comply with the SEC's 2010 guidance on disclosure for climate change. During the stay, the SEC will likely continue to issue comment letters based on their 2010 guidance.

California

In California, a trio of climate-related disclosure laws will impose far-reaching reporting requirements on companies that do business in the state.

The first, the Climate Corporate Data Accountability Act (CCDAA, also referred to as SB 253), will require companies that have more than $1 billion in annual revenue to disclose Scopes 1, 2, and 3 emissions. Reporting these emissions will be subject to any regulations published by the California Air Resources Board (CARB).

The second, the Climate-Related Financial Risk Act (CRFRA, also referred to as SB 261), requires companies doing business in California with more than $500 million in annual revenue to report their climate-related financial risks and measures that they are using to mitigate these risks using the Task Force on Climate-Related Financial Disclosures, or equivalent, framework.

Lastly, the Voluntary Carbon Market Disclosures Act (VCMDA, also referred to as AB 1305) requires companies that operate in California and make claims of net zero, carbon neutrality, or significant emissions reductions to substantiate them on their website. Substantiating these claims will require providing some documentation of the accuracy of the claims and means of achieving the claims or progress toward them. Moreover, the VCMDA includes additional reporting requirements for companies that purchase voluntary carbon offsets.

The timing for when each of the laws in the California trio goes into effect is staggered. The CCDAA requires Scope 1 and Scope 2 emission reporting by January 1, 2026 but delays Scope 3 reporting to 2027, within six months of disclosing Scope 1 and Scope 2 emissions. Similarly, the CRFRA requires that companies have relevant claims substantiated on their websites by January 1, 2026. The VCMDA was originally slated to take full effect on January 1, 2024 and is expected to be amended shortly to delay the disclosure deadline to January 1, 2025.

Despite the trio's goals, we have already seen pushback from businesses. Uncertainty remains around the definition of "doing business" in California under the CCDAA and the CRFRA and how far the ultimate definition will reach. As of now, CARB has not published any notices of rulemaking to promulgate regulations to implement these rules.

EU Corporate Sustainability Reporting Directive

The EU's CSRD, now in effect, imposes rules requiring certain companies to publish information across a number of sectors, including climate change, environmental impact, and societal impact. The European Union adopted the CSRD with aims of modernizing and strengthening reporting requirements on environmental and social information. The new rules are designed to equip investors with information on the impact companies have on people and the environment ("impact materiality") and the impact that climate change and other considerations have on companies financially ("financial materiality")—collectively referred to as "double materiality."

Despite the trio's goals, we have already seen pushback from businesses.

Companies will need to analyze whether their immediate entity or any other related entities are required to report under the CSRD. Reporting requirements will phase in over time.

- 2025 – Relevant EU-incorporated companies already subject to the EU's Non-Financial Reporting Directive are required to publish reports for fiscal years starting on or after January 1, 2024.
- 2026 – Large companies (including non-EU companies listed on an EU-regulated market) and parents of large EU groups (including those headquartered in the United States) are required to publish reports for fiscal years starting on or after January 1, 2025. A large company or large group is defined as a company or group that meets two out of the three following criteria: (1) net turnover of more than €40 million; (2) balance sheet total assets greater than €20 million; and (3) more than 250 employees.
- 2027 – Other small and medium enterprises (other than micro undertakings) listed on an EU-regulated market are required to publish reports for fiscal years starting on or after January 1, 2026.
- 2029 – Non-EU groups (including those headquartered in the United States) with significant activity in the EU are required to publish reports for fiscal years starting on or after January 1, 2028.

The CSRD requires reporting companies to use the European Sustainability Reporting Standards (ESRS) developed by the European Financial Reporting Advisory Group. The standards require reporting companies to report on two general "cross-cutting standards" and also to determine which of 10 "topical standards" are material to its business and accordingly report to those specific standards.

The cross-cutting standards set out sector-agnostic requirements that apply to all the topics covered by the CSRD, separated into (1) general requirements; and (2) general disclosures.

The topical standards are divided into five environmental standards (ESRS E1 through ESRS E5), four social standards (ESRS S1 through ESRS S4), and one governance standard (ESRS G1). This includes Scopes 1, 2, and 3 emissions. Each standard follows the same premise: disclose any relevant risks, impacts, and opportunities that are material for the company, then disclose the policies, actions, and targets in place to mitigate those risks and impacts.

Alternatively, companies should provide an explanation stating why such standards are not material from either an impact materiality or financial materiality perspective. Groups or companies with fewer than 750 employees will have additional time to comply; for example, they will not need to include data on certain greenhouse gas emissions under ESRS E1 and, for the first two years, may disregard standards on biodiversity under ESRS E4 and all of the social standards other than ESRS S1.

The CSRD requires reporting companies to analyze under a "double materiality" assessment that requires an assessment of both (1) the impact of the undertaking on people and the environment; and (2) a financial assessment of how sustainability matters affect the undertaking, and to report accordingly. Information must be provided on the company's own operations as well as its value chain, both upstream and downstream. This materiality determination is broader than standards that focus on investor-perspective materiality.

Companies will initially need to seek "limited" assurance on information to be disclosed. When a non-EU company is subject to the CSRD, reporting should also be certified, either by a European or third-country independent auditor. This standard of assurance may be heightened going forward.

Companies should consider whether their company or any EU subsidiary falls within the scope of the CSRD. The CSRD will require disclosure beyond what is required by the SEC and California. Companies expecting to report under the CSRD should be preparing to collect relevant data to be in a position to report when required. In preparation for eventual reporting, companies should note any revisions to the ESRS.

Companies should consider whether their company or any EU subsidiary falls within the scope of the CSRD.

Takeaways

While the new SEC disclosure rules are currently voluntarily stayed, the rules may later be implemented in original or modified form, creating extensive climate-related disclosure requirements for public companies. Additionally, reporting requirements under the CCDAA, CRFRA, VCMDA, and CSRD create additional requirements that go beyond the scope of the SEC rules.

Affected companies, including public companies, companies with a presence in California, companies operating in the EU, and companies with subsidiaries operating in the EU, should be proactive and not wait until the disclosure is required to begin preparations for applicable required disclosures. Affected companies should consider taking the following steps to prepare for and comply with the required disclosures

under these rules. Below are some next steps companies can take in light of these disclosure rules.

- Determine which climate-related rules and regulations apply to the company to prepare to comply.
- Develop and enhance the company's existing climate-related infrastructure, including data collection and accuracy, internal controls, delegation of responsibility, and climate-related decision-making frameworks.
- Analyze climate risks' impact on the company's business operations, strategy, goals, outlook, and other planning.
- Develop definitions for and familiarize management with terms used in the various climate-related regulations, including "material," "severe weather event," and "natural conditions."
- Consider subjecting climate-related disclosures to more extensive board and auditor review, similar to financial disclosures.
- Review board committee charters to determine if there is a clear delegation of board oversight of climate-related disclosures and tracking processes. If there is no board committee charter containing climate-related responsibilities, companies should consider formalizing the board oversight processes for climate-related activities.
- Determine the materiality—in accord with the applicable disclosure standards—of Scope 1, Scope 2, and Scope 3 emissions to their business and begin to track and identify emissions sources, gather data, and synthesize information to prepare for required disclosures.
- Find third-party service providers to assist with the tracking and reporting of Scope 1, Scope 2, and Scope 3 emissions (if applicable) and any assurances required.
- Educate members of management and the board about the climate-related regulatory framework, the company's reporting obligations under the regulatory framework, and the company's climate-risk management procedures and policies.
- Evaluate the company's existing and proposed climate-related goals and identify tangible actions taken to achieve the goals. ■

Data Breach Notification Requirements Under the Safeguards Rule Now in Effect

This article originally appeared in Alston & Bird's Privacy, Cyber & Data Strategy blog in June 2024.

For years, the Gramm–Leach–Bliley Act (GLBA) has required financial institutions to maintain reasonable safeguards for consumer data but has only had limited breach-reporting requirements. To the extent financial institutions were subject to breach-reporting obligations, these were set by non-GLBA legislation, such as state law, or by relatively narrow incident-reporting rules under interagency guidelines overseen by banking regulators.

This changed on May 13, 2024, when new breach-notification requirements under the Federal Trade Commission's (FTC) GLBA Safeguards Rule came into effect. These new FTC rules represent a significant change for financial institutions overseen by the FTC, requiring a new form of regulatory notification covering a much wider range of incidents.

What Happened? Why Is It Important?

The GLBA has long had its Safeguards Rule that requires financial institutions to maintain the security of customer and consumer information. However, the GLBA itself does not contain breach-notification obligations. Instead, financial institutions' breach-reporting obligations have primarily derived from state law. Additionally, a subset of financial institutions overseen by banking regulators is subject to breach-reporting guidance in the Interagency Guidelines Establishing Security Standards. But, in addition to applying only to a subset of financial institutions, these guidelines only required reporting incidents that impacted a defined subset of "sensitive" customer data fields.

As of May 13, 2024, a new breach-reporting obligation under the FTC's GLBA data security regulations went live. Going forward, financial institutions subject to FTC jurisdiction are now required to report to the FTC data breaches that impact 500 or more individuals.

This may represent a substantial change for in-scope financial services companies. Until now, the FTC's GLBA rules did not contain breach-reporting obligations; FTC-overseen financial institutions generally reviewed breach-notification obligations under state laws, not under the GLBA or federal standards. The FTC's new breach-notification obligations for financial institutions it oversees thus potentially require businesses to implement new policies and processes to aid compliance.

Who Is Covered?

Financial institutions subject to FTC jurisdiction are required to comply. These are financial institutions that are *not* subject to supervision by other financial regulators, such as the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Association, Office of Thrift Supervision, Securities Exchange Commission (SEC), or state insurance commissioners. FTC financial institutions generally include:

- Mortgage lenders
- Finance companies
- Mortgage brokers
- Account servicers
- Wire transferors
- Non-federally-insured credit unions
- Investment advisers that are not required to register with the SEC

What Must Be Reported to the FTC?

Data breaches are considered reportable if they involve the unauthorized acquisition of unencrypted customer information of 500 or more individuals. Unlike in state data breach laws and in the interagency guidelines applicable to banks, "customer information" is defined broadly as any nonpublic personal information whatsoever relating to customers—not an enumerated list of particularly sensitive data fields such as Social Security numbers, credit/debit card numbers, or the like. Thus, the FTC's breach-notification rule potentially requires reporting (or evaluation for reporting) for a broader range of incidents than in the past.

The FTC's new breach-notification obligations for financial institutions it oversees potentially require businesses to implement new policies and processes to aid compliance.

Breaches are considered reportable if they involve the "acquisition" of customer information. In-scope entities would thus potentially have to report incidents when data is "taken" in some way, such as copied, downloaded, or exfiltrated. Unauthorized "acquisition" of unencrypted customer information will be presumed to include unauthorized access of such information unless the financial institution has "reliable" evidence that there has not been, or could not reasonably have been, unauthorized acquisition of the information.

Unlike under certain state laws, the FTC's breach-notification requirement does *not* contain a "risk of harm" analysis or threshold. Previous drafts of the FTC's rules would have required a risk of "misuse" to have been apparent from the incident, but the FTC removed this requirement from the final rule.

In-scope entities required to notify the FTC would have to do so within *30 days* of discovering the breach. This is largely consistent with reporting deadlines in some state data breach statutes.

In efforts to make reporting easy for companies, the FTC has provided an online "security event reporting form." The FTC has stated it intends to publish breach reports it receives on its websites.

What Are Penalties for Noncompliance?

Noncompliance is subject to enforcement by the FTC. Notably, the FTC has read the GLBA in the past as granting it authority to issue fines and civil penalties for "first-time" offenses. Recent FTC cases show the FTC aggressively investigating companies that fail to report security incidents and imposing substantial nonmonetary penalties as well, such as mandated security programs, annual executive compliance certifications, or years of third-party monitoring.

What Can Our Company Do?

If your company is in-scope for FTC supervision, we recommend reviewing internal breach-reporting processes to confirm they can enable compliance with the FTC's new rules.

- Incident response plans should be updated as needed to make sure that (1) incidents are reviewed, escalated, and evaluated under the FTC's definition of a reportable incident; and (2) incident evaluation timelines enable you to meet FTC deadlines.
- Internal data and IT mapping should be updated to reflect where "customer information" potentially subject to FTC breach-reporting obligations is stored. Data may need to be considered for reclassification based on whether it may trigger FTC reporting requirements.
- This is also an opportunity for companies to confirm that their broader cybersecurity and information security programs are compliant with the FTC's GLBA safeguards standards. Any reporting to the FTC could be met with broader requests for information about the company's security practices. The FTC has published detailed guidance about the elements it expects businesses' security programs to include. (We summarized the FTC's requirements on our privacy blog as well.) After a breach notification to the FTC, all of these could potentially become fair game for FTC follow-up requests.
- Lastly, it may be prudent to review contracts with vendors to confirm that vendors provide incident-notification terms needed to enable companies to comply with the FTC's new breach-reporting requirements. ■

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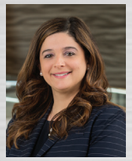

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