Impact of the Proposed Regulations On Securitizations

Introduction

Securitization has been the focus of many rulemaking initiatives in the wake of the financial crisis. The Volcker Rule is not directly targeted at securitization and expressly states that nothing in it should be construed to limit or restrict the ability of a banking entity to securitize loans.[1] Nevertheless, the proposed regulations, if enacted in their current form, would prohibit or restrict banking entities from engaging in many common securitization practices in the asset-backed commercial paper market and in other sectors. The most significant issues arise because the definition of "covered fund," which is intended to target hedge funds and private equity funds, also encompasses many issuers of asset-backed securities (ABS), including collateralized debt obligations (CDOs) and asset-backed commercial paper (ABCP) conduits. Banking entities will be prohibited from holding an ownership interest in or sponsoring a covered fund under the proposed regulations, subject to narrow exceptions. The proposed regulations effectively would mean that a U.S. bank could not sponsor and lend to an ABCP conduit in the manner that most such conduits are currently structured and could not hold an ownership interest in a CDO. In addition, the prohibition in the proposed regulations on proprietary trading would require banking entities, which could include bank-sponsored issuers of ABS that do not fall under the definition of covered funds, to establish and implement compliance programs and satisfy recordkeeping and reporting requirements.

Prohibition on Banking Entity Investment in Covered Funds

The proposed regulations prohibit banking entities from directly or indirectly acquiring or retaining an ownership interest in or sponsoring a covered fund, subject to certain exceptions. A "covered fund" is defined to include "[a]n issuer that would be an investment company, as defined in the Investment Company Act of 1940 … but for section 3(c)(1) or 3(c)(7) of that Act."[2]

Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities (other than commercial paper) are beneficially owned by no more than 100 persons and are not offered in a public offering in the United States.[3] Section 3(c)(7) is an exclusion for issuers who do not offer their securities in a public offering in the United States and who restrict the offering to "qualified purchasers," a category of large investors similar to those who would qualify as "qualified institutional buyers" for the purposes of Rule 144A under the Securities Act.[4] These exclusions are utilized for many types of securitization transactions including CDOs, collateralized loan obligations (CLOs) and ABCP conduit transactions.

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[1] Dodd-Frank Act § 619(g)(2), 12 U.S.C. § 1851(g)(2).

[2] Proposed Regulations § __.10(b)(1).

[3] By a series of no-action letters beginning with Touche Remnant Co., SEC No-Action Letter, 1984 SEC No-Act, LEXIS 2566, at *1 (Aug. 27, 1984), a non-U.S. issuer may conduct an offshore offering and a private U.S. offering simultaneously and count only the U.S. beneficial owners for that test.

[4] Similar to the relief provided in the Touche Remnant no-action letter under Section 3(c)(1), the SEC staff provided no-action letter relief under Section 3(c)(7) in Goodwin, Procter & Hoar, SEC No-Action Letter, 1997 SEC No-Act, LEXIS 375, at *1 (Feb. 28, 1997), to the effect that an offshore fund may conduct an offshore offering and a private U.S. offering simultaneously and only the U.S. beneficial owners need be qualified purchasers under Section 3(c)(7).

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Alternative Investment Company Act Exemptions. Many issuers of ABS rely on other exclusions from investment company status, most significantly Section 3(c)(5) of the Investment Company Act and Rule 3a-7 under the Investment Company Act rules and regulations.[5] Most traditional securitizations, including mortgage loan, auto loan and credit card securitizations, rely on the exemptions provided under Section 3(c)(5) or Rule 3a-7, or both. Many mortgage financing transactions, including those involving real estate investment trusts (REITs), rely on Section 3(c)(5)(C). If an entity, including an ABS issuer, satisfies the requirement for an Investment Company Act exclusion or exemption other than Section 3(c)(1) and 3(c)(7), it will not be a "covered fund" under the proposed regulations, even if that entity is subject to a legal document that requires compliance with Section 3(c)(1) or 3(c)(7).

Other Recent SEC Proposals Modifying Investment Company Act Exemptions. The SEC recently requested public comment on two separate proposals:

- a concept release with respect to Section 3(c)(5)(C) of the Investment Company Act, and
- an advanced notice of proposed rulemaking with respect to Rule 3a-7 and Section 3(c)(5) that could significantly restrict or in some circumstances eliminate the ability of ABS issuers to rely on these exemptions.[6]

In particular, the SEC questions whether Section 3(c)(5) should be amended to limit the ability of issuers of ABS to rely on Section 3(c)(5) and what the effect would be if issuers of ABS could no longer rely on Section 3(c)(5). The result could be that Rule 3a-7 would no longer be just a safe harbor for issuers of ABS but would become the exclusive means for an issuer of ABS to avoid investment company status without also becoming a covered fund under the proposed regulations under the Volcker Rule.

However, the SEC has suggested significant new conditions to obtaining the relief provided by Rule 3a-7, including a requirement for independent review of the underlying assets and an opinion from an independent evaluator regarding expected cash flows from the assets; appointment of a credit risk manager to evaluate repurchase requests related to breaches of representations and warranties, consistent with an SEC proposal for S-3 shelf-eligibility for ABS; and incorporation of requirements that may be adopted with respect to conflicts of interest in ABS transactions and risk retention requirements. These additional conditions could be added in lieu of the current references to ratings from a nationally recognized statistical rating organization that may be removed from Rule 3a-7 in response to the Dodd-Frank Act directive to review any references to or requirements regarding credit ratings in regulations.[7]

It is too early to determine what, if any, additional conditions may be imposed upon reliance on Rule 3a-7 and whether Section 3(c)(5) will remain available for ABS transactions. Ultimately, issuers could find that

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[5] Section 3(c)(5) of the Investment Company Act provides an exclusion for an entity primarily engaged in the business of purchasing or acquiring receivables and other obligations representing part or all of the sales price for merchandise, insurance or services; making loans to manufacturers, sellers or purchasers of merchandise, insurance or services; or purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Rule 3a-7 provides an exclusion for most ABS issuers if they issue fixed-income securities that entitle their holders to receive payments that depend primarily on the cash flow from financial assets that convert into cash within a finite time period, subject to certain conditions.

[6] *See* SEC Press Release, *SEC Seeks Public Comment on Asset-Backed Issuers and Mortgage-Related Pools Under Investment Company Act* (Aug. 31, 2011), *available at* http://www.sec.gov/news/press/2011/2011-176.htm See *also* Concept Release, Request for Comments, *available at* http://www.sec.gov/rules/concept/2011/ic-29778.pdf; Advance Notice of Proposed Rulemaking, *available at* http://www.sec.gov/rules/concept/2011/ic-29779.pdf. The exclusion provided by Section 3(c)(5) was included in the Investment Company Act at a time prior to the development of ABS but was the main exclusion relied upon by issuers of ABS prior to the adoption of Rule 3a-7 in 1992.

[7] Dodd-Frank Act § 939(a), 12 U.S.C. §§ 1817 & 1831(e).

Section 3(c)(5) is no longer available and Rule 3a-7 is subject to prohibitive conditions. The remaining option for issuers in those asset classes would be to pursue private transactions that rely solely upon the exemptions provided by Section 3(c)(1) or Section 3(c)(7), which would cause the issuer to be a "covered fund" under the proposed regulations. [8]

Definition of Ownership Interest. A banking entity is permitted to acquire or retain an interest in, or a security of, an ABS issuer that is a covered fund if the interest or security does not qualify as an "ownership interest" under the proposed regulations. "Ownership interest" means any equity, partnership or other similar interest in a covered fund, whether voting or nonvoting, as well as any derivative of such interest.[9] The focus of the definition is on whether the interest in the covered fund provides a banking entity with exposure to the profits and losses of the covered fund rather than on the form of the interest in the covered fund held by the covered banking entity. A security in the form of debt that would expose the banking entity to the profits and losses of the covered fund could be deemed an ownership interest.

Definition of Sponsor. A covered banking entity is prohibited from acting as a "sponsor" of a covered fund. The proposed definition of "sponsor" focuses on the ability to control the decision-making and operational functions of the covered fund.[10] The definition of "sponsor" used in the proposed regulations is different from the definition used in SEC's Regulation AB, which focuses on the person who organizes and initiates an ABS transaction.[11] In the introduction to the proposed regulations, the agencies request public comment as to whether a "sponsor," as defined under Regulation AB, would be an appropriate party to treat as a "sponsor" under the proposed regulations.[12] While it is not entirely clear, a servicer or a collateral manager could be viewed as a "sponsor" under the proposed regulations, and the agencies specifically request public comment on this potential result.[13]

'Three Percent Rule' Exception. Among the exceptions to the prohibition on a covered banking entity acquiring or retaining an ownership interest in a covered fund is the "3 percent rule," which provides that:

- the banking entity's investment in a covered fund may not represent more than 3 percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule);
- the banking entity's investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment; and
- a banking entity may invest no more than 3 percent of its Tier 1 capital in covered funds.[14]

[8]It should be noted that the SEC has proposed that a private ABS transaction contain all the disclosure required of public ABS transactions in Reg AB relating to that asset class. *See* SEC Proposed Rule Release No. 33-9117 (April 7, 2010) *available at* http://www.sec.gov/rules/proposed/2010/33-9117.pdf. *See also* Skadden, Arps, Slate, Meagher & Flom LLP, Summary of SEC's Proposed Changes to Regulation AB, *available at* http://www.skadden.com/content/sitefiles/Skadden_B8DFAEB3452B3136EB9F870A4E68968B.pdf (June 7, 2010).

[9]Proposed Regulations § __.10(b)(3). *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

[10]Proposed Regulations § __.10(b)(5). *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

[11]In Regulation AB, "sponsor" is defined as the 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 issuing entity. *See* 17 C.F.R. 229.1101(l) (2011).

[12]Notice at 117 (Question 219).

[13]Notice at 117 (Question 220).

[14]Proposed Regulations § __.12a. *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

For a covered fund that is an ABS issuer, depending on the transaction structure, the calculation to determine if the banking entity is in conformance with the 3 percent rule may need to be performed each time a payment is made to any holder of the issuer's ABS and, in any event, no less frequently than at the end of every quarter.[15] A banking entity holding a subordinate interest in a securitization that constitutes an ownership interest would need to consider the possibility of breaching this test if, as is typical, the percentage it represents increases as a percentage of the pool balance as any senior securities that would be viewed as ownership interests are paid down prior to the subordinate interest.

Loan Securitization Vehicle Exemption. The proposed regulations permit a covered banking entity to acquire or maintain an ownership interest in, or sponsor, a covered fund if the covered fund is an issuer of asset-backed securities and the assets or holdings of the ABS issuer are solely comprised of:

- loans;
- contractual rights or assets directly arising from those loans supporting the asset-backed securities; and
- interest rate or foreign exchange derivatives that:
  - materially relate to the terms of such loans or contractual rights or assets; and
  - are used for hedging purposes with respect to the securitization structure.[16]

This provision is designed to implement Section 13(g)(2) of the BHC Act, which provides that nothing in Section 13 of the act is to be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law.[17] The agencies, however, have taken a narrow approach to crafting the exception for this permitted activity. This exemption does not explicitly permit several other types of assets often held by ABS issuers, such as liquidity arrangements (including liquidity and asset purchase agreements and third-party credit enhancement agreements, such as guarantees or letters of credit). Moreover, it does not address servicer advances, which are common features of residential and commercial mortgage securitizations.

Most significantly, the definition of "loans" in the proposed regulations is limited to "any loan, lease, extension of credit, or secured or unsecured receivable."[18] The introduction to the proposed regulations indicates that the definition of "loan" is intended to exclude ABS issued in connection with a loan securitization or otherwise backed by loans, which would mean that holding an ownership interest in or sponsoring a covered fund that is a CDO backed by a portfolio of asset-backed securities would not qualify as a permitted activity for a covered banking entity.[19] In the introduction, the agencies request public comment as to whether a "loan" should exclude a "security."[20] If it does, a covered banking entity would not be permitted under these provisions of the proposed regulations to hold an ownership interest in, or sponsor, a covered fund that is an issuer in a CLO transaction that allows investment in a limited basket of high-yield bonds and other types of securities (and conceivably even re-investment of cash proceeds in short-term investments).

[15]Proposed Regulations § __.12(c)(2)(i).

[16]*Id.* § __.13(d).

[17]Dodd-Frank Act § 619(g)(2), 12 U.S.C. § 1851(g)(2).

[18]Proposed Regulations § __.2(q).

[19]Notice at 45.

[20]Notice at 47 (Question 61).

In addition, the agencies ask whether an ABS transaction with an intermediate securitization, such as an auto lease securitization or many ABCP conduits, should be viewed as a single transaction and included within a securitization of "loans" or viewed as a separate securitization.[21] If viewed as a separate securitization, the exemption for securitization of loans would not apply to the second securitization where the asset is a "security" backed by "loans." This issue would affect not just asset-backed CDOs, but also several common types of traditional securitizations, unless those securitizations can rely on Section 3(c)(5) or Rule 3a-7 rather than Section 3(c)(1) or 3(c)(7). Auto lease securitizations typically involve a trust or other entity that holds the title to the vehicles and leases and issues a security representing the beneficial interest in a specific pool of vehicles and related leases to the entity that issues ABS to third-party investors. Similarly, ABCP conduits often hold variable funding notes issued by securitization vehicles, such as credit card master trusts, as well as direct interests in pools of receivables. If the agencies do not ultimately treat such structures as a single securitization, a covered banking entity would not be permitted under these provisions of the proposed regulations to hold an ownership interest in, or sponsor, a covered fund that holds securities from intermediate securitizations. In this case, the holding of an ownership interest in the covered fund by a banking entity would be limited to the amount permissible under the 3 percent rule. Further, the covered banking entity may be restricted from providing credit and/or liquidity to the ABS issuer.

The provision allowing "contractual rights or assets directly arising from those loans supporting the asset-backed securities"[22] appears to encompass proceeds and rights to foreclose on properties pledged to secure loans; however, it does not explicitly encompass the right to require repurchase of assets for breaches of representations and warranties or the investment of cash proceeds in short-term securities that are cash equivalents pending distribution to security holders.

The proposed regulations limit interest rate and foreign exchange derivatives to a notional amount tied to the outstanding principal balance of the loans supporting the ABS of an issuer.[23] Such derivatives must be used solely to hedge mismatches between the loans and the related ABS. Examples of permitted derivatives include an interest rate swap for a pool of fixed-rate loans collateralizing floating rate ABS or for a pool of loans with rates tied to prime rate collateralizing LIBOR asset-backed securities and a currency swap for a pool of Euro-denominated loans collateralizing dollar-denominated ABS.[24] Interest rate caps related to the terms of the loans also should be acceptable. Credit default swaps and total return swaps would not be permitted assets.

Narrow Exemption for Required Risk Retention. Under Section 941 of the Dodd-Frank Act, regulatory agencies are directed to issue rules regarding risk retention that require a sponsor or originator of an ABS transaction to retain an interest in the securitized assets.[25] The proposed regulations permit the banking entity to comply with this requirement by including an exemption to the prohibition of ownership by a banking entity of an interest in a covered fund that would allow the banking entity to retain the minimum amount required under the risk retention requirements.[26] This allowance is quite narrow given

[21] Notice at 148 (Question 301).

[22] Proposed Regulations § __.13(d)(2).

[23] *Id.* § __.13(d).

[24] Notice at 147.

[25] Dodd-Frank Act § 941(b), 15 U.S.C. § 78o-11. As required under this section, the relevant agencies issued a proposed rule to implement the requirements of Section 15G of the Securities Exchange Act of 1934, as amended. *See* Credit Risk Retention, 76 FR 24090, 24090 (Apr. 29, 2011).

[26] Proposed Regulations § __.14(a)(2)(iii).

that the risk retention proposal acknowledges that investors or other participants in a transaction may require a higher level of retention than is required by the rule. Securitizers offering securities to investors outside the United States may be subject to additional or different risk retention requirements that may exceed the minimum retention required under U.S. regulations.[27] Also, certain forms of retention, like a seller's interest in a credit card securitization transaction, fluctuate in size regularly and thus would typically be maintained in an amount in excess of any minimum requirement to avoid breaching the required minimum when variability causes a reduction in size.

Application of Super 23A and 23B to Securitizations. Issuers of ABS generally have not been considered affiliates of sponsoring banks for purposes of Sections 23A and 23B of the Federal Reserve Act but the proposed regulations generally would deem covered funds to be affiliates of banking entities for purposes of applying Section 23A and 23B. The so-called "Super 23A" prohibitions would restrict certain activities between a banking entity, serving as an investment adviser, investment manager or sponsor to a covered fund, and the covered fund.[28] The proposed regulations generally prohibit banking entities from entering into "covered transactions" with covered funds that would be treated as "affiliates" for 23A purposes.[29] Prohibited covered transactions would include loans or extensions of credit to the covered fund, repurchases of assets from the covered fund — which could prevent a banking entity from repurchasing assets from a covered fund upon a breach of representation or warranty — and issuances of guarantees or letters of credit on behalf of the covered fund.[30] The proposed regulations also provide that any permitted transaction is subject to the requirements of Section 23B of the Federal Reserve Act, as if the banking entity were a member bank and the covered fund were an affiliate of the banking entity.[31] Section 23B requires services and transactions between member banks and affiliates thereof to be on market terms or on terms at least as favorable to the banking entity as those of a comparable transaction by the banking entity with an unaffiliated third party.[32] This would apply to transfers of assets by the banking entity to the ABS issuer and to servicing functions performed by the banking entity.

Effect of Securitization on Proprietary Trading Prohibition. The proposed regulations also contain provisions intended to prohibit banking entities from engaging in proprietary trading transactions.[33] The introduction to the proposed regulations highlights the possibility that issuers of ABS that are not covered funds may be included within the definition of banking entity.[34] This would be the case for an issuer of ABS that does not rely on an exclusion contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act and is an "affiliate" or "subsidiary" of a banking entity, as those terms are defined in the BHC Act.[35] As noted above, issuers of ABS generally do not constitute "affiliates" of their bank sponsors under

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[27] *See, e.g.*, Article 122a of the European Union Capital Requirements Directive, Council Directive 2009/111/EC, art. 122A, 2009 O.J. (L 302) 110, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF.

[28] S*ee* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations

[29] Proposed Regulations § __.16(a).

[30] 12 U.S.C. § 371c.

[31] Proposed Regulations § __.16(b).

[32] 12 U.S.C. § 371c-1.

[33] Proposed Regulations § __.3. *See* Proprietary Trading Restrictions Under the Proposed Regulations

[34] Notice at 21.

[35] *Id.*

the BHC Act because the related bank generally does not "control" the issuer of ABS as defined under the BHC Act. If, however, a banking entity were to satisfy the "control" requirements in relation to an issuer of ABS or the agencies were to interpret the definition of "affiliate" or "subsidiary" broadly, any covered banking entity that exceeds the asset and liability threshold would need to satisfy recordkeeping and internal compliance requirements,[36] which could impose additional costs on securitization transactions and require infrastructure not currently in place for issuers of ABS.

Relationship of the Proposed Regulations to Proposed Conflict-of-Interest Rule Under Section 621

On September 19, 2011, the SEC proposed a new rule pursuant to Section 621 of the Dodd-Frank Act intended to prohibit certain material conflicts of interest between those who create or distribute ABS, including synthetic ABS, and investors in the ABS.[37] The SEC notes in the commentary to the Section 621 conflicts-of-interest rule proposal that, given the similarities between the Volcker Rule and Section 621, the exceptions for risk-mitigating hedging activities and *bona fide* market making-related activities in the proposed Section 621 conflicts-of-interest rule "should be viewed no less narrowly than the comparable exceptions for such activities under the Volcker Rule."[38] The proposed regulations provide much greater detail regarding acceptable market making-related activities and risk-mitigating hedging than is included in the Section 621 conflicts-of-interest rules.[39] These regulations also include detailed compliance and reporting procedures that must be satisfied in order to benefit from the relevant exemptions.[40] Further, the proposed regulations include a provision defining material conflicts-of-interest that are prohibited, if they arise in connection with permitted trading activity, unless addressed and mitigated through timely and effective disclosure or informational barriers.[41]

The Section 621 conflicts-of-interest rule proposal does not explicitly recognize disclosure of information barriers as providing exemptions from the conflicts prohibition, but includes a discussion of disclosure and informational barriers as potential mitigants to conflicts of interest. The guidance provided in the introduction to the proposed regulations with respect to disclosure and informational barriers as mitigants to conflicts of interest establishes a benchmark for potentially incorporating those concepts under the Section 621 conflict-of-interest rule.[42] The proposed regulations require that, in order to be viewed as an effective mitigant to the conflicts-of-interest prohibition, disclosure must be made explicitly and effectively, and in a manner that provides the recipient the opportunity to negate or substantially mitigate any material adverse effect created by the conflict of interest used to restrict the dissemination of information within complex organization.[43] The proposed regulations also provide that information barriers may be a mitigant

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[36]Proposed Regulations § __.20(c). *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[37]*See* Press Release, SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Asset-Backed Securities Transactions (Sept. 19, 2011), *available at* http://www.sec.gov/news/press/2011/2011-185.htm. *See* Skadden, Arps, Slate, Meagher & Flom LLP, SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Securitizations (Sept. 26, 2011), *available at* http://www.skadden.com/Index.cfm?contentID=51&itemID=2538.

[38]*Id.* at 81.

[39]Proposed Regulations §§ __.4(b), __.5, __.13(b).

[40]Proposed Regulation app. C. *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[41]Proposed Regulations § __.8. *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[42]Notice at 189.

[43]Proposed Regulations § __.8(b)(1).

to conflicts, but not if the banking entity knows or should reasonably know that a material conflict of interest arising out of a transaction may result in a material adverse effect on a client, customer or counterparty.[44]

Looking Ahead: Potential Consequences of the Volcker Rule

Despite the inclusion in the Volcker Rule of a provision stating that it is not to be "construed to limit or restrict the ability of banking entities or nonbank financial companies … to sell or securitize loans,"[45] the proposed regulations would prohibit or place significant limitations on common securitization practices. In proposing to define a covered fund by reference to specific exemptions from investment company status, the agencies have swept in ABCP conduits, CDOs, CLOs and other ABS issuers. The consequences of this approach could include:

- forcing ABCP conduits to restructure to qualify for an alternative investment company exemption or exclusion, which could result in fewer types of assets being financed through ABCP conduits;
- eliminating bank sponsored CDOs backed by ABS, high-yield bonds or other securities, which would eliminate a source of liquidity for tranches of residential mortgage loan securitizations and other ABS and therefore make it more difficult for originators to finance those assets and reestablish necessary financing practices in that market;
- placing significant new limitations on the assets that can be included in CLOs, which could hamper that fragile market; and
- restricting banking entities from sponsoring certain auto lease and credit card receivable securitizations that include an intermediate securitization.

[44] *Id.* § __.8(b)(2).

[45] Dodd-Frank Act § 619(g)(2), 12 U.S.C. § 1851(g)(2).