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Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street, SW
Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Docket Number OCC-2013-0010

Securities and Exchange Commission
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Washington, DC 20549-1090
Attn.: Elizabeth M. Murphy, Secretary
File Number S7-14-11

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn.: Robert deV. Frierson, Secretary
Docket No. R-1411

Federal Housing Finance Agency
Constitution Center, (OGC) Eighth Floor
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Washington, DC 20024
Attn.: Alfred M. Pollard, General Counsel
Comments/RIN 2590-AA43

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attn.: Comments, Robert E. Feldman, Executive Secretary
RIN 3064-AD74

Department of Housing and Urban Development
Office of General Counsel
Regulations Division
451 7th Street, SW
Room 10276
Washington, DC 20410-0500
RIN 2501-AD53

Re: Credit Risk Retention Re-Proposal

Dear Mesdames and Sirs:

The Structured Finance Industry Group, Inc. (SFIG)[1] thanks the Office of the Comptroller of the Currency, Treasury (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the U.S. Securities and Exchange Commission (Commission), the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD) (collectively, Joint Regulators) for the opportunity to comment on their Notice of Proposed Rulemaking published in the Federal

[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

Register on September 20, 2013 (Re-Proposal) regarding credit risk retention. The views expressed in this Letter come from our membership, which includes sponsors of structured finance products, investors, financial intermediaries, rating agencies and other market participants.

The SFIG membership believes that securitization is an essential source of core funding for the real economy. It connects investors with appropriate investments and provides consumers and companies with access to capital. Like any powerful tool, securitization must be used carefully, and thoughtful regulation is a part of that. We agree with the Joint Regulators that, "[w]hen properly structured, securitization provides economic benefits that can lower the cost of credit to households and businesses."[2] If carefully designed, credit risk retention can promote behaviors that increase market stability by incentivizing securitizers to monitor and ensure the quality of the assets underlying securitization transactions. If taken too far, however, credit risk retention could render large portions of the securitization market uneconomic, leading to the reduction of available credit and/or increases in borrowing costs for households and businesses.

CRITERIA FOR THE DEVELOPMENT OF RISK RETENTION REQUIREMENTS

We appreciate the effort that the Joint Regulators made in improving their original proposal regarding credit risk retention (Original Proposal)[3] and look forward to working together to ensure feasible risk retention solutions for the securitization industry. In order to do so, we have developed a set of guiding principles that we believe will be helpful in creating appropriate and effective risk retention standards across the industry. We have used these principles, introduced below, to guide our comments across all asset class discussions.

The SFIG membership believes that the criteria laid out in this section provide an evaluation framework that the Joint Regulators can follow to further the goals of risk retention without harming the real economy. SFIG members further believe that both policy and operational issues must be considered in establishing successful risk retention parameters. If either interest is neglected, the risk retention rules will not work well, and may ultimately harm the real economy.

Risk retention requirements should encourage sound underwriting. SFIG members believe that sound underwriting requirements are critical for a strong securitization market that contributes to the strength of the overall financial system and economy.

Risk retention requirements should not be capital prohibitive or, more generally, threaten market viability. SFIG members see value in the Joint Regulators' goal of "minimize[ing] the potential for the proposed rule to negatively affect the availability and costs of credit to consumers and businesses."[4] In order to achieve that goal, risk retention requirements must permit sponsors and originators to continue to structure efficient and effective securitizations. For certain asset classes, the risk retention requirements currently outlined in the

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2 Re-Proposal, 78 Fed. Reg. 57,931 (Sept. 20, 2013).

3 76 Fed. Reg. 24,090 (Apr. 29, 2011).

4 Re-Proposal, 78 Fed. Reg. at 57,934.

Re-Proposal are incompatible with many sponsor business models and common deal structures on an operational and economic basis, as we will further explain in this Letter. This lack of compatibility may ultimately cause market participants to exit these markets, thus leading to the reduction of available credit and/or increases in borrowing costs for a broad group of consumers and businesses. We urge the Joint Regulators to reevaluate the benefit of the proposed requirements in such cases and to consider the principles discussed herein as they finalize the risk retention rules.

The proposed requirements should not necessitate a fundamental overhaul of industry segments that have been working well. Proposed risk retention standards that diverge too significantly from the way in which well-performing loans are currently originated and securitized would require needless and sweeping changes to lending and securitization practices across certain asset classes. The SFIG membership appreciates the significant progress that the Joint Regulators have made in improving the Re-Proposal to address this, and the individual asset class sections of this Letter make additional suggestions to ensure smooth and effective compliance with the risk retention rules.

The economic impact of the proposed requirements should be commensurate with their benefits. We suggest that the Joint Regulators analyze the proposed standards across asset classes to understand both the potential benefits of such standards as well as their impacts on the securitization markets, borrowers, and ultimately the real economy. This approach, when coupled with the other suggestions made in this Letter, will help the Joint Regulators perform their statutorily-mandated cost-benefit analysis of the proposed rules by helping to measure the proposed rule's economic impact, identify relevant costs across asset classes and ascertain reasonable alternative scenarios to assess or quantify the likely quantitative and qualitative costs and benefits of the final rule.

The Joint Regulators should provide clear mechanisms for interpreting and enforcing the risk retention rules. As the securitization market evolves and changes, the effect of the risk retention rules will also change. A rule that is designed to accommodate existing products could unintentionally deter innovation and improvements in the securitization market, particularly if the market cannot determine, with sufficient certainty, how new products or structural innovation will be treated under the rules. Accordingly, market participants must have a clear, efficient, and timely mechanism for obtaining interpretive and other advice from the Joint Regulators. Otherwise market participants may be reluctant to use the financial markets in the face of ongoing uncertainty, as they have been, to some extent, while waiting for the regulations to be implemented. Similarly, in order for the market to fully embrace the regulations and obtain the type of regulatory certainty necessary for smooth and economically stable operation, the Joint Regulators should affirmatively establish in the rules the mechanisms by which the rules will be enforced.

The Joint Regulators must consider how the interplay between this proposal and other regulations will impact the market. We strongly encourage the Joint Regulators to consider how various regulations (both proposed and final) could place untenable constraints on specific markets, resulting in reduced access to financing for a wide range of borrowers. A vast array of regulatory requirements initiated by the Dodd-Frank Act and the Basel Accords have already significantly reduced risk within the financial system. However, rules that are inconsistent or unduly burdensome will impede market recovery. In order to be effective, the credit risk retention rules must consider the impact that other applicable requirements—such as tax, accounting, and bankruptcy rules—play in structuring products in the securitization market and have the flexibility to continue to do so as those requirements evolve over time.

The Joint Regulators must provide sufficient flexibility in the risk retention rules to address the dynamic nature and operational realities of the securitization markets. The industry has developed structures that facilitate particular industries, investors, and assets. The industry is subject to an incredibly complex legal and regulatory regime that has evolved over a significant period of time. This means that there are no "one size fits all" solutions. The final risk retention rules must address the realities of each asset class by identifying the right parties to retain credit risk, the best mechanisms for retaining credit risk and the most effective methods for calculating the requisite credit risk to be retained, and by harmonizing the risk retention rules with other laws applicable to each specific asset class. We have made suggestions for addressing asset-class specific concerns in this Letter. The risk retention rules must integrate smoothly into this legal framework and must have the flexibility to allow market participants to continue to comply with the risk retention rules as those laws are amended over time and to continue to adapt to other changing legal requirements over time. SFIG and its members believe that all of the above are possible while still creating a risk retention framework that will fully support the goals of the Dodd-Frank Act.

EXECUTIVE SUMMARY

A. General Issues.

The SFIG membership believes that the Re-Proposal in many ways furthers the goals of risk retention while still being mindful of the impacts that risk retention will have on securitization markets, and ultimately the real economy. The SFIG membership believes that there are, however, a number of aspects of the Re-Proposal which will adversely impact a wide range of asset classes and the goals of risk retention in general, and ultimately, could impede the achievement of the criteria laid out above.

First, from both policy and operational perspectives, the calculation of fair value and the certifications and calculations required with respect to eligible horizontal retained interests (EHRIs) and internal controls raise a number of concerns for SFIG members. Calculation of fair value under generally accepted accounting principles (GAAP) does not result in a definitive answer, but rather a range of values, which raises a host of questions for which SFIG members seek additional clarity from the Joint Regulators. In addition, many sponsors who consolidate their issuing entities do not utilize fair value calculations today for their securitization interests, so requiring them to do so for risk retention would be a significant burden and expense.

Second, the SFIG membership proposes several alternatives to the Closing Date Projected Cash Flow Rate/Closing Date Projected Principal Payment Rate Calculation required by the Re-Proposal, in order to address concerns raised about the viability of such a fair value calculation for certain asset classes. For example, some deal structures set up to have increasing overcollateralization over time (generally viewed as something that should reduce the credit risk for investors) cannot meet the requirements of this calculation.

Third, given the multitude of transaction types and structures that make up today's financing markets and the continual innovation in this area, SFIG members request that the Joint Regulators pursue a final rule that is more flexible while still fostering the important goals of risk retention. To this end, SFIG members request (1) several alternative options for holding the required risk retention (including the reinstatement of representative sampling methods, and the addition of participating interests and third party credit support as alternative methods) and (2) exemptions to the proposed risk retention scheme to address differences in deal structures and regulatory regimes across asset classes.

Finally, the SFIG membership asks the Joint Regulators to establish a clear mechanism for providing clarifications, resolving interpretive questions, and determining appeals with respect to the final rules.

B. Residential Mortgage Backed Securities.

Members of SFIG appreciate the improvements that the Joint Regulators have made in response to the comments received on the Original Proposal. Certain aspects of the Re-Proposal's treatment of residential mortgage backed securities (RMBS) enjoy broad support from SFIG's membership. In particular, SFIG's members support the inclusion of the qualified mortgage (QM) criteria in the definition of qualified residential mortgage (QRM) and the removal of the premium capture cash reserve account (PCCRA) concept. SFIG's membership does, however, believe that certain modifications are required to ensure that the final risk retention rules accomplish the goals of the Dodd-Frank Act while also supporting a robust return of the private label RMBS market.

SFIG's membership has differing views on the question of whether the Joint Regulators should adopt the definition of QM as the full definition of QRM, or whether they should adopt a more restrictive definition of QRM that requires a minimum down payment requirement or borrower equity. To the extent that a down payment requirement were to be included in the definition of QRM, SFIG's membership also has differing views on what down payment or borrower equity requirement should be applied.

Most of SFIG's membership believes that the Joint Regulators should allow for some form of reduced risk retention on blended pools of qualified and unqualified assets, and that the Joint Regulators have the statutory authority to do so. Similarly, most of SFIG members believe that the Joint Regulators should expand the current definition of "seasoned loan" to enable a robust secondary market for these loans that will provide an efficient mechanism to finance legacy assets. Finally, SFIG's members believe that the Joint Regulators should exclude non-economic residual interests (NERs) and lower tier residential mortgage investment conduit (REMIC) interests from the definition of ABS interest in order to fully exempt them from the risk retention rule.

C. <u>Commercial Mortgage Backed Securities</u>.

In addition to the general issues discussed in this letter, SFIG's commercial mortgage backed securities (CMBS) membership has certain recommendations with respect to the Re-Proposal as it relates to CMBS. SFIG issuers, underwriters, sponsors, and originators and four of SFIG's investment grade CMBS investor members together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that the CMBS most junior investor (B-piece buyer) retention option should be adjusted to permit two B-piece buyers to hold their interests on a senior/subordinate basis. Six of SFIG's investment grade CMBS investor members are supportive of the Re-Proposal as written and do not support a senior/subordinate option. SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that the definition of qualifying CRE loan (QCRE) should be adjusted so that a larger percentage of the commercial mortgage loans that are currently securitized can potentially qualify for the CMBS risk retention exemption. Four of SFIG's investment grade CMBS investor members are open to potentially expanding the definition of QCRE subject to evaluation of specific criteria, while six of SFIG's investment grade CMBS investor members are comfortable with the QCRE metrics as currently proposed and do not support such adjustment.

With respect to the remaining proposed changes, there is a consensus view among all of SFIG's CMBS members. Those proposed changes include changing the requirements of the Re-Proposal to (1) clarify that certain subordinate or *pari passu* interests held in "loan" form would qualify as an acceptable form of risk retention, (2) adjust the definition of commercial real estate loan (CRE loan) to include certain "land loans," (3) provide that a sponsor's risk retention obligation would terminate with respect to a CMBS transaction in which all of the loans have been defeased, and (4) clarify that multiple sponsors in a CMBS transaction can divide up the risk retention obligation among themselves *pro rata* based on their contribution to the deal.

D. Revolving Master Trusts.

The Re-Proposal includes a number of revisions that reflect current market practice for master trusts. However, the SFIG membership believes that additional modifications to the Re-Proposal are needed in order to make the revolving master trust option a viable form of risk retention.

Most importantly, the seller's interest form of risk retention, as currently proposed, cannot be utilized by any master trust currently in the market. In addition, there is a substantial segment of the master trust market—most notably, floorplan securitizations—that do not currently incorporate a *pari passu* seller's interests as a significant structural feature and therefore do not expect to utilize the seller's interest option as their primary form of risk retention. Accordingly, it is critical that there be a workable horizontal interest option for master trusts. However, the cash flow payment restrictions in the standard eligible horizontal residual interest option of the Re-Proposal are not structured in a way that would allow revolving master trusts and other issuers to comply with such an option. Additionally, the combined trust and series level risk retention option for revolving master trusts does not accurately capture existing master trust cash flow structures, leaving no viable horizontal risk retention mechanism.

Finally, many SFIG members are concerned that the limited risk retention options proposed for master trusts, even if modified to work for the majority of existing structures, will fail to capture the nuances among various master trusts and the different asset classes that use the master trust structure. As a result, there will be master trust securitizations that cannot fit within any of the proposed options and consequently will be cut off from the capital markets. This is a significant concern with implementing the risk retention rules. Therefore, SFIG and its members encourage the Joint Regulators to be more flexible and principles-based with respect to the proposed forms of risk retention for master trusts, and to offer more risk retention options for such issuers, including, at the very least, a representative sample option, a vertical option and a cash reserve account option.

E. Collateralized Loan Obligations.

SFIG's members appreciate the recognition by the Joint Regulators that applying risk retention to collateralized loan obligations (CLOs) will reduce the number of CLO issuances and competition among CLO managers. SFIG's members do not believe, however, that applying risk retention to CLOs is at all necessary or desirable. Furthermore, SFIG's members do not believe that CLO managers should be classified as "securitizers." CLOs are not originate-to-distribute securitizations of the type that Congress intended to target through risk retention. As a result, applying risk retention will not further the core legislative purpose of Section 15G of the Securities Exchange Act (Exchange Act) of 1934 (Section 15G) in ensuring appropriate underwriting of the underlying commercial loans.

Moreover, SFIG's members believe that the Re-Proposal's lead arranger/open market CLO option is not viable as proposed and, accordingly, suggest several revisions and additional options that, if adopted, would provide necessary flexibility for risk retention compliance and mitigate the negative impacts that the Re-Proposal will have on the CLO market and its ability to facilitate the broad availability of reasonably priced financing for corporate borrowers.

F. Asset Backed Commercial Paper.

Many SFIG members question the framework of the Re-Proposal with respect to ABCP issuers generally in light of the significant bank support provided to ABCP programs and the types of ordinary customer banking activities in which most ABCP issuers engage. To the extent that the Joint Regulators desire that ABCP Conduits and their sponsors be subject to risk retention requirements, there are a number of revisions to the Re-Proposal that SFIG's members believe are necessary to ensure that the ABCP markets are not unnecessarily disrupted. We address challenges presented by the Re-Proposal with respect to asset restrictions, liquidity support requirements, disclosure requirements, compliance monitoring requirements, ABCP tenor restrictions, and the grandfathering of existing customer transactions currently funded by ABCP Conduits.

G. International Issues.

This Letter also addresses the safe harbor eligibility calculation for foreign securitization transactions provided in § __.20 of the Re-Proposal. Specifically, a number of members have recommended: (1) clarifications related to the eligibility calculation, (2) an increased trigger percentage and (3) the adoption of a substituted compliance framework to minimize the adverse effects that could result from differences in risk retention requirements among major markets. Adoption of a substituted compliance framework would be aligned with global policy objectives supported by the Financial Stability Board and others.

H. Automobile, Equipment, and Floorplan Securitizations.

SFIG vehicle and equipment ABS sponsors support the adoption of the "Simplified Approach" discussed in Section A.4 of Part I of this letter to reduce the complexity, cost and burden of the calculations and comparisons of fair value, Closing Date Projected Cash Flow Rate and Closing Date Projected Principal Payment Rate and the related disclosures. The SFIG vehicle and equipment ABS sponsors also believe that if the calculations and comparisons of fair value, Closing Date Projected Cash Flow Rate and Closing Date Projected Principal Payment Rate are kept in the final rule, they must be modified to work in the context of revolving transactions. Our vehicle and equipment ABS sponsors also believe that it is critical for the representative sample and participating interest alternatives to be acceptable forms of risk retention.

In addition, SFIG members that are auto ABS sponsors or issuers are seeking changes to the Qualifying Auto Loan (QAL) exemption to be more consistent with the indirect auto finance business, which involves facilitating the sale of a vehicle during the short time frame within which a customer is purchasing a vehicle at an auto dealership. These changes include the elimination of the down payment requirement, calculating the obligor's DTI relying on information in the obligor's credit application and credit bureau report without independent

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verification of that information and eliminating the requirement for QALs to be only "for personal family or household use."

In addition, SFIG members that originate motorcycle loans note that motorcycle loans perform as well as auto loans, and are requesting that the exemption for qualifying loans focus on the quality of the loans and their underwriting criteria rather than discriminate against motorcycle loans as an asset class.

SFIG members that originate equipment loans are requesting an exemption for qualifying equipment loans. Unfortunately the exemption for qualifying commercial loans was not designed for commercial equipment finance.

SFIG members that are floorplan sponsors are requesting that the Joint Regulators include a subordinated seller's interest risk retention option in the final rule, and that subordinated seller's interests be valued at par value like *pari passu* seller's interests, rather than at fair value. In addition, if the Joint Regulators do not provide a subordinated seller's interest option, it is critical that the Joint Regulators modify the special horizontal interest option for master trusts as discussed in Part IV of this Letter or floorplan sponsors will be left with no viable risk retention options.

I. Student Loans.

SFIG members continue to believe that the final rule should include an exemption from risk retention for ABS collateralized or otherwise backed solely by FFELP loans (FFELP ABS) because FFELP loans are Federally guaranteed and no longer originated. This approach would be consistent with the approach adopted by the Re-Proposal for other Federally-guaranteed loan programs, including those under which new loans can still be originated.

J. Resecuritizations.

Resecuritization is an important portfolio management tool that serves a productive purpose in the financial economy. Many of SFIG's members believe that the Joint Regulators took an important step in the right direction by expanding the resecuritization exemption to take account for resecuritizations of certain RMBS that are structured to address prepayment risk. However, a significant portion of SFIG's membership respectfully seeks further amendment of key terms and measures in order to foster the smooth operation of resecuritization transactions.

These members seek four key modifications: (1) permission for unrestricted tranching in a resecuritization transaction consisting of a single tranche of compliant or exempted ABS; (2) the expansion of the definition of "originator" to include ABS owners who initiate resecuritizations or purchasers of junior tranches of resecuritization who select the collateral; (3) the incorporation of an alternative risk retention measure that would accommodate the fact that most resecuritizations are initiated by owners, and not by the broker-dealers who facilitate the transaction; and (4) the expansion of the resecuritization exemption to include resecuritizations of single-pool, legacy ABS, or Qualified Asset Backed Securities (QABS).

These SFIG members believe that the adoption of these four key modifications will satisfy the goals of risk retention without impeding the valuable role that resecuritizations currently play in the economy, particularly in connection with securitization market participants' ability to efficiently manage their legacy assets and free up private capital for newly originated assets.

K. **Municipal Bond Repackaging/Tender Option Bonds**.

SFIG's members urge the Joint Regulators to exempt municipal bond repackagings (MBRs) from the risk retention requirements because MBRs are not an "originate-to-distribute" product and do not present the moral hazard highlighted in the Re-Proposal's commentary. Instead, MBRs are transactions in which the party selecting the underlying asset(s) uses the MBR structure as a financing tool, directly benefits from the performance of the underlying asset(s) and, most importantly, retains virtually all of the risk of such asset(s) through its residual or subordinate interest, regardless of the nominal principal or notional amount of that interest.

Applying risk retention rules to MBRs would restrict and potentially eliminate a key demand component for municipal bonds or securities and consequently increase the effective borrowing costs for municipal issuers. Because the Joint Regulators have acknowledged the importance of effective and efficient municipal financings by exempting securities issued by municipal entities from risk retention, they should likewise exempt MBRs.

While SFIG's members appreciate the Joint Regulators' proposal of two options intended to reflect current market practice, SFIG's members do not agree that these options would be available to, or workable for, a significant segment of the current MBR market. In the event an exemption for the MBR market is not offered, SFIG members propose revisions to the Re-Proposal that are necessary to accommodate all or substantially all of the various transactions in the current MBR market.

L. **Corporate Debt Repackaging**.

SFIG's members urge the Joint Regulators to exempt corporate debt (bonds or loans) repackagings (CDRs) from risk retention under Section 15G. CDRs are not "originate-to-distribute" products and do not present the moral hazard that prompted these risk retention requirements. Subjecting CDRs to risk retention would not further the core legislative policy that underlies Section 15G and would restrict and potentially eliminate an effective and valuable financial tool that permits institutional investors to tailor desired investments from underlying corporate debt with different interest rates or currencies of payment.

Since CDRs are usually "secondary" market transactions, applying risk retention would have little effect (if any) on the underwriting of the underlying corporate debt, which (as the Joint Regulators properly note) is not an ABS and for which risk retention is not required or appropriate.

Even so, SFIG's members propose new options for CDR risk retention with a view to preserving this important financial tool for institutional investors that benefits market liquidity and transparency in the corporate debt markets.

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I. GENERAL ISSUES

SFIG's membership believes that several aspects of the Re-Proposal raise issues that impact multiple asset classes and, as a result, require further attention from the Joint Regulators. To that end, this Section addresses the following:

1. issues inherent to the calculation of fair value as the basis for determining the amount of risk that sponsors must retain;

2. the overly restrictive and cumbersome certifications and calculations with respect to eligible horizontal residual interests (EHRIs);

3. modification to the new certification requirements with respect to depositors' internal controls to verify qualifying assets;

4. other alternative methods of risk retention, including representative samples, participating interests, and third party credit support;

5. the lack of a clear mechanism for the Joint Regulators to provide clarifications, resolve interpretive questions, and determine appeals with respect to the final rules causes interpretive challenges and potential restraints on innovation;

6. the overly narrow investment restrictions on reserve accounts restricting investment options and resulting in lower yield to investors, rather than furthering goals of risk retention;

7. the need for clarification of the cure rights with respect to non-qualifying assets in blended pools;

8. the need for necessary clarification of which affiliates of sponsors are permitted to hold the required risk retention;

9. the desirability of a lower minimum threshold amount of retained risk for blended pools which will better serve the goals of risk retention; and

10. the need for clarification of issuers' rights to enter into hedges and other credit support.

This section addresses each of these issues in turn. In addition, we propose a number of technical corrections to the text of the Re-Proposal, which are outlined in Appendix B.[5]

[5] The changes proposed in Appendices B, C; D and H reflect some suggested edits and additions to the proposed rule. They do not reflect an exhaustive list of changes to the proposed rule suggested by this Letter.

A. Issues Inherent to the Calculation of Fair Value Necessitate Changes to the Re-Proposal.

The SFIG membership acknowledges and generally appreciates the removal of the fundamentally-flawed PCCRA concept from the Re-Proposal and considers its replacement by a fair value concept to be a constructive improvement regarding the appropriate amount of risk to be retained. However, the fair value concept in the Re-Proposal creates several issues that require revisions to create a workable mechanism for sponsors and other holders of retained risk to calculate required risk retention amounts in the industry going forward.

1. *Issues Created by the Use of Fair Value to Determine Required Risk Retention.*

There are several policy and operational issues that arise from the use of fair value to determine the requisite amount of risk retention. The SFIG membership believes it is important to identify these issues at the forefront, so that the Joint Regulators may weigh and understand them when considering the suggestions proposed herein.

First, fair value under GAAP for many ABS interests is, by any measure, a complex and sophisticated determination. The measure of fair value under GAAP has also undergone substantial revision over time. FASB's original codification of fair value measurement in Statement No. 157 consumes 158 pages, and the Accounting Standards Code - Topic 820 (Fair Value Measurement) is 331 pages in length. In addition, fair value under GAAP is not designed to be a single result, but rather to be a reflection of the market-based value of an asset. As a result, there may be several legitimate fair values for a particular asset, some or all of which may vary over time. This is especially likely if, under the GAAP fair value measurement hierarchy, the fair value of an asset is being determined by assumptions or projections rather than by means of the preferred independent observable market price. This inherent mutability of fair value raises concerns about how a *minimum* risk retention requirement can be met if there are, in fact, multiple possible fair values, *e.g.*, whether the standard is met if the least fair value is held or only if the greatest fair value is held.

Second, while most SEC-reporting entities and others that have experience with preparing GAAP financial statements will be generally familiar with fair value measurement under GAAP, non-public ABS sponsors and foreign entities who are currently not required to calculate or report fair value of their securitization transaction for balance sheet deals may not be. Accordingly, the requirement that risk retention be determined using fair value will impose a significant burden on the securitization transactions of such entities and will likely serve to reduce their interest in using U.S. capital markets, potentially reducing investment options for domestic institutional investors. Of course, sponsors that are, or would be consolidating their securitization transactions for financial reporting purposes would not necessarily be measuring fair value and, if this were required, it would be a new and materially burdensome requirement.

Third, if fair value is to be determined by a sponsor prior to pricing, as the Re-Proposal would require, the preferred determinant of fair value—namely, an independent observable market price—would not be available, and in some cases, may be nearly impossible to calculate in a meaningful way at such time. Under the GAAP fair value hierarchy, fair value calculations required prior to pricing would be determined only from secondary and, as a practical matter, less reliable sources, such as a comparable market price. Moreover, in the absence of a recent and closely comparable market price, fair value would need to be calculated based on discounted cash flow projections which, as discussed in more detail below, would require the sponsor to make numerous assumptions regarding bond sizes, interest rates, discount levels, defaults, recovery and prepayment rates, and correlation of the assets included in the pool and, for revolving pools, reinvestment. For some asset classes, like RMBS, fair value would be nearly impossible to provide pre-pricing with any degree of accuracy since variables like bond sizes, pricing and discount levels are not known pre-pricing. Even after pricing, there may be multiple comparable prices. For example, in a securitization transaction with several purchasers of the most junior tranche, each buyer of such junior tranche will typically pay a different price, based on how such buyer values the investment. Accordingly, there may be several possible fair values for the same ABS interest.

A significant number of SFIG members have questioned the need for pre-pricing and other determinations and disclosures of fair value in light of these and other issues highlighted in this Section, as it will not provide meaningful information in connection with investment decisions or foster the goals of risk retention.[6] As should be clear from the above discussion of methodologies for calculating fair value under GAAP, pricing is a more reliable method because of the benefit of available independent inputs.

We also note that the Re-Proposal is silent on the very real possibility that the fair value at pricing will be different (and possibly substantially different) than the pre-pricing fair value determination, particularly if final pricing is lower than was expected. While this issue may be avoided for some asset classes (like RMBS) by moving the timing of the calculation to the closing of the securitization transaction, as further discussed below, for some product types where there is not typically significant overcollateralization in the deal structure (like certain auto securitizations), making this switch not practicable because the required 5% risk retention amount would need to be factored into the size of the offering at the time of pricing. Thus, regular deviations are likely to occur between pre-pricing fair value calculations and fair value calculations based on final pricing.

Those SFIG members who have questioned the need for pre-pricing and other determinations and disclosures of fair value believe that it should be sufficient for a sponsor to disclose to prospective purchasers that a securitization transaction will comply with the risk retention requirements ultimately adopted by the Joint Regulators.

Fourth, if (as explained above) fair value is determined on the basis of discounted cash flow projections, the related assumptions underlying those calculations would typically be considered proprietary and/or commercially-sensitive information by many sponsors. Moreover, for some asset types like auto leases, even using alternative sources for some of the valuations can be problematic, because the companies that provide these (like Automotive Lease Guide (ALG) in the case of lease residual values) do so on a proprietary basis and will not likely permit their methodologies to be described publicly. For these reasons, any benefit from such a disclosure is easily outweighed by the potential damage that it would cause to the related

[6] Specifically we suggest that such fair value disclosures should be disclosed only to applicable Federal regulators upon request, similarly to the internal control certifications discussed in Part C.3 of this Section I.

sponsor, from disclosure of proprietary and/or commercially sensitive information or by its impact on the availability of credit if such requirements dissuade sponsors from engaging in securitization transactions. Typically, GAAP disclosures related to reported fair value calculations would include limited descriptions of the assumptions made, not the precise measures and assumptions required to be reported under the proposed rules with regard to fair value. It is difficult to understand why investors in the sponsor or its parent need less thorough disclosures about the sponsor's retained risk in a securitization than investors in a securitization vehicle that generally does not have recourse to the sponsor.

In short, the requirements under § _.4(d) (sponsor must disclose fair value to potential purchasers at a reasonable time prior to sale) and § _.4(b)(1) (fair value determined as of the date on which the price of the ABS to be sold is determined) will likely provide different—and, in some cases, materially different—fair values, and thus risk significant confusion for purchasers. In addition, the requirements under § _.4(d)(1)(iii) (that the sponsor disclose a description of the methodology used to determine fair value) and § _.4(d)(1)(iv) (that the sponsor disclose the "key" inputs and assumptions used in determining fair value) would not provide useful information to purchasers—and may serve only to confuse them—while also requiring sponsors to make potentially harmful disclosures of proprietary and/or commercially-sensitive information, a factor that could lead sponsors not to issue ABS subject to that requirement.

Fifth, the fair value approach introduces deeply troubling potential liability risks to issuers and underwriters resulting from the required disclosure of the assumptions underlying the calculation of the fair value of an EHRI, particularly the required disclosure of loss assumptions. Issuers have rarely in the history of ABS disclosed loss projections.[7]

A significant number of SFIG members are highly concerned about the litigation risks that will result when, inevitably, there are differences between projected and actual losses in ABS transactions. We note that the risk retention provisions in the Dodd-Frank Act were intended solely to require "skin-in-the-game", and were not intended to expand the scope of securities law liability in ABS transactions. Nothing in the Dodd-Frank Act suggests that Congress was seeking disclosure of loss projections. This liability risk is likely to deter many issuers from accessing the ABS market or using securitization where it would otherwise be the most attractive form of financing. This increased risk of liability will also result in greater costs for due diligence by underwriters or initial purchasers, including expanded requirements for "agreed upon procedures" (AUP) letters by accountants and the resulting increased costs and possibly time to complete a securitization transaction.[8]

Because of the issues discussed above, those SFIG members concerned with litigation risks strongly believe that, rather than requiring disclosure of the fair value calculations to potential purchasers, as proposed by the Re-Proposal does, the final rule should require only that the sponsor maintain a record of those calculations—including the methodology and material assumptions underlying them—and require that those records be available for inspection and

[7] Certain RMBS deals prior to the financial crisis included loss tables based upon certain assumptions of loss, but the disclosures in such transactions did not in any way suggest those assumptions of loss were correct.

[8] As AUP letters can only be provided to specified parties, it is unlikely that sponsors would be able to rely on them.

copying by the Commission and appropriate banking agencies, if any, upon request, for a period of five years.[9] Taking such an approach would still protect purchasers since they would have the benefit of the disclosure of fair value calculations prepared in accordance with GAAP, while putting the disclosure obligations of issuers and sponsors with respect to fair value more in line with the spirit of their current reporting obligations under Federal securities laws.

2. *The Final Rule Should Establish a Safe Harbor for Fair Value Calculations that are Grounded on Reasonable Methodology And Good Faith Assumptions.*

There is nothing in § 941 of the Dodd- Frank Act that suggests that Congress intended for the rules that implement the risk retention requirements to require disclosures of sponsors' fair value calculations or to create potential liability to purchasers or other third-parties for innocent or other unintended errors in those calculations. The Re-Proposal makes this risk particularly acute by requiring a pre-pricing determination and disclosure of fair value, increasing the likelihood that the sponsor will have to make its fair value calculations using a discounted cash flow methodology based upon myriad assumptions. But even if the final rule were not to require a pre-pricing fair value determination, there may be—and likely will be—cases where the applicable sponsor will be required under GAAP to use assumptions and projections with similar risk of error.

Many SFIG members believe that the Re-Proposal's required disclosures to potential purchasers fails to provide a benefit to such purchasers that is commensurate with the risk of harm and costs to sponsors. However, if the final rule retains the disclosure requirement, it should at a minimum provide a clear and unequivocal safe harbor for the sponsor if: (1) the methodology used to determine fair value under GAAP was reasonable; and (2) the assumptions underlying any projections that support the fair value calculation were made in good faith, even if erroneous in some way. Unless such errors were intentional or the result of reckless disregard for the facts—for which the usual "fraud" remedies would exist—there should be no liability for a sponsor arising from its efforts to satisfy the fair value determination under the risk retention rules.

3. *There Should Be No Fair Value Calculation or Related Disclosure Required for Vertical Risk Retention.*

Because eligible vertical interests (EVIs) will inherently have a fair value equivalent to 5% of the aggregate fair value of the securitized assets in any transaction, EVIs should be exempted from the fair value calculation and reporting requirements of § __.4 (b)(1). To ensure that EVIs are a true vertical "slice" of any transaction, the definition of "eligible vertical interest" in § __.2 should be revised to make clear that an EVI will be either a *pro rata* interest in each class of ABS interests issued, or a single class of ABS interests entitled to a *pro rata* percentage of the aggregate cash flows payable to all classes of ABS interests in each period. If structured in accordance with these requirements, a 5% EVI (either individually or in the aggregate) will inherently have a fair value equivalent to 5% of the aggregate fair value of the securitized assets.

9 This proposed retention time is consistent with the Commission's requirements under Rule 302(b) of Regulation S-T 17 C.F.R. § 232.302(b) for maintenance of original signatures in connection with electronic submissions.

Accordingly, no separate fair value measurement should be required. This proposed exclusion of EVIs from the fair value calculation and reporting requirements should apply regardless of whether a sponsor holds EVIs only or meets its risk retention obligations by holding a portion as EVIs and a portion as EHRIs. In addition, exclusion of the EVI is consistent with its treatment under the Original Proposal's PCCRA mechanics.

While many SFIG members believe that it is appropriate to eliminate the delivery of fair value calculations to potential purchasers for the reasons discussed above, if the final rule does include a requirement for disclosure of these calculations, it also should clarify that no such disclosure is required when an EVI is the means used to satisfy required risk retention. Exempting EVIs from the certification requirement of § _.4(b)(2)(ii) is appropriate because sponsors holding EVIs are exposed to the same risks of loss as all other purchasers. There is no danger that sponsors will evade the intended requirements for risk retention.

4. *Joint Regulators Should Allow a Simplified Approach For Simplified Structures with Obvious Retention of At Least 5% of the Credit Risk.*

There are many simple situations in which there is no doubt that the sponsor is retaining at least 5% of the credit risk, and therefore it would be unnecessary to impose on the sponsor the additional complexity, costs and liability risks of the fair value determinations and related disclosures. For example, in many securitizations, the principal amount of the bonds issued is clearly less than 95% of the principal amount of the securitized receivables. In fact, some auto lease or floorplan transactions have more than 10% overcollateralization.

In simplified transaction structures, it is obvious that at least 5% of the credit risk is retained by the sponsor. These structures do not pose the risks of "abuse" that led the Joint Regulators to require fair value in the re-proposal or to require the PCCRA in the original proposal. Simplified structures do not have complex "interest-only" or other securities that monetize excess spread. In simplified structures, the sponsor holds the residual and sells only traditional interest bearing debt securities to investors. Therefore, we believe that transactions should have a "safe harbor" that avoids the additional complexity, costs and liability risks of the fair value determinations and related disclosures where it is obvious that this additional complexity and cost is not necessary to assure that at least 5% of the credit risk is retained.

If the weighted average interest rate on the receivables exceeds the weighted average interest rate on the bonds sold to investors, and if distributions to the residual holder are always at the bottom of the distribution waterfall, then it is manifestly clear that the sponsor is retaining at least 5% of the credit risk of the receivables.

We note that the Joint Regulators recognized in Request for Comment 2(a) that a first-loss residual position would impose the most economic risk on the sponsor. Therefore, we are providing that the simplified approach would only be available when the sponsor retains a first-loss residual position.

We request that the Joint Regulators allow this simpler approach to be used in appropriate situations. Specifically, this approach would apply when the following criteria are satisfied as of the cut-off date prior to the sale of securities to investors:

a. the principal amount of the ABS interests sold to third parties is less than 95% of the principal amount (or securitization value[10]) of the securitized assets (and, in the case of a pre-funded transaction, any cash held in a pre-funding account);[11]

b. the weighted average interest rate[12] on the securitized assets (or discount rate in the case of a securitization value calculation) is not expected to be less than the time-weighted average interest rate on the ABS interests sold to third parties;[13] (in the case of revolving or prefunded transactions, this condition shall be satisfied upon the completion of each addition of additional assets);

c. all of the ABS interests sold to third parties are traditional interest-bearing debt securities; and

d. the residual interest retained by the sponsor or other holder of a retained interest otherwise meets the requirements of an EHRI (or, in the case of a revolving master trust, meets the requirements of § __.5(f)).

The final rule should also provide that if these criteria are satisfied a sponsor will not be required to: (1) determine the fair value of any of the ABS interests; (2) determine the Closing Date Projected Cash Flow Rate or the Closing Date Projected Principal Repayment Rate; (3) include any related disclosures with respect to the foregoing; or (4) comply with the related record maintenance requirements.

An additional advantage of this approach is that it is likely to encourage issuers to use more simple structures. This could represent an advantage for issuers and investors alike.

We wish to emphasize that it is extremely important to many of our issuer members that the Joint Regulators create some type of safe harbor relief for the most simple structures that would avoid the calculations of fair value, the modeling of the comparison of Closing Date Projected Cash Flow Rate to the Closing Date Projected Principal Repayment Rate and the presentation of the related disclosures. These issuers would be willing to sacrifice some of the economic efficiency of their securitization transactions to keep things simple. Although we present some ideas in this section, our issuer members wish to emphasize the importance of

10 Many ABS structures like auto lease ABS or securitizations of non-interest-bearing receivables often use a discounted securitization value calculation. The Securities and Exchange Commission recognized this in the definition of "asset backed security" in Item 1101 of Regulation AB. In some transactions that include "1.9%" or other promotional receivables, only the receivables with an interest rate lower than the discount rate are discounted.

11 If it would be helpful in assuring that the retention of at least 5% of the credit risk is sufficiently obvious, our members who are most supportive of the Simplified Approach alternative would accept a risk retention percentage for the Simplified Approach alternative that is greater than 5%, perhaps 6%.

12 For leases, the "interest rate" would be the implicit interest rate used to calculate the lease payments.

13 This is intended to be a test that can be applied at the cut-off date prior to the initial offering of securities. At cut-off date, the issuer would need to determine the maximum interest rate that would satisfy this requirement, and assure that this rate is not exceeded when the securities are priced.

obtaining some relief in this area, even if the Joint Regulators take a more conservative view of the transactions eligible for relief than the ideas presented.

5. *Joint Regulators Should Allow Relief for Private Transactions.*

Many securitization transactions are truly private transactions. For example, many securitizations are funded directly by a bank or a bank-sponsored ABCP conduit and more closely resemble traditional bank loans than securities offerings. Other transactions are sold to a single sophisticated investor. In these circumstances, the bank or investor is typically not receiving a prospectus or other offering document but instead is performing its own due diligence. In these situations, if disclosure is required, an issuer would need to prepare an offering memo or other disclosure solely because of the risk retention requirements. That strikes us as unnecessarily burdensome. In addition, sophisticated investors in private transactions probably would prefer to perform themselves the calculations of fair value, the modeling of the comparison of Closing Date Projected Cash Flow Rate to the Closing Date Projected Principal Repayment Rate in a truly private transaction. We request that the Joint Regulators provide relief from the disclosure obligations of the rule, and also from the determinations of fair value, and the modeling and comparison of Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate for situations in which the investors are a small number of sophisticated investors who have the opportunity to perform due diligence.

B. Limitations on Eligible Horizontal Residual Interest (EHRI) Distributions.

The Re-Proposal's provision in § _.4(b)(2)(i) that a sponsor using EHRI to satisfy the risk retention requirement must calculate the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate is problematic for the same reasons as the requirement for fair value calculations and disclosures discussed above. Moreover, this requirement is structurally flawed because: (1) it fails to distinguish payments of interest on the related EHRI and other ABS interests from payments of principal on those same interests; (2) it requires calculations and certifications that revolving structures will be unable to make on the closing date; (3) it involves an "apples to oranges" type of comparison that even naturally deleveraging transactions will fail; and (4) the required calculations should be based on cumulative cash flow projected to be paid to the sponsor through the date at issue, and not just cash flow projected as of a particular date.

1. *The Closing Date Projected Cash Flow Rate/Closing Date Projected Principal Repayment Rate Calculations are Structurally Flawed.*

Our first concern with the required Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate calculations is that these requirements fail to distinguish payments of interest on the related EHRI and other ABS interests from payments of principal on those same interests. As discussed below in Section A of Part V, this differentiation is an important feature of securitization transactions involving many types of ABS interests, especially securitization transactions with revolving or reinvestment periods, where it is expected that principal—and, in some cases, interest—receipts from the underlying pool during such period will be applied to the acquisition of additional collateral items that will support all outstanding ABS interests. These securitization transactions have other structural features that serve to protect the senior ABS interests, such as: (1) overcollateralization or similar tests that apply to determine the appropriate amount of principal receipts that may be reinvested or that must be used to reduce the outstanding principal of senior ABS interests; and (2) "turbo" provisions that operate to divert interest receipts otherwise payable to holders of junior ABS interests to principal reductions of senior ABS interests. The SFIG membership fails to perceive any reasonable basis for the Re-Proposal's effective elimination of otherwise permissible interest or yield to be paid to the sponsor's EHRI (or to other purchasers holding the same ABS interest) in connection with required risk retention.

A second problem is that requiring such calculations and the related certifications and disclosures is incompatible with revolving structures used for many types of transactions. The proposal appears to have been designed solely with static pools in mind. In these types of transactions, assets may be added to the issuing entity after the closing date. Common examples include warehouse facilities for equipment loans and leases, auto loans and leases, and student loans. Since these transactions typically do not constitute master trusts, the provisions of § __.5 are not applicable to them.

For these revolving structures, there are a number of difficulties with the projections and certification requirements for EHRIs. As an initial matter, the sponsor will not know on the closing date what the composition of its securitized assets will be at any particular time. For example, on the closing date, the issuer may own only a portion of the assets which would ultimately back the ABS interests. In addition, since it is common in warehouse facilities for the revolving period to be regularly extended (typically as part of the renewal of the commitments of lender(s)), and since there is typically an option to use collections to either add new assets to the facility or to pay down the ABS interests owned by lenders to the extent necessary to maintain compliance with the "borrowing base" in the facility, sponsors will not necessarily know on the closing date when the amortization period will commence. Finally, since revolving warehouse facilities have a pool which may change over time, it also is not possible to precisely predict the loss profile for the pool on a forward looking basis.

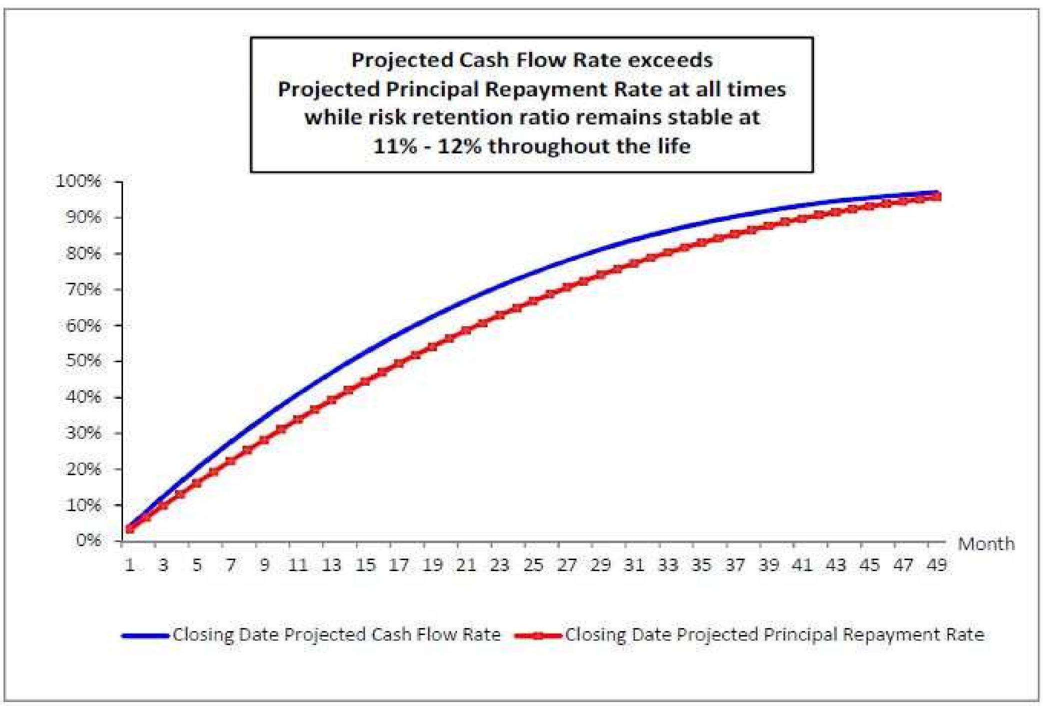
Because of these difficulties, many SFIG members support having the self-adjusting horizontal option described below be made available as part of § _.4. The "self-adjusting horizontal option" would work conceptually as follows. The certification would be required only at the initial closing of the transaction, delivered without regard to future additional investments by investors or any additional assets to be added in the future, assuming that the pool would immediately begin to amortize in accordance with the transaction documents. The transaction documents would require, as a condition of each increase in the investment amount by investors and each addition of additional assets, that the principal amount of the ABS interests owned by third parties always would be less than or equal to 95% of the principal amount (or securitization value[14]) of the securitized assets, assuming that all future payments on the securitized assets are timely paid on their respective due dates (without regard to any future additional investments by

[14] Many ABS structures like auto lease ABS or securitizations of non-interest-bearing receivables often use a discounted securitization value calculation. The Securities and Exchange Commission recognized this in the definition of "asset backed security" in Item 1101 of Regulation AB. In some transactions that include "1.9%" or other promotional receivables, only the receivables with an interest rate lower than the discount rate are discounted.

investors or any additional assets to be added in the future, assuming that the pool would immediately begin to amortize in accordance with the transaction documents). In other words, a revolving transaction would need to satisfy the risk retention requirements as a static pool each time the investment amount increases or additional assets are added to the transaction.[15] Further, payments on the residual interest on any payment date would not be permitted to the extent the discounted value of the residual interest would be reduced below 5% of the total of all ABS interests.

A third structural issue with the required calculation and reporting of the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate is that this is an "apples to oranges" type of comparison. First, the Closing Date Projected Cash Flow Rate includes all cash flows received by the EHRI holders, while the Closing Date Projected Principal Repayment Rate includes only principal payments. Second, the Closing Date Projected Cash Flow Rate is expressed in discounted dollars, while the Closing Date Projected Principal Repayment Rate is expressed in nominal dollars. The result of these differences is that the earlier cash flows in the Closing Date Projected Cash Flow Rate will tend to be greater on a cumulative percentage basis than the Closing Date Projected Principal Repayment Rate. For example:

Generic Auto Retail ABS with a Fixed Percentage of Overcollateralization (10%) – Closing Date Projected Principal Repayment Rate and Cash Flow Rate.[16]



[15] The implications of this with respect to CLOs are discussed in Section B of Part V.

[16] Rates shown in this graph are based on the following assumptions: 10% overcollateralization or "hard" enhancement; 0.5% cash reserve; 1.25% cumulative net credit loss; and the residual interest discounted at 10%.

As one would expect, the greater the discount rate used to calculate the fair value of the Closing Date Projected Cash Flow Rate, the worse this problem becomes. SFIG members have reported that in test calculations run on existing transactions with naturally deleveraging structures, the sponsor would fail this test, even when the fair value of the retained risk on each payment date was actually increasing. In addition, the Joint Regulators' proposed alternative cap on amounts paid to EHRIs described in the Joint Regulators' Request for Comment 15(a)[17] is flawed because, as one would expect, the EHRI cumulative cash flows will eventually exceed its "proportionate share." Towards the end of the securitization transaction, the EHRI—having served its purpose of protecting the senior notes which are now mostly amortized—will receive relatively large cash flows. This is expected, and does not mean that the EHRI is less "economically meaningful."

The result of this "apples to oranges" comparison is particularly problematic for issuers who use large amounts of excess spread as their primary method of credit enhancement or who issue securities having a principal amount that is significantly less than 95% of the principal amount of the securitized assets. For example, the Re-Proposal would require an issuer whose excess spread exceeds 5% of the fair value of the transaction to maintain that greater-than-5% level rather than be allowed to decline to 5% during the life of the transaction.

If the "apples to oranges" comparison is kept in the final rule, it will have an unintended effect on investor protection. Sponsors would be motivated to structure ABS offerings with risk retention much closer to the regulatory 5% minimum. Hence, the proposed alternative could produce precisely the misalignment between investor and sponsor objectives which the risk retention rule is intended to avoid.

The "apples to oranges" comparison also would discourage highly-rated sponsors from using securitization, because those originators typically issue only senior securities with a low interest cost because the relatively high interest rates demanded by investors in subordinated ABS classes would not be economically efficient compared to their corporate borrowing costs. The EHRIs for such sponsors would be noticeably larger than the EHRIs of less highly-rated sponsors—a benefit to investors in ABS originated by those companies. But insisting that such sponsors be locked in to an artificially high closing date risk retention percentage, and be barred from receiving prepayments and other residual cash flow which would reduce that percentage <u>to any extent</u>, would demotivate them from securitizing. The biggest losers from such an equation would be the customers of those sponsors, who would no longer benefit from the lower cost of funds which securitization has provided to those sponsors.

A fourth problem is that the required calculation of the Closing Date Projected Cash Flow Rate under § __.4(d)(1)(vi) should be based on the cumulative cash flow projected to be paid to the sponsor through the date at issue, and not just cash flow projected as of a particular date. The Closing Date Projected Cash Flow Rate, like the Closing Date Projected Principal Payment Rate, measures for a particular payment date the cumulative amount of payments projected to be made for all payment dates from the closing date through such payment date. In light of this, the SFIG membership generally believes that the look-back disclosure requirement should focus on the cumulative amount of payments made to the holder of the EHRIs, rather than the

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17 Re-Proposal, 78 Fed. Reg. at 57,941.

"cash flow projected to be paid to the sponsor on such payment date" as currently specified in § __.4(d)(1)(vi).[18] Whether the amount that was projected to be paid on any specific payment date was exceeded or not is just not relevant.

In addition to these structural flaws, calculations of the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate would, of necessity, require the same sort of projections and assumptions discussed above regarding the fair value calculations. As a result, these closing date calculations pose the same risks to sponsors as do the fair value calculations. Therefore, the final rule should require only that: (1) the sponsor maintain a record of the closing date calculations, including the methodology and material assumptions underlying them; (2) those records be available for inspection and copying by the Commission and appropriate banking agencies, if any, upon request, for a period of five years; and (3) sponsors be provided with an identical safe harbor to the one discussed in Section A.2 of Part I above.

Finally, it should be noted that the Re-Proposal allows a sponsor to sell its EHRI once certain time or unpaid principal balance thresholds are met.[19] Given this ability to sell the EHRI during the life of the deal, one can argue that the restriction on the rate at which the EHRI can receive cash flows should be similarly limited to the same time period or pool balance. After all, if the sponsor can eliminate 100% of its retained risk after such time or pool balance is reached, it certainly should also be allowed to receive a disproportionate share of its value after such time or pool balance is reached.[20]

2. *Proposed Solutions.*

As discussed above, requiring calculation and reporting of the Closing Date Projected Cash Flow Rate and the Closing Date Projected Repayment Rate in connection with EHRIs makes this highly desirable form of risk retention significantly more difficult for certain product types like CLOs and CMBS. This effect seems to the SFIG membership to run counter to the Joint Regulators' previously stated goal of encouraging risk retention through EHRIs.

Some SFIG members believe that simply requiring sponsors to calculate and report the fair value of their EHRIs to investors should be sufficient, and that this additional requirement is simply burdensome on sponsors (and certain product types) without a corresponding benefit to purchasers.

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18 *Id.* at 58,000.

19 *See id.* at 57,977 (Section F, Sunset on Hedging and Transfer Restrictions) and Section C of Part III of this Letter.

20 Request for Comment 11(g) asks whether the proposed requirement for the sponsor to disclose, for previous ABS transactions, the number of times the sponsor was paid more than the issuer predicted for such transactions reach the right balance of incremental burden to the sponsor while providing meaningful information to investors. We believe this information is of limited value to investors. If sponsors do a good job on their predictions, they will be wrong approximately half the time. Further, an important reason the sponsor might have been paid more than predicted is that the transactions might have performed better than expected

To the extent that the Joint Regulators reject this approach, the SFIG membership has identified several alternatives to deal with the problems inherent in the proposed calculations of the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate in connection with EHRIs. Because of the differences in cash flows for various types of securitization transactions, we strongly believe that a one-size fits all test with respect to EHRIs would be very difficult for all types of transactions to satisfy. Instead, we propose that the following options be included in the final rule, and that a sponsor would meet its risk retention obligations so long as it is able to satisfy one of the following tests based on projections of the sponsor or an assumption of timely payment:

a. On the closing date, the projected fair value of the amount retained as of each payment date will not be less than the required 5% risk retention amount.

b. On the closing date, the level of overcollateralization (or "hard" enhancement) in the transaction, calculated based on the amortizing balance of the ABS interests as of each payment date, is not projected to decline below 5% over the life of the transaction.

c. On the closing date, the projected principal payments to be paid to the EHRI as of each payment date will not exceed its *pro rata* share of all payments made to ABS interest holders on such payment date. In such a circumstances, there would be no limitations on the amount of interest the EHRI could receive.

3. *The Final Rule Should Permit Several Other Forms of Risk Retention.*

Many SFIG members, particularly sponsors, are grateful for the flexibility given in the Re-Proposal to allow sponsors to elect different ways to meet the risk retention requirements. However, in order to better adapt the risk retention rules to the multitude of different kinds of securitization transactions in the market place, SFIG members would like to propose the addition of the following practical alternative forms of risk retention: (1) a simplified form of the "Representative Sample" method (Representative Sample) of risk retention set forth in the Original Proposal, which would be available if the sponsor will continue to hold similar unsecuritized assets representing at least 5% of the amount of the securitized assets; (2) an option for the retention by the sponsor of a participating interest representing at least 5% of the asset pool to be securitized; and (3) third party credit support.

a. A Simplified Representative Sample Similar to the FDIC's Safe Harbor.

We agree that the original Representative Sample proposal was impractical and too burdensome to be useful to sponsors, but it is not necessary to "throw out the baby with the bath water." The Representative Sample approach is particularly useful for sponsors who do not securitize all of their assets. It is also an extremely helpful alternative for sponsors who seek off-balance sheet treatment for their securitizations by selling the residual interest in the issuing entity. For these reasons, many SFIG members have requested that a simplified version of the

Representative Sample method similar to the FDIC's safe harbor under 12 C.F.R. § 360.6 (the FDIC Safe Harbor)[21] be included in the final rule.

It is important for the Joint Regulators to note that the Representative Sample method is one of the few permitted forms of risk retention under the existing FDIC Safe Harbor for securitizations. We note that several banks have issued asset backed securities under the FDIC Safe Harbor, all without any of the burdensome complexity and cost required under the Original Proposal. The only requirement under the FDIC Safe Harbor is that the retained sample is, in fact, representative. There are no detailed requirements for the selection of the securitized pool and the retained pool, no servicing requirements, and no required reports from independent accountants. Given that this simpler approach is working now for risk retention under the FDIC Safe Harbor, there is no reason why it cannot be employed for risk retention under these rules.

We also note that the Representative Sample is one of the alternative methods of risk retention permitted under Article 122a of the European Union's Capital Markets Directive.[22] If the Representative Sample method of risk retention is not permitted in the United States, it will be more difficult for global offerings of asset backed securities originated outside the United States to be sold to investors in the United States.

In addition, many of our sponsor members who are banks would prefer that the representative sample method be made available as an alternative method of risk retention based on a representative sample of most receivables, which would result in lower capital charges than retention of EVI. Under the Basel III capital rules, receivables will generally have lower capital charges than securitization exposures.

We believe that the most important requirement for a representative sample is that the securitized assets and the retained representative pool are selected from a common pool of assets on a random basis. If these conditions are satisfied, particularly for a relatively large pool, all of the objectives of the risk retention rules will have been satisfied without the additional complications of the Original Proposal. We understand that with respect to a designated pool containing at least 6,000 receivables for which the statistical variance in the material characteristics is sufficiently modest (*e.g.*, a pool of prime auto loans originated by the same entity), the mean value of each material characteristic within the designated pool is almost assured to fall within the 95% confidence interval derived from any single 5% random sample. Therefore in such circumstances, there is no need for the final rule to require any "representativeness" test for the 5% random sample in order to satisfy the 95% confidence interval standard specified in the initial proposal.

In implementing a Representative Sample method in the final rule, we would also suggest a minor technical change to Original Proposal's requirement that "individuals responsible for servicing the assets" in the unsecuritized pool and the ABS pool be unable to "determine whether an asset is owned or held by the sponsor or owned or held by the issuing entity."[23] It is certainly

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[21] 12 C.F.R. § 360.6 (2013).

[22] Article 122a of Directive 2006/48/EC, as amended by Directive 2009/111/EC.

[23] Original Proposal, § __.8(e), 76 Fed. Reg. 24,160.

feasible for collections personnel to use the same level of care and attention for both pools, but of course it will often be necessary for cash flows from the securitized pool to be directed as provided in the securitization transaction documents. For these reasons, we suggest that this requirement for Representative Sample servicing standards be limited solely to the collection and enforcement of the securitized assets with respect to the obligors.

Our sponsor members believe that the Original Proposal's requirements for agreed upon procedures reports, subsequent monthly testing, and reporting of the comparative performance of the unsecuritized representative pool with the ABS pool were unnecessary, costly, and burdensome. However, some aspects of the original proposal would make sense to include in the final rule. For example, it would be appropriate to include a description of the characteristics as of the cutoff date of the representative sample pool, including detailed stratifications in the same manner as the pool of securitized assets. It is also appropriate that the sponsor have in place policies and controls to assure that the retained sample pool not be transferred or sold until the date permitted by the final rule.

Our sponsor members wish to emphasize that they believe it is essential that the final rule include the representative sample alternative. It is very important to our sponsor members to have the representative sample method as an alternative, even if the final Rule is more burdensome that they would prefer.

Although all of our sponsor members would prefer an alternative that is similar to the FDIC Safe Harbor, some of our sponsor members would like to emphasize their willingness to accept other elements of the Original Proposal's representative sampling method, if essential. For example, these members would accept the additional costs and burdens of a 95% confidence interval test if limited solely to material features of the pool such as average principal balance and weighted average remaining term. These members would also accept a post-selection review of the 5% sample pool to assure that it is representative if that review could be done internally without the additional expense and delay of an independent accountant's AUP letter.

b. Participating Interests as a Form of Acceptable Risk Retention.

A number of SFIG members continue to strongly support the inclusion in the final rule of an option for a sponsor to hold a participating interest representing at least 5% of the asset pool to be securitized as an acceptable variation of the Representative Sample method of risk retention. These members recognize that the most "representative" of all samples is a 5% interest in every asset in the actual securitized pool of assets. A qualifying participating interest would be required to satisfy the requirements of the definition of "participating interest" in § 860-10-40-6A of the FASB Accounting Standards Codification.

In the Re-Proposal, the Joint Regulators stated that they had rejected participations because they thought "there would be little to no economic benefit for allowing this option because the option is currently not used by the market and would unlikely be used."[24] We disagree with this reasoning. First, there has not been a general risk retention requirement in effect. It therefore makes perfect sense that currently, sponsors have not utilized the participating

24 Re-Proposal, 78 Fed. Reg. at 58,013.

interest option in the market; however, sponsors that are SFIG members believe that this would be an important option as risk retention requirements are finalized and implemented. Second, the risk retention obligations will create significant new impediments to achieving off-balance sheet treatment for securitizations by selling the requisite interests in the issuing entity if the final rule can only be satisfied through the retention of ABS Interests. Accordingly, the implementation of the final rule itself will create new incentives for sponsors and underwriters to consider alternative structures to achieve off-balance sheet treatment for securitizations. Like the Representative Sample approach, a qualifying participating interest would be an extremely helpful alternative for sponsors who seek off-balance sheet treatment for their securitizations because it permits risk retention to be held in the form of interests in securitized assets rather than ABS Interests. However, because a Representative Sample approach is not provided for in the Re-Proposal, and some sponsors may not hold a sufficiently large pool of assets to utilize a Representative Sample approach if it were included in the final rule, a participating interest option would be a useful alternative for some sponsors regardless of whether the Representative Sample approach is included in the final rule.

One of the significant advantages of the participating interest method is that there is little risk of abuse. There is no concern that the retained interest will not be "representative." The retained Participating Interest will be identical in all respects to the securitized pool because it will be necessarily identical (on a percentage basis) to the securitized pool.

Another important advantage of the participating interest is that it can be efficiently created at very low cost. For example, if we assume that the sponsor plans to securitize $100 million of receivables. The sponsor would select a pool of receivables equal to, in this example, $105 million (or $105,264,000). The entire $105 million (or $105,264,000) pool would be transferred to a bankruptcy remote entity (the depositor). Then the depositor would transfer the entire pool of assets to the issuing entity, but the issuing entity would transfer back to the depositor, as part of the consideration, a 5% or 5.264% *pari passu* interest in all of the collections received with respect to the pool of receivables. The participation agreement could be as simple as a one page document for the entire pool. This simplicity and low cost could be very advantageous for sponsors. We see no disadvantages to investors or others from this alternative form of risk retention.

The Proposed Rule already allows for the retention of EVI. A participating interest functions in essentially the same way as EVI because the holder of the participating interest would still be holding a vertical interest in the assets. In fact, many of SFIG's members who are banks would prefer that the participating interest option be made available as an alternative method of risk retention to EVI because this would result in lower capital charges than retention of EVI. Under the Basel III capital rules, receivables will generally have lower capital charges than securitization exposures.[25] A participating interest in a pool of receivables generally will be

[25] For example, while the risk-based capital charge for the types of assets most commonly securitized is 8%, the risk-based capital charge for a single vertical security backed by those same assets would be at least 12% under the Simplified Supervisory Formula Approach (SSFA). Under SSFA, a single vertical security would have an attachment point of 0% and a detachment point of 100%. Where the delinquency parameter (W) is 0%, the capital charge under SSFA would be 12%. If parameter W is greater than 0%, the capital charge under SSFA for a single vertical security would be even higher

treated for regulatory capital purposes in the same manner as the underlying receivables. If the participating interest option provides for more favorable capital treatment and functions in essentially the same manner as EVI, there seems to be no reason to not include participating interests as an option.

In addition, a participating interest alternative could be implemented using the specific text provided in Appendix C of this Letter.[26] However, the implementation of a participating interest alternative also would require accommodating revisions to Rule 190 under the Securities Act to exempt securitized participating interests from registration under Section 3 of the Securities Act.

c. Third Party Credit Support as a Form of Acceptable Risk Retention.

Finally, a number of SFIG members would like the Joint Regulators to allow sponsors risk retention credit for third party credit support—such as insurance policies, guarantees, and standby letters of credit—as additional forms of acceptable risk retention. While we recognize that the Joint Regulators have "[g]enerally . . . declined to recognize unfunded forms of risk retention for purposes of the proposal (such as fees or guarantees),"[27] the Joint Regulators have allowed this for Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) backed transactions under certain circumstances.[28] Such SFIG members believe that there is a strong argument for expanding this to other types of third party credit support as well.

These SFIG members believe that allowing sponsors to receive credit toward their risk retention obligations for forms of credit support where the sponsor ultimately bears the risk of loss if such credit support is drawn upon will continue to achieve the goals of the risk retention requirements, while giving sponsors flexibility to elect the best method for keeping "skin-in-the-game" given the needs of their businesses and the mechanics of the particular transaction. A sponsor that provides (or has provided on its behalf by a third party) a guarantee, surety bond, or a letter of credit to an issuing entity is no less exposed to risk of loss than a sponsor that holds an EHRI or EVI. This is because the sponsor will pay for or backstop those obligations 100% if such credit support is drawn because of problems with the quality of the underlying assets. In addition, in such a situation, the sponsor has a real incentive to make sure that underwriting of the underlying assets is of a high quality, just as it would if it were directly holding an EHRI or EVI. As a result sponsors retain substantially all risk associated with such types of third party credit support. Furthermore, the Committee of European Banking Supervisors (CEBS) has recognized the value of alternative forms of risk retention by "synthetic, contingent or derivative

26 The text provided in Appendix C of this Letter is based upon proposed text originally contained in a letter sent to the Commission by the Federal Regulation of Securities Committee and the Securitization and Structured Finance Committee of the American Bar Association on August 10, 2012.

27 *Id.* at 57,963.

28 *See id.* at 57,933.

means," expressly including the provision of a letter of credit as an acceptable form of risk retention in Article 122a.[29]

The ultimate credit quality of the sponsor providing such credit support is of course an important consideration for purchasers, but purchasers—acting on adequate disclosure regarding the form of risk retention and the financial condition of an enhancement provider—should make this decision, rather than the Joint Regulators. Therefore, we ask that the Agencies reconsider the merits of permitting sponsors to satisfy their risk retention obligations by retaining unfunded risk exposure through letters of credit, guarantees, and other forms.

C. **The New Certification Requirements Regarding Internal Controls Should Be Modified.**

The Re-Proposal introduces new requirements pursuant to which the related depositor in certain ABS transactions that are exempt from risk retention must: (1) make certifications regarding its internal supervisory controls for ensuring that the underlying assets are qualified assets; and (2) provide copies of those certifications to potential purchasers prior to closing.[30] Many SFIG members believe that revisions should be made to the final risk retention rules so that:

a. These certifications are required only for RMBS transactions that are exempt from the standard risk retention requirements due to the inclusion of QRMs.

b. Sponsors are required to provide these certifications only to the Commission and their appropriate Federal banking agencies, if any, as currently defined in the Re-Proposal.[31] and

c. It is clear that these certifications must be retained by the sponsor for a period of no more than five years.[32]

As further explained below, such SFIG members believe that the interests of purchasers are sufficiently protected under Federal securities laws without requiring the delivery of these certifications to purchasers. They also are concerned about the potential liabilities created for sponsors and issuers by requiring that such certifications be delivered to potential purchasers, the costs of which will ultimately be borne by consumers.

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29 Article 122a of Directive 2006/48/EC, as amended by Directive 2009/111/EC.

30 *See* Re-Proposal, § ___.13(b)(4)(i), 78 Fed. Reg. at 58,037, § ___.16(a)(8)(i), 78 Fed. Reg. at 58,039, § ___.17(a)(10)(i), 78 Fed. Reg. at 58,041, and § ___.18(a)(8)(i), 78 Fed. Reg. at 58,042.

31 *See id.* § ___.2, 78 Fed. Reg. at 57,939 (definition of "[a]ppropriate Federal banking agency).

32 *See* footnote 7 above.

2. *The Certification Requirement Should Apply Only to Residential Mortgage Transactions Exempt From Standard Risk Retention Requirements.*

The Re-Proposal requires depositors of securities backed by certain types of qualified assets—residential mortgage loans,[33] commercial loans[34], CRE loans[35], and automobile loans[36]—to make certifications regarding the effectiveness of their internal supervisory processes for ensuring that the underlying assets for these securities are qualified assets.[37] Sponsors are further required under the Re-Proposal to provide these certifications, or cause them to be provided, to potential purchasers prior to the sale of the related ABS, and to provide copies of the certifications to the Commission and appropriate Federal banking agencies, if any, upon request.[38]

Many SFIG members believe that requiring such certifications broadly across the asset classes described above would extend the certification requirements beyond those outlined in § 941 of the Dodd-Frank Act. Under § 941(e)(6) of the Act, issuers are required to certify "for each issuance of *an asset backed security collateralized exclusively by qualified residential mortgages*, that the issuer has evaluated the effectiveness of the internal supervisory controls of the issuer with respect to the process for ensuring that all assets that collateralize the asset backed security are qualified residential mortgages" (emphasis added). This language makes no mention of certifications with respect to qualified commercial loans, CRE loans or automobile loans. Furthermore, this provision was intended to help ensure quality control of residential mortgage loans in the "originate to distribute" market. For these reasons, these SFIG members believe that the certification requirement in § 941(e)(6) of the Dodd-Frank Act was intentionally drafted to apply only to securities backed by qualified residential mortgages and requests that the certification requirements set forth in the Re-Proposal for securities backed by commercial loans (§ ___.16(a)), CRE loans (§ ___.17(a)) and automobile loans (§ ___.18(a)) be removed.

3. *The Final Rule Should Require that Certifications of Internal Controls be Disclosed Only to Specified Federal Regulators.*

A significant number of SFIG members—particularly issuers and sponsors—believe that potential purchasers already are sufficiently informed of the details of securitization transactions by the substantial disclosures required by existing Federal securities laws, making the additional certifications required under the Re-Proposal unnecessary.[39] Current offering disclosures for

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33 Re-Proposal, § ___.13(b)(4)(i), 78 Fed. Reg. at 58,037.

34 *Id.* § ___.16(a)(8)(i), 78 Fed. Reg. at 58,039.

35 *Id.* § ___.17(a)(10)(i), 78 Fed. Reg. at 58,041.

36 *Id.* § ___.18(a)(8)(i), 78 Fed. Reg. at 58,042.

37 *See id.* § ___.13(b)(4)(i), 78 Fed. Reg. at 58,037, § ___.16(a)(8)(i), 78 Fed. Reg. at 58,039, § ___.17(a)(10)(i), 78 Fed. Reg. at 58,041, and § ___.18(a)(8)(i), 78 Fed. Reg. at 58,042.

38 *Id.* § ___.13(b)(4)(iii), 78 Fed. Reg. at 58,037, § ___.16(a)(8)(iii), 78 Fed. Reg. at 58,040, § ___.17(a)(10)(iii), 78 Fed. Reg. at 58,041, and § ___.18(a)(8)(iii), 78 Fed. Reg. at 58,043.

39 For some asset classes (like autos), such certifications could be possible on an annual basis (*see* Section VIII of this Letter); however, for others (like RMBS) this solution will not work. Accordingly, such a solution would be of limited applicability across asset classes.

ABS of the type for which such certifications would be required already include disclosure of the underwriting and due diligence processes used to evaluate the underlying collateral. Rule 193[40] and Item 1111 of Regulation AB[41] promulgated by the Commission mandate review of the pool of assets underlying ABS, and require disclosure of the nature of the review performed by the issuer or sponsor and the findings and conclusions of such review. While technically applicable only to publicly-issued ABS offerings, in practice the majority of the private ABS transactions in the market today also comply with these rules. Furthermore, Rule 15Ga-1[42] obligates sponsors and issuers of ABS to report statistics with respect to demands for repurchases of underlying assets as a result of breaches of the applicable seller's or originator's representations and warranties. Accordingly, even without receipt of the proposed certifications, potential purchasers are provided with information to help them determine whether the underlying collateral consists of qualifying assets before deciding to purchase the related securities.

In addition, the Re-Proposal and current Federal securities laws provide purchasers with post-issuance protection from risks associated with breaches of depositors' and sponsors' internal supervisory controls with respect to the underlying assets. Under the Re-Proposal, in the event that assets included in the pool underlying non-risk-retained transactions (or reduced risk-retained transactions, in the case of blended pools) fail to meet all of the criteria set forth in the Re-Proposal for qualifying assets, sponsors may avail themselves of a safe harbor by repurchasing the non-qualifying assets.[43] This mechanism protects purchasers by encouraging sponsors to remove non-qualifying assets from the pool when such assets are identified. Sponsors' obligations under Rule 15Ga-1[44] to disclose repurchases in other sponsored transactions likewise help potential purchasers to identify sponsors who may have inadequate supervisory controls in place for selecting qualifying assets. Furthermore, Federal securities laws (including § 10(b) of the Securities Exchange Act of 1934[45] and Rule 10b-5[46] promulgated thereunder) already provide purchasers with a remedy for losses incurred when a depositor fails to comply with the internal supervisory controls described in the offering disclosure and, as a result, non-qualified assets are included in the pool—*i.e.*, there is a blended pool that is not disclosed as being "blended" or the applicable percentage of risk retained is based on the applicable assets being exempt. This provides all parties (sponsors, underwriters, issuers and purchasers) with a well-established standard of liability built upon a settled body of Federal law

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40 17 C.F.R. § 230.193.

41 17 C.F.R. § 229.1111(a)(7) and (a)(8). *See* Issuer Review of Assets in Offerings of Asset backed Securities, 76 Fed. Reg. 4231 (Jan. 25, 2011) (amending 17 C.F.R. § 229.1111 and adding 17 C.F.R. § 230.193).

42 17 C.F.R. § 240.15Ga-1. While 15Ga-1 does not require disclosure of the particular representations and warranties that were breached to trigger a repurchase obligation under the underlying documentation, such reporting will provide evidence to purchasers as to whether a sponsor has a history of deals with significant representation and warranty breaches, which would suggest that internal controls for identifying eligible collateral might be lacking.

43 Re-Proposal, § ___.13(c), 78 Fed. Reg. at 58,037, § ___.16(b), 78 Fed. Reg. at 58,040, § ___.17(b), 78 Fed. Reg. at 58,042, and § ___.18(b), 78 Fed. Reg. at 58,043.

44 17 C.F.R. § 240.15Ga-1.

45 The Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10, 48 Stat. 881 (codified as amended at 15 USC §§ 78a-77kk).

46 17 C.F.R. § 240.10b-5.

and abundant legal scholarship which they can use to guide their business decisions. For these reasons, a significant portion of SFIG members believe that the final rule should require that these certifications need only be provided to the Commission and appropriate Federal banking agencies, upon request.

4. *The Final Rule Should Limit Sponsor's Ongoing Disclosure and Retention Obligations for Certifications of Internal Controls.*

As noted above, a significant portion of the SFIG membership believes that the foregoing certifications should be provided only to the Commission and appropriate Federal banking agencies, upon request. The SFIG membership would further ask the Joint Regulators to modify the final risk retention rules slightly on this point to clarify the period for which the sponsor must maintain, and be obligated to provide to the Commission and Federal banking agencies, copies of the certifications ultimately required under § 941(e)(6) of the Dodd-Frank Act. The Re-Proposal is currently silent on this issue, which creates an ambiguity for sponsors in understanding their record-keeping obligations.[47] To remedy this, the SFIG membership proposes that sponsors be required to maintain copies of such certifications for a period of no more than five years. As noted above, such a period for retention would be consistent with the Commission's requirements for retaining original signature pages of electronically submitted documents.[48]

The Re-Proposal's certification requirement combined with the right of the Commission and appropriate Federal banking agencies to request and review those certifications will provide these regulators with the tools necessary to ensure that depositors are complying with their obligations to properly select and identify qualifying assets. Certification also provides sponsors with evidence to support their decisions to enter into transactions on a non-risk-retained basis (or a reduced risk-retained basis in the case of a blended pool). Both outcomes ultimately benefit and protect purchasers opting to purchase securities in transactions that are exempt from the risk retention rules. For these reasons, SFIG members request that the modifications to the Re-Proposal described in this section be adopted in the final rules.

D. A Clear Mechanism For the Joint Regulators to Provide Interpretive Guidance Should be Established in the Final Rule.

The SFIG membership is concerned that the Re-Proposal lacks a clear mechanism for the Joint Regulators to provide clarifications, resolve interpretive questions, and determine appeals.

The Joint Regulators have asked for feedback about whether staff interpretations and guidance that are to be issued publicly should be issued jointly. Our concern with the process of joint responses and joint guidance is that they are quite time consuming to publish. The time it has taken to implement the Dodd-Frank Act is clear evidence of this. On the other hand, allowing each Joint Regulator to issue its own guidance will inevitably lead to conflicting guidance on issues. To this point, the Re-Proposal only addresses the need for joint responses from the Joint Regulators to the extent they are to be provided publicly. So it is quite possible that a market

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[47] *See* Re-Proposal, § ___.13(b)(4)(iii), 78 Fed. Reg. at 58,037, § ___.16(a)(8)(iii), 78 Fed. Reg. at 58,040, § ___.17(a)(10)(iii), 78 Fed. Reg. at 58,041, and § ___.18(a)(8)(iii), 78 Fed. Reg. at 58,043.

[48] 17 C.F.R. § 232.302(b).

participant seeking guidance from several different Joint Regulators on a specific interpretive question could receive in response non-public staff comment letters from various Joint Regulators that differ in their advice. The Re-Proposal in its current form leaves the market without any clear guidance as to how to reconcile or appeal such a situation.

For these reasons, the SFIG membership strongly believes that the final rule should include a mechanism to request clarifications, resolve interpretive questions and formally determine appeals, and should establish a clear timeline for the Joint Regulators to respond in each instance. The final rule should also clearly lay out the hierarchy of authority for which Joint Regulators are required to provide binding or generally applicable interpretations, particularly in relationship to the definition of "asset backed security." Furthermore, the final rule should specify a clear, single initial point of contact among the Joint Regulators for all market participants seeking guidance. The Re-Proposal provides that market participants *may* seek guidance from their primary Federal banking regulator, or if none, from the Commission, but the Re-Proposal does not make this exclusive.[49] The SFIG membership considers the mechanism as currently proposed to be inefficient and likely to handicap the interpretive guidance process because multiple Joint Regulators may well be processing similar requests for clarification or guidance at the same time, which could be avoided if all requests for clarification or interpretive guidance with respect to the final rules were processed through a single point of contact among the Joint Regulators. As for the other specifics of such a mechanism, the SFIG membership sees these as elements best developed among the Joint Regulators to fit within their processes, so long as the result is a clearly defined, expeditious process.

On a related note, we anticipate that there will be a gap between the date on which the final rule is adopted and the date on which the risk retention rules become effective. During this time, there will be market participants that are early adopters of the rules, and because of this, there is likely to be a need for clarification or resolution of interpretative issues during this period. The SFIG membership feels that it would also be very helpful if the final rule would specify a mechanism that market participants should follow to obtain such guidance during the interim period, *e.g.*, either through the FDIC under 12 C.F.R. 360.6, the same mechanism outlined in the adopted final rule (along the lines of what we suggested above), or some other interim mechanism to be identified.

While the SFIG membership fully appreciates the efforts of the Joint Regulators to improve and clarify the Re-Proposal, the U.S. securitization markets are dynamic—they are continuously changing and innovating—which will of course lead to interpretive questions that will need to be addressed by the Joint Regulators from time to time. This makes the need for a mechanism by which the Joint Regulators promptly and efficiently respond to inquiries of the utmost importance, and SFIG's members look forward to working with the Joint Regulators to develop the best process possible.

E. Investment Restrictions on Reserve Accounts Need to Be Eased.

Some SFIG members are concerned that the Re-Proposal's restrictions in § ___.4(c)(2) on the types of eligible investments in which reserve account funds can be invested are unduly

[49] Re-Proposal, 78 Fed. Reg. at 57,933.

restrictive. No money market mutual fund would qualify—even those that exclusively invest in government securities. Most securitization trustees receive some compensation directly from the mutual funds, and these "advisory fees" are part of the trustee business model. Without the fees from the mutual funds, additional compensation would have to be provided either from the waterfall or in upfront fees paid by the sponsor. The transaction, therefore, would be hurt twice by lower investment returns and higher fees. These restrictions also would result in the reserve account being more highly rated than the highest rated tranche of the securitization.

F. Cure Rights for Blended Pools Should Be Clarified in the Final Rule.

The Re-Proposal's blended pool provisions typically require that if a securitizer relies on a qualified asset provision to reduce its risk retention obligations, and a qualified asset ceases to be qualified, the securitizer must either cure or buy-back that asset from the deal.[50] While this requirement makes sense in the context of a transaction backed purely by qualified assets, it is problematic for transactions backed by blended pools. In a blended pool transaction, the qualifying asset ratio is calculated as of the cut-off date, meaning that the percentage of credit risk retention for the transaction will be set at that time. Because of this, SFIG members believe that the Joint Regulators should offer two different options for cure: (1) the proposed cure/buy-back option for pools with qualifying assets only; and (2) a separate option for blended pools, where a cure/buy-back would only be required to the extent that the classification of such an asset as not qualifying for exemption under the risk retention rules would have caused the percentage of risk retained by the sponsor (or other holder of the required retained interest) to be less than the applicable risk retention percentage that would have been required if such assets were treated as non-qualifying assets, calculated as of the cut-off date.

G. Clarification on Ability of Majority Owned Subsidiaries to Hold Risk Retention is Needed.

Although § __.3 now says that a majority owned affiliate of the sponsor can hold the required risk retention under § _.4 through § __.10, the provisions of § _.4 through § __.10 do not reflect this (except § _.5(f), about which we comment below) and continue to refer to the "sponsor" as the only entity which may retain the required risk. These sections should be modified to make clear that risk may be retained by "the sponsor (or a majority owned affiliate of the sponsor). Moreover, SFIG members question the requirements of § __.5(f), to apply the more stringent standard of a wholly-owned affiliate to master trusts. As discussed further in Section G of Part IV of this Letter, this should also be modified to require only "a majority owned affiliate of the sponsor" consistent with the other sections.

H. SFIG's Issuer and Underwriter Members Believe that the Proposed Minimum Threshold Risk Retention Amount For Blended Pools Should Be Lowered to 1% and 0% in the Case of Auto and RMBS Blended Pools.

The Joint Regulators have indicated in the Re-Proposal that they are considering inclusion of a minimum required risk retention amount for blended pools of at least 2.5%,[51] with

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50 *See e.g.*, *id.* § __.16(b), 78 Fed. Reg. at 58,040.

51 *Id.* at 57,986, 58,047, and 58,039.

the possibility that they may also consider a lower percentage. The SFIG membership understands and agrees that a minimum threshold amount of retained credit risk is necessary to make the concept of risk retention meaningful.

However, many SFIG members believe that including a 2.5% risk retention requirement for blended pools would create a disincentive for sponsors to include more than 50% qualified assets in their blended pools.[52] Since there would be no incremental reduction in the retention requirement as the percentage of qualified assets increases above 50%, sponsors would be unlikely to put more qualifying assets into such a pool. The effects of this would be that costs to consumers for non-qualifying assets would be higher, because their placement in securitization pools is more limited. Furthermore, the 2.5% floor actually punishes originators that have as their business model the origination of mostly qualified assets.

A number of SFIG members believe, however, that the goals of risk retention would still be served if the required minimum threshold amount of risk retention in blended pools was reduced to 1% (or 0 % in the case of QAL blended pools and QRM blended pools).[53] Assuming for simplicity's sake that the fair value of securities issued in a blended pool transaction is $100 million (which is quite small by comparison to many of today's deals), requiring a sponsor to hold securities of $1 million is quite meaningful, particularly if the securities represent a first-loss piece. On the other hand, some SFIG members, particularly investors, do not support such a reduction of the proposed minimum risk retention requirement for blended pools, on the basis that permitting less "skin-in-the-game" and allowing more latitude to blend qualifying and non-qualifying assets at the same time is a combination that may result in the gaming of the risk retention rules.

I. <u>Clarification of Assets Included in "Servicing Rights" Is Needed.</u>

SFIG members believe that the final rule should clarify that issuers of securities backed by qualifying assets are permitted to hold hedging agreements, bond insurance policies, pool insurance polices, and other forms of credit enhancement and hedging agreements as discussed under Items 1114 and 1115 of Regulation AB.[54] Interest rate hedges, bond insurance policies, pool insurance policies and other forms of credit enhancement form an important component of many securitization structures and provide clear benefits to investors.

The commentary to Re-Proposal related to the definition of "servicing assets" suggests that the definition of "servicing assets" was meant to be defined broadly, and could be read to include such types of contracts and related rights, including specifically, "derivative agreements of the issuing entity used to hedge interest rate and foreign currency risks;"[55] however, such

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[52] Auto and RMBS issuers have raised concerns about the disincentives such a high minimum risk retention requirement would have for blended pools. *See* Section B of Part II and Section J of Part VIII.

[53] As discussed in Part J of Section VIII and Part B of Section II, a number of members have proposed a threshold of 0% risk retention which would apply to QAL/non-QAL blended pools and QRM/non-QRM blended pools.

[54] 17 C.F.R. §§ 229.1114 and 1115.

[55] Re-Proposal, 78 Fed. Reg. at 57935.

breadth is not clear from the definition of "servicing assets" itself under the Re-Proposal[56] and, indeed, the use of the term "servicing" in the defined term, "servicing assets" may lead to a view that a more limited meaning was intended. SFIG's members are concerned that without clarification in the final rule, issuers using such agreements and other forms of credit enhancement would not be able to benefit from the exemptions from risk retention otherwise clearly allowed under the Re-Proposal, the costs of which could ultimately be borne by investors (in the form of less credit enhancement) and borrowers (in the form of higher interest rates).

[56] "Servicing assets" are defined to mean "*rights or other assets designed to assure the timely distribution of proceeds* to ABS interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. Servicing assets include amounts received by the issuing entity as proceeds of rights or other assets, whether as remittances by obligors or as other recoveries." (emphasis added). Re-Proposal, §___.2, 78 Fed. Reg. at 58026.

II. <u>RESIDENTIAL MORTGAGE BACKED SECURITIES</u>.

SFIG's membership appreciates the improvements that the Joint Regulators have made in the Re-Proposal with respect to residential mortgage backed securities (RMBS). Specifically, we believe that the Re-Proposal has taken positive steps toward fulfilling the criteria we set out in Section B of this Part, including, in the case of RMBS, the inclusion of the QM criteria in the definition of QRM and the removal of the PCCRA concept included in the Original Proposal.

Nevertheless, there remain some areas of the Re-Proposal dealing with RMBS that are of concern to a number of SFIG's members. To the extent that our membership is in general agreement regarding these concerns and how best to resolve them, we set out below our recommendations to further enhance the Re-Proposal. In those cases where SFIG's membership has divergent views, we have highlighted the key arguments and counter-arguments relating to those issues.

While we have identified a range of criteria that we believe are essential to the successful implementation of any risk retention requirement for ABS generally, the need to enable a vibrant private-label RMBS securitization market is fundamental to the Administration's housing reform goals. Accordingly, while market considerations are of clear import for any asset class, they are particularly important when it comes to the residential mortgage sector as we look to facilitate the broad availability of reasonably priced and responsibly underwritten home mortgage loans.

With that aim in mind, this section of the comment letter will address the following topics:

a. the proposed adoption of the Truth in Lending Act's (TILA)[57] QM definition as the definition of QRM for risk retention purposes and the alternative proposal to define QRM using a QM-Plus standard;

b. the need to permit blended pools combining (1) QRM assets with non-QRM assets and (2) seasoned assets with unseasoned assets, both of which pools would be subject to lower risk retention requirements consistent with other qualified asset types;

c. suggested changes to the exception for seasoned loans; and

d. the need to modify the risk retention requirements to exclude NERs and lower-tier regular REMIC interests created for tax purposes.

[57] 15 U.S.C. § 1601 *et seq.*

A. SFIG Members Support the Inclusion of QM Criteria in the Definition of Qualified Residential Mortgage, But Membership's Views on QM-Plus are Mixed.

1. *Qualified Mortgage as Qualified Residential Mortgage.*

In January 2013, the Consumer Financial Protection Bureau (CFPB) promulgated final regulations defining QM under TILA.[58] The Re-Proposal adopts that definition as the definition of QRM for the purposes of the credit risk retention rules.

There is support across our membership for the inclusion of the QM criteria in the definition of QRM. The QM definition imposes a debt to income limit and requires, among other things, that loans be fully documented, that they not have certain specified features such as negative amortization, interest only periods or balloon payments (except under limited circumstances),[59] and that the lender must verify the borrower's income and assets.[60] These requirements are intended to encourage the use of underwriting and product features that are indicative of a lower risk of default according to historical loan performance data.[61] SFIG's membership supports the inclusion of these factors in the final definition of QRM.[62]

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58 12 C.F.R. § 1026.43, Ability-to-Repay and Qualified Mortgage Standards Under the Truth In Lending Act (Regulation Z), 78 Fed. Reg. 6408 (Jan. 30, 2013) (Ability-to-Repay). The definition of QM will not take effect until January 10, 2014 and remains subject to continuing clarifications such as the CFPB's recent amendment of the rule on September 13, 2013. Because of the uncertainty that this unsettled definition already creates within the industry, the addition of yet another standard would be particularly problematic from sponsors' and originators' points of view. Additionally, as discussed in Section B of this Part below, blended pools of qualified and unqualified RMBS assets are necessary to ensure that future changes to the definition of QM and QRM do not cause unintended instability or fragmentation in the securitization markets.

59 CFPB rules permit loans with balloon payments, limited verification of employment status, and less than complete review of credit history to qualify as QMs under certain very narrow circumstances. For QMs originated by small creditors (those which originate fewer than 500 residential mortgages per year and possess assets less than $2 billion), there is no specific requirement that the creditor verify employment status or review the borrower's credit history. Nevertheless, an interest in prudent underwriting would generally cause these creditors to undertake these analyses. Balloon payment QMs can only be originated by small creditors who primarily serve rural or underserved areas, and their QM status can be lost if these loans are sold, assigned or transferred after consummation. Accordingly, most of SFIG's members believe that such non-standard QMs will constitute a *de minimis* portion of the total RMBS market.

60 As further defined in regulations promulgated by the CFPB, a standard QM loan must have: (1) regular periodic payments that are substantially equal; (2) no negative amortization, interest only, or balloon features; (3) a maximum loan term of 30 years; (4) total points and fees that do not exceed 3% of the total loan amount, or the applicable amounts specified in the Final QM Rule for small loans up to $100,000; (5) payments underwritten using the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment is due; (6) consideration and verification of the consumer's income and assets (including employment status if relied upon), current debt obligations, mortgage-related obligations, alimony and child support; and (7) total debt-to-income ratio that does not exceed 43%.

61 *See e.g.* Bureau of Consumer Financial Protection, *Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)*; Ability-to-Repay, 78 Fed. Reg. at 6410-12.

62 Notwithstanding this endorsement of one criteria of QM that is concerning for some SFIG members is the limitation of credit scoring models that can be used for QM loans to only FICO models. The QM criteria in part are built off of the conditions established by FHFA for the purchase by GSEs of mortgage loans, and the GSEs are permitted to accept only FICO credit scoring models. We believe that both consumers and lenders

Including the QM criteria in the final definition of QRM should enhance significantly the credit quality of those loans that are exempted from the risk retention requirement, without unduly increasing the cost or reducing the availability of credit to consumers by creating inefficient barriers to private secondary residential mortgage market activity.

Some SFIG members, primarily issuers and underwriters, support the adoption of the QM standard as the standard for QRM in the Re-Proposal. These members believe that the improvements in eligible product types and the inclusion of other QM criteria are sufficient, efficient and sustainable. Additionally, the regulatory certainty of one standard and the market efficiency that it provides would minimize the increased costs to securitizers and ultimately to consumers without undermining the goals of risk retention. This would successfully encourage responsible underwriting and align the interests of securitizers and purchasers without unduly disrupting the RMBS market.

The SFIG members that support adopting the QM standard as the QRM standard generally believe that using the QM standard helps ensure that underwriting criteria will not deteriorate when market conditions and volumes improve. These members are of the opinion that the wider spreads demanded by investors along with the increased credit enhancement determined by rating agencies for securities backed by high LTV/low-down-payment loan pools fairly compensate investors for any increased risk. They believe that further tightening of the QRM requirements would unjustifiably restrict consumer credit as well as the secondary market in private-label RMBS.

Other SFIG members, notably many of our investor members, feel that the QM criteria make a significant contribution to the quality of loans being securitized, but that they do not do enough on their own. As further discussed in Section A.2 of this Part below, these members feel that the inclusion of additional criteria, especially a minimum down payment requirement, is critical for achieving the goals of risk retention.

2. *"QM-Plus" Metrics.*

The Joint Regulators requested comment on whether they should adopt additional "QM-Plus" metrics for the definition of QRM. Essentially, this standard would require that, in addition to satisfying the elements of QM, a QRM must: (1) have a minimum 30% down payment or 70% maximum loan-to-value (LTV) ratio for refinancings; (2) be a first lien mortgage on the borrower's primary residence; (3) if the mortgage is a purchase money loan, not have any junior liens; and (4) satisfy certain credit history requirements with respect to the borrower.[63] The

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would be served best by allowing lenders a choice of credit scoring models, validated by the GSEs. Since our membership broadly favors incorporation of the QM standards into the definition of QRM (with or without additional criteria as discussed above), we believe that the best way to address this issue in not by modifying the definition of QRM, but rather for FHFA to allow GSEs to accept FICO models *and* other validated credit scoring models from other developers. This approach would bring the flexibility requested, while still aligning QM criteria with those in the definition of QRM.

63 Re-Proposal, 78 Fed. Reg. at 57,993. The specified QM-Plus credit metrics may be problematic because they will potentially disqualify large numbers of borrowers who would otherwise qualify for QRM loans. SFIG's issuer members have highlighted that all of the features addressed by QM-Plus already are subject to detailed

advisability of including these criteria, particularly the minimum down payment or borrower equity requirement, has proved to be among the most controversial aspects of risk retention within SFIG's membership.

a. Some SFIG Members Support QM-Plus Because It Encourages Borrowers To Keep "Skin-in-the-Game."

Some of our membership, notably, many of our investor members, do not believe that the mere tightening of underwriting criteria as in the QM standard is sufficient to encourage stability in the RMBS markets in the future. These members believe that, the existence of a down payment or borrower equity requirement prior to the financial crisis would have had a significant impact on a homeowner's equity and would therefore have had a positive impact on both the incidence and size of mortgage defaults by reducing any incentive to abandon underwater mortgages.

Many investors believe that defaults are driven by three key factors: stability, ability and willingness to pay. These investors argue that while many of the QM criteria focus on stability and ability to pay, the existence of an equity stake in a home, via QM-Plus, should significantly drive the "willingness to pay" factor and consequently reduce the credit risk of the loan. This reduction in risk is something investors feel should be reflected as an option to consumers, whereby if they elect to make a down payment or have equity in a home they reap the benefits of a lower interest rate driven by a pricing concession for QM-Plus loans in the market. Essentially, these investors believe that consumers should have a choice as to how they manage their mortgage debt exposure. They may either subscribe to the QM standards or they may elect to make a down payment or keep equity in a home and consequently achieve QM-Plus status.

The choices consumers make and the consequent risk that these choices present, should then be reflected in the interest rate the consumers are charged on their loan. Failure to present such a differentiation will effectively disincentivize any borrower from making a down payment, which could ultimately create increased risk across the whole mortgage sector, implicitly creating higher costs for all consumers, irrespective of their risk profile. Therefore many investors believe that requiring borrowers to have some amount of "skin-in-the-game" should be an essential criterion for a sponsor to obtain an exemption from holding credit risk.

Of those members in favor of a QM-Plus standard, a minority have argued that the final rule should establish a high bar to qualify for an exemption from risk retention, and thus support a 30% down payment or borrower equity requirement. However, the majority of members favoring QM-Plus do not necessarily favor a 30% down payment or borrower equity criterion, recognizing that only a small proportion of home loans originated today would satisfy this requirement, and even highly stable prime home loans are typically originated with much lower down payments or borrower equity.

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disclosures to potential purchasers and rating agencies, who incorporate them into their pricing and spread and subordination requirements, respectively.

While a range of other down payment suggestions have been put forward, the general consensus among our investor members is that a 20% down payment or borrower equity would strike the best balance between ensuring that borrowers have "skin-in-the-game" and setting a standard that is workable in current market conditions. These investor members also point out that total mortgage risk is driven by a number of factors, including the potential severity of a loss if the underlying borrowers default on their obligations and by the ability and willingness of borrowers to repay. Given this, such SFIG members believe that a dynamic, multi-variable approach to assessing total mortgage risk in loans identified as QRM should be employed, with a minimum down payment or borrower equity required in the definition of QRM in the final rules.

b. QM-Plus Cannot Assure a Robust Securitization Market for Non-QM Loans But May Result In a Fragile Securitization Market for Non-QRM Loans.

The adoption of QM-Plus as the definition of QRM would segment the RMBS securitization market for newly-originated loans into three sectors: (i) QRM, (ii) QM loans that are not QRM, and (iii) loans that are neither QRM nor QM. Non-QM loans would be a significant portion of any non-QRM market, regardless of whether the Joint Regulators adopt QM-Plus. Such loans face substantial hurdles to securitization because TILA imposes assignee liability, foreclosure defenses, and various other requirements that make them difficult to securitize.[64] The development of a robust securitization market for non-QM loans is expected to be dependent upon future experience with the Ability-to-Repay Rule. Because non-QM loans are so difficult to securitize for reasons other than their treatment under the risk retention rules, neither the existence nor the vitality of an RMBS securitization market will assure a robust securitization market for non-QM loans.

Applying a QM-Plus standard for the definition of QRM would shrink the size of the QRM pool, while growing the size of the non-QRM pool. Many issuers and originators are concerned that at various points in time, loans satisfying the QM-Plus criteria or satisfying the QM criteria but not the QM-Plus criteria may not be available in sufficient quantities to permit their economical securitization and that the RMBS securitization may not be able to meet the

[64] In the context of TILA, a non-QM is legal so long as it satisfies the ability-to-repay requirement. However, such a loan does not enjoy the protections of a rebuttable presumption or safe harbor from this requirement. In that regard, TILA imposes assignee liability for violations of the ability-to-repay standard, and this potential liability exists for the life of the loan. Purchasers of non-QM loans therefore must evaluate this potential risk. In the context of a whole loan sale, the buyer would likely perform extensive loan level diligence on the pool to ascertain compliance with the ability-to-repay requirement. In the context of securitizations, ratings agencies have historically struggled to ascertain the risks presented by assignee liability. The industry's experience with the Georgia Fair Lending Act (GFLA) (Georgia Code 1981, § 7-6A-1) is instructive. Prior to its amendment, the GFLA included potentially unlimited assignee liability for acts of the originator. Because the liabilities were so difficult to value (and could theoretically exceed the value of the loans themselves), ratings agencies refused to rate RMBS including loans covered by the GFLA. Thus, no rated securitizations included any home loans subject to the GFLA, as originally enacted and other Georgia loans were excluded based upon concerns that these loans could be covered by the GFLA. Ultimately, the Georgia Legislature amended the GFLA to cap assignee liability and mortgage lenders resumed originating loans in Georgia. Accordingly, SFIG believes that non-QM loans will be dramatically more difficult to securitize than loans that enjoy the QM safe harbor or rebuttable presumption that the loan satisfies the ability-to-repay requirement because of the potential assignee liability.

funding needs for both types of loans. Many investors, however, do not believe that these difficulties will materialize.

SFIG's issuer and underwriter members also are concerned that, even if a viable securitization market were to develop with respect to non-QM-Plus loans, this market could be vulnerable during times of economic stress. Thus, an industry participant, receiver or conservator confronted with a legacy book of non-QM-Plus loans may not be able to use existing securitization markets to efficiently dispose of those assets, even in the event that the QM-Plus criteria create viable markets for both QRM and non-QRM but QM securitizations at the time the final rule is enacted.

This market fragmentation would also likely mean that credit for borrowers would become more expensive. On the other hand, some investors do not believe that market fragmentation will be a serious problem and that a QM-Plus standard would cause QM-Plus loans to trade at a premium, resulting in better rates for borrowers who make the required down payment or keep the required equity. Even assuming that both classes of loans can be originated in sufficient quantities to support independent and efficient securitization markets for QRMs and loans that are QM but not QRM, splitting the market into multiple classes that cannot be mixed will result in longer aggregation periods and increased hedging costs. As discussed below in Section B of this Part, many SFIG members believe that the best tool to both ensure that the greatest variety of loans can be securitized and reduce market fragmentation is blended pools of qualified and unqualified mortgage loans subject to reduced risk retention requirements in proportion to their particular mix of assets.

c. Operational Difficulties and Costs of Regulatory Compliance Should the Joint Regulators Adopt QM-Plus.

Since the promulgation of the QM definition, residential mortgage market participants have devoted substantial amounts of time and money to developing systems to ensure that they can comply with the new QM standards. SFIG's issuers and underwriters believe that necessitating duplicative systems in order to comply with a separate risk retention requirement for non-QM-Plus loans would create artificial technological barriers to entry (or re-entry) into the RMBS market. Such systems would likely need to be created in-house by the financial institutions who intend to issue RMBS because they would not be of general utility to mortgage originators. Third party vendors may not have incentives to create and license systems for such a narrow market. The costs and complications would be an artificial technological barrier for an individual institution seeking to enter into the RMBS market, reducing market volume and increasing market concentration, which may reduce competition and increase costs to consumers.

3. *Conclusion*.

The SFIG membership generally supports the inclusion of the QM core criteria in the definition of QRM, while the membership is split on the inclusion of additional criteria such as QM-Plus in the definition of QRM.

Many SFIG members—particularly issuers, sponsors, and originators—believe that the improvements already adopted by the industry and now required by the QM standard achieve the goals of § 941 of the Dodd-Frank Act. Specifically, they promote the origination of affordable consumer mortgage loans with credit risk that is both lower and more transparent. SFIG members holding this view tend to believe that having the same criteria for QM and QRM will increase the availability of credit on terms favorable to consumers, while requiring large down payments or borrower equity for qualified assets will reduce such availability. They feel that the QM as QRM paradigm is the best way to ensure that sufficient volumes of high quality mortgage loans are originated to support a vibrant RMBS market.

Conversely, other SFIG members, particularly investors, take the view that the QM-Plus criteria, and the down payment or borrower equity requirement in particular, are necessary to ensure that securitizers *and* borrowers retain sufficient "skin-in-the-game" to align their incentives with RMBS investors. These members feel that without significant borrower incentives to follow through on their commitments, the RMBS market could become unstable if the residential housing market were to suffer another substantial and sustained decline in housing prices.

While there is disagreement among SFIG's membership as to whether a down payment or borrower equity requirement should be a component of the QRM definition, a large portion of the SFIG membership agrees that a 30% down payment requirement would be excessive. Such a requirement could negatively impact affordable housing goals. In essence, housing is made more affordable using leverage. On the other hand, such leverage does create risk, and SFIG investor members are concerned that this risk can easily become excessive.

B. <u>Blended Pools for RMBS Should Be Permitted</u>.

In keeping with the treatment of other types of qualified assets, SFIG members believe, by consensus, that to the extent that QRM is not defined as QM, RMBS transactions should be permitted to use blended pools of qualified and unqualified assets. SFIG's issuer and underwriter members further believe that an RMBS blended pool option should be provided regardless of how QRM is defined. As discussed below in the section on statutory authorities, the SFIG membership believes that the Joint Regulators have broad statutory powers to provide such an exemption from the risk retention requirements.

Many of SFIG's issuer and underwriter members believe that there should be no minimum level of risk retention on RMBS blended pools, and that the amount of risk retained should be based purely on the ratio of qualified to unqualified assets in the pool. Under this approach, all non-QRM loans would still be subject to full 5% risk retention and all QRM loans would be exempt.[65] Accordingly, the total risk required to be retained across the pool would be somewhere between 0% and 5%, depending on the ratio of QRM to non-QRM in the pool. Such SFIG members believe that this approach is the best method of implementing the goals of risk

[65] SFIG members believe that the Joint Regulators have the authority to permit blended pools of QRMs and non-QRMs (*see* section B.1 of this part II). To the extent that QRM is not defined as QM and the Joint Regulators feel that a more restricted form of RMBS blended pools is appropriate, SFIG's issuer and underwriter members believe that QRM loans should be exempt from the risk retention requirement as long as they are not pooled with non-QM loans, and in such case all non-QRM loans would still be subject to the full 5% risk retention in all cases.

retention for blended pools, from such members' perspective, since it considers appropriate risk retention at the individual loan level.

If the proposed exemption were to apply regardless of how QRM is defined as many of SFIG's members suggest, all non-QRM loans would still be subject to full 5% risk retention and all QRM loans would be exempt. Accordingly, the total risk retained across the pool would be somewhere between 1% and 5%,[66] depending on the ratio of QRM to non-QRM in the pool.

Other members, particularly many investor members, feel that providing unlimited flexibility with respect to the mixing of qualifying and non-qualifying assets could create opportunities for practices that would be inconsistent with the principles of risk retention. Therefore, to the extent that RMBS blended pools are permitted to proportionally lower required risk retention, these members believe that there should be a 2.5% risk retention minimum. They feel that this minimum would provide investors some protection in scenarios where sponsors pool lower quality non-QRM loan with higher quality QRM loans.

The ability to blend pools of asset types would avoid the risk of market fragmentation in the event that the Joint Regulators adopt QM-Plus. Allowing for blended pools of QRM and non-QRM home loans, as well as blended pools of eligible seasoned and unseasoned loans,[67] would ensure that those types of loans have ready access to the securitization markets, regardless of the particular origination volumes of each at a particular point in time. This would preserve the flexibility of securitization as a whole while still offering purchasers the protections of risk retention when they invest in pools that contain newly originated non-QRM loans, and especially non-QM loans.

Without blended pools, the adoption of QM-Plus would fragment the market into at least three segments: loans that are neither QM nor QRM; loans that are QM but not QRM; and loans that are both QRM and QM since there would be no benefit for issuers to include any higher quality assets in a pool with non-QRM assets (for the reasons we discussed above in Section I of Part I).[68] In a best case scenario, securitizers would have to divide their portfolios into a greater number of smaller transactions to benefit from the QRM and seasoned loan exemptions, incurring substantially higher costs of doing business. There may also not be sufficient quantities of certain types of assets to justify securitizing them, freezing entire categories of loans out of the securitization market.

If, however, the Joint Regulators adopt some form of blended pool provision together with QM-Plus, securitizers will not have to divide their portfolios inefficiently, and the market

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66 A number of SFIG members support reduction of the minimum required risk retention amount to 1% (or 0% in the case of QAL blended pools). *See* Section H of Part I and Section J of Part VIII.

67 *See* Section D of Part III of this Letter, *infra*, for a discussion of seasoned loans. Certain of SFIG's investor members question the need to blend pools of seasoned and unseasoned loans because ABS backed by these types of assets are unlikely to appeal to the same types of investors. Typically, an investor seeks to invest in seasoned loans or unseasoned loans specifically, and so a blended pool would have no appeal to investors who do not invest in assets backed by seasoned loans. This distinction is based on the desirability of seasoned loans as an investment generally, and not necessarily on concerns related to risk retention.

68 The number of categories would increase to six if you consider seasoned and unseasoned loans.

will not become fragmented. This will improve a given loan's access to the secondary market without depriving purchasers of the benefits of credit risk retention or risk running afoul of a statutory mandate. Increased secondary market efficiency will reduce the costs of credit to consumers.

1. *Statutory Authority.*

As an initial matter, support for the concept of blended pools can be found in the Joint Regulators' broad discretion under the Dodd-Frank Act to define QRM. The only restriction that the Dodd-Frank Act places on the definition of QRM is that it can be no broader than the definition of QM, *i.e.*, it must be at least as restrictive as the definition of QM. Thus, the Joint Regulators have the implicit authority to require zero risk retention on pools composed exclusively of QM loans. It would not be rational for Congress to grant the Joint Regulators full discretion to exempt QMs from the risk retention requirements on the one hand, but prohibit them from granting exceptions for these same loans in blended pools if the Joint Regulators adopt some form of QM-Plus as the definition of QRM.

Moreover, the Joint Regulators plainly have the authority under § 941 of the Dodd-Frank Act to permit blended pools of QRM and non-QRM loans as proposed here. While Congress provided generally for the adoption of rules requiring 5% risk retention on securitized assets, including on QRM loans when pooled with non-QRM loans,[69] Congress likewise gave the Joint Regulators broad authority to exempt both securitizations and entire asset classes from these requirements. Specifically, § 15G(c)(1)(G)(i) authorizes the Joint Regulators to provide "a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors." Likewise, Congress empowered the Joint Regulators to "jointly adopt or issue exemptions, exceptions, or adjustments to the rules issued under this section, including exemptions, exceptions, or adjustments for classes of … assets relating to the risk retention requirement."[70] The only restrictions that Congress placed on the Joint Regulators' discretion to exercise their power to exempt asset classes from the risk retention requirements are that "[a]ny exemption, exception, or adjustment" must "help ensure high quality underwriting standards," "encourage appropriate risk management practices," and "improve the access of consumers and businesses to credit on reasonable terms."[71] Consistent with this direction, Congress authorized the Joint Regulators to allow less than 5% of the credit risk to be retained on non-QRM loans that collateralize an ABS when those loans satisfy underwriting standards that indicate a low credit risk.[72] In other words, the Joint Regulators can allow securitization of assets subject to risk retention of less than 5% so long as any reduction is based on the low credit risk of the underlying assets or if it is in the public interest to do so.

Indeed, many SFIG members do not believe that reducing the risk retention requirements imposed on securities backed by blended pools of QRM/QM loans (or, from some members' standpoint, all kinds of non-QRM loans) would negatively impact purchasers of such ABS. The

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69 *See* § 15G(c)(1)(B)(i).

70 § 15G(e)(1).

71 § 15G(e)(2).

72 *See* §§ 15G(c)(1)(B)(ii) and (c)(2)(B).

characteristics of underlying loans in a securitization have been disclosed to potential purchasers of ABS and will continue to be disclosed under the Re-Proposal. Percentages of QRM and non-QRM loans comprising the pool would simply be another asset characteristic like debt to income (DTI), LTV, or geography that a potential purchaser will consider before buying. Further, if investors decide that they want a security backed solely by a particular loan type, it would be possible to accommodate their requests, so long as they are willing to pay any potential premiums in RMBS pricing because of the scarcity of the related loans. Permitting commingling simply makes loan types, like non-QRM, more liquid (and thus less expensive) than they otherwise would be.

C. **The Definition of Seasoned Loan Needs to Be Revised to Provide a Meaningful Exemption.**

The exemption from risk retention for seasoned loans as currently drafted in the Re-Proposal is not helpful because the volume of loans satisfying the criteria is too small to support securitizations composed entirely of seasoned loans, and the Re-Proposal would not proportionally exempt blended pools of seasoned and unseasoned loans from the risk retention requirements. A significant portion of SFIG's membership believes that the seasoned loans exception could make a meaningful contribution to RMBS markets and improve the industry's ability to manage and finance portfolios of legacy residential mortgage loans without impacting the credit quality of asset pools if certain specific changes were made to the Re-Proposal. A workable definition of "seasoned loan" would encourage a market for these securitizations and would help originators to manage their existing portfolios of such loans.

As an initial matter, the Re-Proposal would exclude modified loans from the definition of seasoned loans regardless of the credit quality of the loan.[73] The most creditworthy borrowers are often solicited to refinance their homes on competitive terms, and their lenders frequently modify their existing loans to improve the terms rather than lose their best customers.[74] Additionally, even creditworthy borrowers may from time to time miss a payment on their loans for reasons unrelated to their creditworthiness. For example, travel, family events, or simple forgetfulness may result in a missed payment that is made up in the next month. Even changing the loan's servicer could result in confusion. A borrower may send its payment to the wrong address, resulting in a delinquency as an otherwise timely payment makes its way to the correct servicer.[75] These loans are not a higher credit risk because of these missed payments and should not become subject to risk retention as a result.

While stable and established payment streams are a major source of the appeal of seasoned loans to purchasers of RMBS, the minor fluctuations described above are so common

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[73] An example of a loan modification that does not impact credit quality is the New York practice of modifying loans in lieu of refinancing them in order to avoid the recordation costs that would otherwise be incurred.

[74] Some SFIG members believe that it would be appropriate for the Joint Regulators to require additional disclosure of the terms used by issuers to determine the reasons that loans included in securitization pools were modified.

[75] On February 11, 2013, the CFPB issued bulletin 2013-01, notifying servicers of its intention to require them to submit their plans to minimize and mitigate errors resulting from servicing transfers to the CFPB.

that securitization vehicles are designed to seamlessly accommodate them. For instance, when a payment is late, but made up the next month, the servicer of the loan generally advances the late payment and then recoups its costs when the payment is subsequently made. Thus, such delinquencies have no effect on payments to purchasers. Securitization vehicles can also accommodate other fluctuations significant to purchasers of RMBS. For example, loans that suffer changes in home value that sometimes result in a home's appraised value being less than the outstanding balance of the loan that it secures can still be securitized. In this case, the securitization would reduce the advance rate for that loan to ensure that the value of the home as of the cut-off date adequately collateralizes the purchaser's exposure to that loan.

For the reasons given above, the consensus view among SFIG's issuer and underwriter members-based on their analysis of publically available data obtained from GSEs-that the definition of seasoned loan should be broadened to include certain modified loans and loans that have been outstanding and performing for five years, with no more than three 30 day delinquencies (and no 60 day delinquencies) during that time, so long as the loan is current (*i.e.*, not 30 days delinquent) at the time of securitization.[76]

Additionally, seasoned loans should be permitted to be included in blended pools with non-seasoned loans, whether qualified or unqualified. As such, it is appropriate to include them in blended pools using the Joint Regulators' statutory authorities under §§ 15G(e), 15G(c)(2)(B) and 15G(c)(1)(G)(i).

D. **The Joint Regulators Should Permit an Investor Who Selects Collateral to Elect to Retain the Required Risk.**

Many securitizations of mortgage assets are intended to provide financing to a credit investor who is not otherwise able to invest in the mortgage assets directly (such as mortgage whole loans). In these transactions, the investor never takes direct possession of the assets prior to the closing of the securitization. Rather, the investor contracts with a broker-dealer to purchase specific mortgage assets. The broker-dealer sells the assets to the securitization trust, sells senior securities on behalf of the credit investor, and delivers the subordinate securities to the credit investor.

These transactions improve efficiency and liquidity in the financial markets, for the benefit of asset investors and consumers, by enabling a wider universe of credit investors than would be possible if risk retention was limited to securitization issuers. In this circumstance, the credit investor should be permitted to elect to be the party subject to risk retention, and to be disclosed as such in the securitization offering documents, because the securitization is a tool to provide financing to the credit investor, who selects the collateral underlying the securitization and bears the economic risk in the assets.

[76] SFIG notes that as the proportion of outstanding loans that are QRMs increases, the importance of this exception will decline.

E. **<u>Non-Economic Residual Interests and Lower Tier REMICs Should Be Exempt From Credit Risk Retention</u>.**

As a general rule, special purpose vehicles holding pools of mortgages and issuing securities whose payments are based on the payments received on the underlying mortgage loans are treated as taxable mortgage pools and subject to taxation as corporations. Recognizing the chilling effect that this had on RMBS securitizations, Congress introduced the concept of a REMIC to remove entity level taxation and encourage a robust RMBS market. The Internal Revenue Service rules require REMICs to follow certain rules, such as restrictions on the types of entities that can hold residual interests and limitations on the ways in which cash flows can be divided in exchange for their tax exempt status. These two requirements in particular are relevant to the risk retention rules.

Certain RMBS REMIC transactions include a NER. NERs should be excluded from the definition of ABS Interest and should not impact risk retention calculations in any way. NERs are not investment instruments. They are purely products of the REMIC rules. NERs generally receive a single *de minimis* payment on the first distribution date and subsequently only retain tax obligations. They typically have a negative value at issuance, which would unnecessarily complicate fair value calculations without materially enhancing the sponsor's exposure to the credit risk of the assets underlying the RMBS transaction. Indeed, this negative value would likely *reduce* the required retention amount.

In addition to the unnecessary complications that NERs could introduce to fair value calculations, treating them as ABS Interests subject to the risk retention rules could set up a conflict with the tax laws governing REMICs. Not all issuers are qualified to retain NERs. As a result, such issuers could find themselves in the impossible situation of being required by the risk retention rules to hold 5% of the NER while being prohibited from doing so by the applicable tax laws. Given the number of transactions that are structured as REMICs, such a result clearly is not to the benefit of either securitizers or purchasers. Therefore, the SFIG membership strongly suggests that NERs be exempted from the definition of ABS Interest.

In a related clarification, the ABS Interest definition should be interpreted to exclude REMIC regular interests issued by lower tier REMICs. Many RMBS transactions electing REMIC status include several internal tiers of REMIC interests, with each lower tier REMIC held by the next tier. These lower tier REMIC interests are tax creations established under the REMIC rules to allow the transaction to achieve both the desired tax treatment and cash flow management—they are never available to purchasers directly. Crucially, all of the various REMIC tiers represent a single *economic* interest. The Joint Regulators should clarify that these internal REMIC regular interests are not independently subject to risk retention, but are instead covered when appropriate risk is retained by the securitizer in accordance with the ABS Interests that are ultimately issued.

III. COMMERCIAL MORTGAGE BACKED SECURITIES.

SFIG's CMBS membership[77] has reviewed and discussed the Re-Proposal as it relates to CMBS and respectfully submits the recommendations set forth below.

In addition to the issues addressed in Sections A, B and H of Part I of this Letter, the following issues are of particular concern to many participants in the CMBS market:

- SFIG issuers, underwriters, sponsors, and originators and four of SFIG's investment grade CMBS investor members[78] together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that the CMBS retention option that permits investment by up to two B-piece buyers to satisfy the risk retention requirement should be adjusted to, among other things, permit the respective B-piece buyers to hold their interests on a senior/subordinate basis. Six of SFIG's investment grade CMBS investor members are supportive of the Re-Proposal as written and do not support a senior/subordinate option.

- SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that the definition of QCRE and the related exemption mechanism should be adjusted so that a larger percentage of the commercial mortgage loans that are currently securitized can potentially qualify for the CMBS risk retention exemption. Four of SFIG's investment grade CMBS investor members are open to potentially expanding the definition of QCRE subject to evaluation of specific criteria, while six of SFIG's investment grade CMBS investor members are comfortable with the QCRE metrics as currently proposed and do not support such adjustment.

With respect to the following points, there is a consensus view among all of SFIG's CMBS members.

- The Re-Proposal should clarify that certain subordinate or *pari passu* interests held in "loan" form would qualify as an acceptable form of risk retention.

- The definition of CRE loan should be adjusted to include certain "land loans".

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77 SFIG's CMBS membership includes issuers, underwriters, sponsors, originators and investment grade investors. There are ten investment grade CMBS investor members of SFIG with CMBS assets under management totaling approximately $66.7 billion (based on data provided by such members to SFIG regarding their assets under management as of June 30, 2013). According to Securities Industry and Financial Markets Association research, on June 30, 2013, there were $634.5 billion in U.S. non-agency CMBS outstanding in the market. See http://www.sifma.org/research/statistics.aspx (follow "US Non-Agency CMBS and RMBS Outstanding" hyperlink).

78 SFIG's investment grade CMBS investor members' views highlighted in this Part III of this Letter do not include the views of B-piece buyers, which are also CMBS investors.

- The Re-Proposal should provide that a sponsor's risk retention obligation would terminate with respect to a CMBS transaction in which all of the loans have been defeased.

- In the case of a CMBS deal with multiple sponsors, the final rule should clarify that such sponsors can divide up the risk retention obligation among themselves pro rata based on their contribution to the deal (with no minimum contribution requirements).

A. <u>B-Piece Held by Two B-Piece Buyers.</u>

The Re-Proposal expanded the Original Proposal's B-piece retention option to allow up to two B-piece buyers to satisfy the risk retention requirement in a CMBS transaction. SFIG's membership welcomes this expansion of the B-piece retention option that was set forth in the Original Proposal and believes that with the proper adjustments, the B-piece retention option will be a useful form of risk retention for CMBS market participants.

While up to two B-piece buyers are permitted to hold an EHRI (B-piece) in a CMBS transaction, the Re-Proposal requires that their interests be held *pari passu* with each other. SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors request that the B-piece retention option be modified to allow the respective B-piece buyers to hold their interests in the B-piece on a senior/subordinate basis for the reasons described below. Four of SFIG's investment grade CMBS investor members also support such request. Six of SFIG's investment grade CMBS investor members believe that limiting the permitted B-piece division to *pari passu* is more appropriate for the reasons set forth below.

SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that an agreement between the B-piece buyers as to the allocation of cash flow and losses between them would not adversely impact the strength of the B-piece buyer retention option because each B-piece buyer would still: (1) have exposure to losses on the entire pool of assets on a subordinated basis; (2) be obligated to perform due diligence and review all of the assets in the pool as required by the Re-Proposal; (3) have positive influence over the selection of the assets in the pool; and (4) be subject to the limits on financing, transferring and hedging its B-piece and to the other applicable requirements under § __.7 of the Re-Proposal. Additionally, as with the *pari passu* option, this senior/subordinate option would provide each investor in the transaction with the benefit of two close examinations of the underlying assets in the pool as required by the Re-Proposal. Moreover, each B-piece buyer remains subject to the risk of losing its investment in its horizontal retention piece because it receives cash flow at the bottom of the waterfall, which risk SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe continues to be an incentive to each B-piece buyer to ensure proper underwriting.[79]

[79] This is consistent with the definition of "eligible horizontal residual interest" under the Re-Proposal, which requires that any losses be applied to such ABS interest prior to any other ABS interest in the transaction "until the amount of such ABS interest is reduced to zero." Re-Proposal § __.2, 78 Fed. Reg. at 58025.

Furthermore, SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors also believe that the CMBS market and the related borrowers would benefit from the efficiency that is made possible if B-piece buyers are able to match the yield on their portion of the B-piece to their risk and to their particular investment needs. The portion of a CMBS deal that will constitute an EHRI in an amount necessary to satisfy the 5% fair value retention requirement (required B-piece) would include a more senior tranche (senior tranche) that has typically been sold to investment grade investors, not to typical B-piece investors. That senior tranche is usually valued and priced by the market at a different level than the remaining, more subordinate tranches of the required B-piece based on investors' assessment that the risk of the most subordinate tranches of that required B-piece is very different than the risk of the more senior tranche.

SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors are of the view that requiring two B-piece buyers to hold their respective interests *pari passu* removes pricing flexibility by imposing one blended price for the entire B-piece instead of allowing the market to maximize profitability by tailoring the pricing of each tranche based on investor demand. Also, the investment risk and return goals of typical investors in the subordinate tranches of the required B-piece are not satisfied by the risks and returns provided by the senior tranche. Allowing two B-piece buyers to hold the required B-piece in a senior/subordinate structure allows more efficient matching of investor needs to the offered investments. Otherwise, the B-piece buyer(s) purchasing the required B-piece will demand more discounted pricing of the senior portion which will in turn result in higher interest rates to borrowers.[80] Four of SFIG's investment grade CMBS investor members can support the idea of the creation of a senior/subordinate B-piece option, while they may not specifically subscribe to the above arguments and rationale.

Six of SFIG's investment grade CMBS investor members express a different view with respect to this comment and do not support the elimination of the requirement that two B-piece buyers hold the required B-piece *pari passu*. They are concerned that allowing the risk to be divided into senior and subordinate tranches would dilute the risk retention obligation and distance the B-piece buyer holding the senior B-piece tranche from the underwriting and origination process. These SFIG investment grade CMBS investor members believe that the return provided to the holder of the senior B-piece tranche would not provide the necessary incentive to carefully diligence the pool and review the loans, and that the investors who likely would invest in the senior B-piece tranche may not have the resources to conduct the necessary review. By way of explanation, these SFIG investment grade CMBS investor members believe that the returns generated by differently rated investments are a major driver of the level of due diligence that an investor is willing to undertake. Lower-rated (and implicitly higher risk) investments generally come with higher returns, allowing an investor to use some of those returns to invest significantly in extensive, often loan-by-loan, due diligence. These SFIG investment grade CMBS investor members are concerned that, even though the Re-Proposal

[80] Note that permitting B-piece buyers to hold their interests in a senior/subordinate structure would be consistent with the Joint Regulators' goal of maintaining the historical structure of CMBS transactions. Re-Proposal, 78 Fed. Reg. at 57936.

requires a B-piece buyer to perform diligence,[81] returns on a higher-rated, senior B-piece tranche are likely not sufficient to finance the due diligence levels needed.

Despite the requirement under the Re-Proposal that each B-piece buyer perform the necessary review,[82] these SFIG investment grade CMBS investor members are also concerned that they could not rely, to the extent they feel necessary, on the diligence and review of the investor holding the subordinate B-piece tranche. In their view, investors in the subordinate B-piece tranche are focused on a return on their investment that is driven by the interest payments (rather than the principal payments) on the underlying CRE loans. Therefore, their payback period may not be consistent with that of an investor in the investment grade tranches, which relies on both principal and interest repayment. The result in the view of these SFIG investment grade CMBS investor members would be a decrease in review from the perspective of an investor that is focused on the repayment of principal and a loss of the alignment of interests among the sponsor, the investment grade investors and the B-piece buyers in the transaction. Therefore, these SFIG investment grade CMBS investor members believe that the *pari passu* requirement under the Re-Proposal better aligns the interests of the B-piece buyer with those of the other more senior bondholders.

B. <u>Qualifying CRE Loan Definition.</u>

The Re-Proposal would permit a sponsor to securitize a pool made up entirely of QCREs with no risk retention requirement, and would permit a *pro rata* reduction of the 5% risk retention requirement for any pool that includes QCREs (subject to a 2.5% floor). If structured properly, SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that this exemption, whether total or partial, will increase the viability of the CMBS market and reward high standards in underwriting CRE loans. As explained below, some SFIG CMBS members believe that the definition of QCRE should be expanded, but SFIG's CMBS members have not been able to sufficiently analyze historical data and develop an alternative proposal with respect to the QCRE definition within the time available for comment. Developing such alternative proposals is essential as a basis for a meaningful discussion on QCRE parameters, and since that process has not occurred, the below comments on QCRE are made without the benefit of a robust dialogue among SFIG's CMBS members.

SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors strongly support the recommendations of the Commercial Real Estate Finance Council with respect to proposed changes to the definition of QCRE as described in their letter regarding the Re-Proposal, dated and filed on October 30, 2013. As currently drafted, SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors feel that the definition of QCRE is prohibitively restrictive, as only approximately 7%[83] of the existing

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[81] Re-Proposal § __.7(b)(4), 78 Fed. Reg. at 58031.

[82] *Id*.

[83] *See* Jeffrey Berenbaum et al., *CMBS Strategy & Analysis Notes; Alert: Most Expectations Met, But Nuances Matter in Risk Retention Rules Re-Proposal*, Citi Research; Securitized Products, Aug. 29, 2013.

CMBS loan universe would qualify. SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors argue that the historical loss experience of CMBS transactions and low default rates on CMBS loans support an expansion of the number of CRE loans in the current market that should qualify as QCRE.

Furthermore, SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors believe that various characteristics of CMBS transactions (such as relatively smaller numbers of loans in each pool, greater investor scrutiny of each loan and more extensive disclosure on the loans) provide a high degree of transparency. They assert that, while such characteristics are shared by all CMBS deals, they are particularly present in single borrower/single credit CMBS transactions which involve only one loan (or a pool of cross-collateralized loans that essentially functions as one loan). SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors argue that the single borrower/single credit CMBS transactions are high quality transactions, have low default rates and allow a greater degree of transparency and diligence, but despite these characteristics, only a *de minimus* number of the loans in single borrower/single credit CMBS transactions would qualify as QCRE loans under the Re-Proposal. They believe that the above described CMBS characteristics, in combination with appropriate expanded parameters for QCRE, would provide sufficient safeguards to the market and ensure sound underwriting.

While they may not specifically subscribe to the above arguments and rationale, four of SFIG's investment grade CMBS investor members may be willing to consider an expansion of the QCRE parameters currently proposed, after a full analysis of any such proposed changes and all necessary supporting data and historical performance.

Six of SFIG's investment grade CMBS investor members take the view that for risk retention to be effective, the QCRE definition should remain as proposed in the Re-Proposal and not be revised to exempt more loans. They believe that only the highest quality CMBS loans should qualify for an exemption and are concerned that loosening the QCRE metrics would make it easier to manipulate the criteria with respect to riskier loans that should not qualify for an exemption from the risk retention obligation. Furthermore, these SFIG investment grade CMBS investor members believe any exemption goals should be based on the credit risk characteristics of the specific assets in question. Specifically they would argue that, because of the unique characteristics of each underlying property, an analysis of DSCR and LTV metrics in isolation does not provide a sufficient basis to assess risk. While DSCR and LTV are important measures of leverage, other property-specific attributes, including property location, property age, stability and diversification of tenancy, quality of tenancy, capital expenditure requirements, construction of new competing properties, and submarket average rents and vacancy, should be considered in order to develop a clear understanding of default risk.

These SFIG investment grade CMBS investors believe that two loans with identical DSCR and LTV metrics could have vastly different risk profiles. For example, one loan might have a low probability of default due to a stable and diversified tenant base that pays rent that is well below market average while another loan, with an identical DSCR and LTV, might have a high probability of default given a single tenant that pays above market average rent and has a lease expiration that occurs prior to the maturity date of the loan. Both loans would be viewed as equivalent under the QCRE definition due to the narrow focus on DSCR and LTV. Unless a less simplistic definition is developed that encompasses these complex elements of risk associated with commercial real estate properties, and goes beyond the limited DSCR and LTV criteria, these SFIG investment grade CMBS investors would prefer that the QCRE definition remain narrow.

C. **Form of Risk Retention.**

SFIG's members believe that the Re-Proposal should be modified to allow for risk retention in the form of *pari passu* or subordinate interests in individual loans, including CRE loans. In many CMBS transactions, a CRE loan included in the pool (trust mortgage loan) consists of a note secured by a mortgage that also secures one or more other notes (companion loans) that are not owned by the securitization trust. As a result, a portion of the mortgage debt is held by the trust within the securitization and portion of the mortgage debt is held outside the trust in a non-securitized form. The companion loan may be structured to be subordinate to the trust mortgage loan in payment rights (subordinate companion loan) or to be *pari passu* to the trust mortgage loan in payment rights (*pari passu* companion loan). Similarly, instead of using separate notes, a mortgage loan can be split by issuing participation interests in the mortgage loan, with a senior participation interest (trust participation interest) owned by the securitization trust and a subordinate participation interest (subordinate participation interest) or a *pari passu* participation interest (*pari passu* participation interest) owned by individual institutions in a non-securitized form. Another way that CRE loans have been structured into multiple interests is by transferring the entire CRE loan to the securitization trust and dividing the CRE loan into a senior component (which is pooled with the rest of the loan pool) and a subordinate component, which is represented by a loan-specific class of certificates, known as a "rake bond," which represents the subordinate interest in that CRE loan.

1. *Pari Passu Loan Interests*

A *pari passu* companion loan or a *pari passu* participation interest (each, *pari passu* loan interests) in each asset in the pool held by a sponsor or originator should qualify as vertical risk retention. Depending on the size of each such *pari passu* loan interest the sponsor or originator elects to retain, the *pari passu* loan interests could be the sole form of risk retention in a transaction, or they could be used in combination with other forms of risk retention in a transaction as necessary to satisfy the 5% requirement. If each such *pari passu* loan interest is at least 5% of the related loan in the transaction, all such *pari passu* loan interests collectively should constitute vertical risk retention of 5% and would satisfy the entire risk retention requirement. If one or more such *pari passu* loan interests in a transaction is less than 5% of the related loan(s), all such *pari passu* loan interests in the transaction collectively should constitute a vertical risk retention of a percentage equal to lowest percentage that any such *pari passu* loan interest represents in the related loan, and could be used in combination with other forms of risk retention. A *pari passu* loan interest represents the same credit risk to the sponsor or originator as vertical risk retention in the form of an ABS interest, and because the sponsor and the issuing entity will proportionally share in all collections and losses on each loan in the pool, this option perfectly aligns the interests of the sponsor and the investors. Furthermore, this option provides the sponsor with better capital treatment with respect to the interest it retains.[84]

2. *Subordinate Loan Interests*

A subordinate companion loan, a subordinate participation interest and a rake bond (each, subordinate loan interests) each absorbs the first losses on the related underlying CRE loan and represents the same credit risk as would a B-piece ABS interest if the subordinate loan interest had been included in the trust. Because such subordinate loan interests act like subordinate interests in the securitization, a subordinate loan interest in each asset in the pool held by a sponsor, an originator or B-piece buyer or any combination of such parties should qualify as horizontal risk retention. As with *pari passu* loan interests, depending on the size of each such subordinate loan interest, the subordinate loan interests collectively could be the sole form of risk retention in a transaction, or they could be used in combination with other forms of risk retention in a transaction as necessary to satisfy the 5% risk retention requirement.

D. CRE Loan Definition.

The Re-Proposal provides that a CRE loan does not include a "land loan," which is defined to include, *inter alia*, a loan made to the owner of a fee interest in the land that is ground leased to a third party who owns the improvements on the land.[85] The result is that these loans would not be eligible to be included in a CMBS transaction in which the B-piece option is used, nor would they be eligible to be considered as QCREs. Ownership and operation of many commercial properties are structured so that one party owns the fee interest in the land and another party ground leases the land and owns and operates the improvements on the land. The owner or purchaser of the fee interest frequently requires financing, and the CMBS market has historically provided such financing. The Re-Proposal should be revised to allow such loans to qualify under the definition of a CRE loan. The Joint Regulators' concern that including such loans in the definition of CRE loan would permit riskier QCRE loans is mitigated because, to be considered a QCRE loan, a loan would be subject to all QCRE loan requirements and if a particular ground leased loan does not meet the necessary thresholds, a sponsor would be required to hold risk retention with respect to such loan.

E. Defeasance.

In CMBS transactions, many loan documents provide the borrower the ability to obtain a release of the related mortgaged property collateral by pledging to the securitization trust U.S. Government securities as substitute collateral for the loan. For such collateral substitution to be allowed, the scheduled payments on these U.S. Government securities must be in such amounts

[84] Note that this "loan" form of vertical risk retention is permitted under the risk retention requirements applicable to European sponsors pursuant to Article 122a of Directive 2006/48/EC, the guidance for which provides that retention of at least 5% of the nominal value of each of the tranches transferred to investors "may be achieved by retaining at least 5% of the credit risk of each of the securitized exposures, if the credit risk thus retained with respect to such securitized exposures always ranks *pari passu* with, or is subordinated to, the credit risk that has been securitized with respect to those same exposures." *See* Guidelines to Article 122A of the Capital Requirements Directive, December 31, 2010, Paragraph 1, Recital 46.

[85] Re-Proposal § __.14, 78 Fed. Reg. at 58037; *see also* Re-Proposal, 78 Fed. Reg. at 57980.

and payable at such times as necessary to timely make all remaining debt service payments due on the defeased loan. Because the defeased loan is secured by U.S. Government securities, the risk of default on the defeased loan is greatly reduced as compared to a loan secured by commercial property. Based on the reduced risk associated with defeased loans, the final rule should provide that a sponsor's risk retention obligation with respect to a CMBS transaction should terminate if and when all of the loans in such transaction have been defeased.

F. Multiple Sponsors.

The final rule should clarify that, in a CMBS deal with multiple sponsors, such sponsors can divide the risk retention obligation among themselves *pro rata* based on their contribution to the deal (with no minimum contribution requirements). This is consistent with the provisions of the Re-Proposal that allow a B-piece buyer to share the risk retention obligation with another B-piece buyer and with the provisions of the Re-Proposal that allow a sponsor to share the risk retention obligation with a qualifying originator.

It is desirable to investors for CMBS transactions to provide exposure to multiple originators. The common method of providing such exposure is to have the originators act as additional sponsors in the CMBS transaction, but in many instances, such sponsors do not meet the threshold of having contributed at least 20% of the assets in the pool. Allowing risk retention by multiple sponsors should not negatively impact the investors in the deal, all of which would receive the same protections as they would in a situation in which one sponsor holds all of the required risk retention. On the contrary, not allowing multiple sponsors, including sponsors that contribute less than 20% of the assets in the pool, to share the required risk retention could discourage the use of multiple sponsors, which would be detrimental to investors' desire to gain exposure to multiple originators.

G. Technical Clarifications

The Re-Proposal includes a statement that "the agencies preliminarily believe that non-economic residual interests would constitute ABS interests".[86] However, at the very least, non-economic REMIC residual interests should be excluded from the definition of ABS interests. The failure to exclude such interests is particularly troublesome for CMBS transactions, as this would require a sponsor using vertical risk retention to hold the vertical retention percentage of the REMIC residual interest. Also, since a REMIC residual interest is required to receive all remaining cash flow after all of the "REMIC regular interest" securities in the transaction have been paid their distribution entitlement, classifying a non-economic REMIC residual interests as an ABS interest would require a sponsor using horizontal risk retention to hold the non-economic REMIC residual interest in its entirety. In each case, this would place on the sponsor the tax liabilities associated with a REMIC residual interest, which are completely unrelated to the credit quality of the underlying collateral in the pool. Furthermore, if the sponsor is not qualified under REMIC rules to hold REMIC residual interests, but the risk retention rules require that the sponsor hold this interest in the transaction, it would be impossible for such a sponsor to meet the requirements of both rules.

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[86] Re-Proposal, 78 Fed. Reg. at 57935.

Lastly, including non-economic REMIC residual interest in the ABS interest definition would be contrary to the purpose of the Re-Proposal in that it would actually have the effect of reducing the amount of credit risk a sponsor must retain. This is because non-economic REMIC residual interests usually have negative value, since they have no cash-flow entitlement and have net tax liabilities associated with ownership. Including them as ABS interests would reduce the fair value of all ABS interests issued in a transaction and thereby reduce the risk retention requirement.

The Re-Proposal should also clarify that, for purposes of risk retention, ABS interests do not include uncertificated REMIC interests used in RMBS and CMBS transactions to structure cash flows for tax purposes and either held solely by one of the REMICs constituting the issuing entity or combined into a single certificated security. As described above, a requirement that a sponsor hold such interest presents conflicts with the REMIC rules and would subject such sponsor to risk and costs that are not associated with the credit quality of the underlying collateral.

H. Conclusion

SFIG has provided recommendations from our members regarding their view on the Re-Proposal. We have represented the divergent views of our membership where applicable as SFIG issuers, underwriters, sponsors, and originators together with some B-piece buyers and some non-SFIG investment grade CMBS investors, on one hand, and six of SFIG's investment grade CMBS investor members, on the other hand, may see certain matters from a different perspective. We are confident that the CMBS market can be strengthened through regulation that is consistent with the principles set forth in the introduction to this Letter.

IV. REVOLVING MASTER TRUSTS

A. Additional Flexibility is Needed to Accommodate Existing Structures and Market Practice, and to Facilitate Future Innovations.

The revolving master trust structure has been used to securitize assets since the late 1980's, when the structure quickly became the predominant method for financing credit and charge card receivables in the capital markets. Captive auto finance companies adopted the revolving master trust structure as early as 1990 to securitize their floorplan loans to auto dealers to finance dealer inventory as it was well-suited to these fast pay revolving accounts. Over the last twenty-five years there have been many structural developments in master trust transactions, including the introduction of the multiple-trust structures and de-linked structures discussed in the Re-Proposal. Another major development affecting master trusts has been the expansion of the number of asset classes utilizing the master trust structure, which has led to ever growing nuances and differences between transactions that all fall under the umbrella of "master trusts." Today, the master trust structure is used to securitize not only credit card receivables and floorplan loans, but also insurance premium loans, fleet leases, servicing advance receivables, home equity lines of credit, and other types of non-revolving personal loans and commercial loans.

These developments underscore the importance of two overarching principles highlighted in prior industry comment letters on the Original Proposal:

- the risk retention rules must appropriately take into consideration the degree of heterogeneity in all aspects of the securitization market;[87] and

- the risk retention rules must be flexible enough to accommodate future innovation in the securitization market.[88]

The SFIG membership believes that, with respect to revolving master trusts, the Re-Proposal does not provide sufficient flexibility to accommodate the existing heterogeneity among securitizations currently using the master trust structure, and that such inflexibility is likely to stifle future structural innovations and cause sponsors to incur substantial costs in order to meet needlessly rigid requirements.

The SFIG membership appreciates that a number of revisions have been incorporated into the Re-Proposal to better reflect current market practice, including important clarifications made for multiple-trust structures. However, most SFIG members believe that additional modifications to the Re-Proposal are needed in the following areas in order to make the revolving master trust option consistent with current market practice:

- The definition of revolving master trust is too narrow, and needs to be flexible enough to include all issuing entities that are commonly considered to be master

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87 *See* ASF Comment Letter on Risk Retention, American Securitization Forum 15 (June 10, 2011), *available at* http://www.sec.gov/comments/s7-14-11/s71411-57.pdf (the June 10, 2011 ASF Comment Letter).

88 *See id*. at 106.

trusts. In particular, the seller's interest option should be available to any issuing entity (not just trusts) without regard to the organizational form of the issuing entity and should be available for issuing entities that issue ABS interests that are collateralized by separate pools of collateral, including series trusts. (Sections B.1 and B.5 of this Part)

- The definitions of revolving master trust and seller's interest both need to be modified to allow for allocations of excess concentration receivables on a non-*pari passu* basis to the seller's interest or one or more specific series of ABS interests. (Section B.3 of this Part)

- Even for existing master trusts that utilize *pari passu* seller's interests, in virtually all such structures, the seller's interest is *pari passu* to each series of investors' ABS interests with respect to allocations of principal collections only during the revolving period. Therefore, any requirement in the final rule that the seller's interest be *pari passu* to investors' ABS interests should at the very least apply only during a revolving period. (Section B.4.a of this Part)

- Many master trust structures utilize subordinated seller's interests as the principal source of credit enhancement, and the SFIG membership generally believes that the Joint Regulators should recognize this existing form of "skin-in-the-game." A seller's interest that exposes the sponsor to a greater share of the credit risk through subordination of the cash flows allocated to the seller's interest should not be treated differently than a *pari passu* seller's interest. Many seller's interests provide for elements of subordination of cash flows, but are not otherwise structured as typical horizontal interests, and therefore cannot satisfy the requirements for a *pari passu* seller's interest or any form of horizontal risk retention proposed in the Re–Proposal. (Section B.4.b of this Part)

- The standard EHRI option does not provide a viable horizontal risk retention option for master trusts, because, among other reasons, master trusts typically could not satisfy the proposed EHRI cash flow tests. Unless the standard EHRI option is revised to accommodate master trusts, it is imperative that the proposed special horizontal risk retention option for revolving master trusts be revised as discussed below to recognize the significant forms of horizontal risk retention commonly held by sponsors of master trusts. (Section C.1 of this Part)

- The special horizontal risk retention option for master trusts should be flexible enough to cover transactions that use either one waterfall for all cash flows or two separate waterfalls for principal and non-principal cash flows, and the requirements relating to priorities of cash flows must be better aligned with market practice as discussed in more detail below. (Section C.2 of this Part)

- The special horizontal risk retention option for revolving master trusts appears to be designed to cover only a retained residual interest in excess spread and is not flexible enough to encompass many typical forms of horizontal risk retention that are already used in current master trust structures, including interest-bearing retained classes and tranches of ABS interests, horizontal interests that are subordinate to more than one series of ABS interests, trust-wide horizontal interests and horizontal interests issued by legacy trusts. (Section C.2 of this Part)

- The measurement of subordinated seller's interests and horizontal interests at fair value would be overly burdensome for master trusts, and is not justified for master trusts that do not monetize excess spread. (Section D.1 of this Part)

- Greater flexibility is needed to give credit to horizontal interests on a proportional basis, even if a sponsor does not hold a specified minimum level of horizontal risk retention in every series. (Section D.2 of this Part)

- The seller's interest measurement date should be revised to incorporate the cure periods provided for in securitization transaction documents, and the seller's interest should be measured not more frequently than once per month. (Section E.2 of this Part)

- The offset for pool-level excess funding accounts includes a requirement regarding allocation of losses to the excess funding account. This requirement should be eliminated because no master trust in the market allocates losses to a cash account. (Section G of this Part)

Given the stated intent of the Joint Regulators to align the risk retention rules with current market practice,[89] the SFIG membership is hopeful that our concerns with respect to inconsistencies between current market practice and the Re-Proposal will be addressed in the final rule. The following comments will highlight more specifically the areas in which the SFIG membership believes that additional modifications to the risk retention rules are needed in order to recognize market structures and interests that represent significant "skin-in-the-game," but do not meet the technical requirements of the proposed rule.

Finally, although many SFIG members are pleased that the Joint Regulators have endeavored to create a seller's interest option designed to work with existing master trust structures, that option should not be the exclusive form, or one of only two permissible forms, of risk retention available for revolving master trusts. The SFIG membership asks that the Joint Regulators craft a final rule that will be flexible enough to accommodate other forms of risk retention that are currently used in the securitization market (such as horizontal cash reserve accounts and the representative sample method), as well as additional forms of risk retention (such as a vertical option for master trusts) that may become necessary or desirable as transaction structures evolve. In particular, the representative sample method of risk retention is one of the two permissible forms of risk retention under the FDIC Safe Harbor,[90] and therefore has been the primary form of risk retention used by new bank-sponsored master trusts created during the last few years.

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[89] Re-Proposal, 78 Fed. Reg. at 58013(stating "The definitions of a seller's interest and a revolving master trust are intended to be consistent with current market practices …")

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

B. **The Seller's Interest Option for Revolving Master Trusts Must Be Better Aligned With Current Market Practice.**

The Joint Regulators have proposed the seller's interest option as the primary form of risk retention for master trusts, and have offered master trust sponsors limited options to offset the value of horizontal residual interests and excess funding accounts against the 5% seller's interest requirement. By offering so few options to master trusts, the Joint Regulators have raised the stakes for getting the seller's interest option right. If the seller's interest option is to be the primary option for master trusts, it must be an option that works for all master trusts, including master trusts that use subordinated seller's interests. It would be difficult for the Joint Regulators (or even the SFIG members contributing to this Letter) to delineate the technical features of every master trust. Therefore, it is critical that the definition of seller's interest be flexible enough to accommodate the diversity that currently exists in market practice, particularly as among different asset classes that use the master trust structure.

As noted elsewhere in this Part, SFIG members wish to emphasize that, unless changes are made to the final rule, it is unlikely that master trust sponsors will be able to amend existing structures to comply with the risk retention rules. As highlighted in Section B.4.a of this Part (in connection with the discussion of the *pari passu* requirement for seller's interests) and in Section C.2.b of this Part (in connection with the discussion of the cash flow priorities for series-level horizontal interests), the types of amendments required to comply with the proposed rule could very well be adverse to investors. It is possible that such amendments could not be implemented without the approval of investors, and, in the case of rated securities, confirmation from the applicable rating agencies that such amendments would not have an adverse impact on the ratings for such securities. It is uncertain whether such consents and ratings confirmations could be obtained.

This Section B includes the specific recommendations from SFIG's members for aligning the proposed definitions of revolving master trust and seller's interest with existing market practice, including specifically the proposed changes to § __. 5 of the rule set forth in Appendix D of this Letter.

1. *Technical corrections are needed to make the definition of revolving master trust accessible for all issuing entities that operate as master trusts.*

The issuing entities that are commonly called "master trusts" are not, in fact, always formed as common-law or statutory trusts.[91] While it is true that credit card and floorplan master trusts in particular have historically been organized in trust form, it is no longer the case that all securitization vehicles that would otherwise meet the description in clause (2) of the proposed definition of revolving master trust[92] are formed as trusts. Many such vehicles are formed as corporations, limited liability companies or even limited partnerships in order to satisfy other structural, legal and tax considerations. In other structures, particularly in connection with

[91] This Letter consistently uses the term "master trust;" however the SFIG membership recommends that the term "revolving issuing entity" (or a similar term) be substituted for the term "revolving master trust" in the final rule.

[92] *See* Re-Proposal, 78 Fed. Reg. at 58028.

transactions organized outside the U.S., the securitized assets are subject to a trust agreement, whereby a trustee agrees to hold the assets in trust for the beneficiaries of the trust, but the issuing entity is not a separate legal entity. Clause (1) of the proposed definition of revolving master trust[93] does not add anything new to the definition that is not otherwise covered by clause (2), and therefore the SFIG membership recommends that clause (1) be dropped from the definition of revolving master trust.

In addition, some master trusts may not technically be "established to" issue on multiple issuance dates one or more ABS interests secured by a common pool of collateral, in the sense that the issuing entity's organizational documents may not dictate that the entity issue multiple series. Nonetheless, the issuing entity may operate in the manner contemplated by clause (2) of the proposed definition. Therefore, the SFIG membership requests that the words "issues (or proposes to issue)" be substituted for "established to issue" in clause (2) of the definition of revolving master trust.

2. *The requirement that all ABS be collateralized by a common pool of securitized assets is overly restrictive.*

In the Supplementary Information, the Joint Regulators state that "[t]he seller's interest option would not be available to a trust that issues series of ABS at different times backed by segregated independent pools of securitized assets within the trust as a series trust."[94] Many SFIG members believe that this limitation is too rigid and that the definition of revolving master trust (which requires all ABS to be "collateralized by a common pool of securitized assets") would exclude certain vehicles that operate as, and are commonly considered, master trusts. For example, many master trusts provide the flexibility to issue series in multiple "groups." All series in the same group are backed by a separate and common pool of collateral specific to such group, though it is not contemplated that every series would be collateralized by a separate pool of collateral as in a series trust.

It is not obvious why a master trust with two or more groups of ABS interests, each backed by a separate and common pool of collateral, should not be permitted to use the seller's interest option for revolving master trusts. In fact, many SFIG members are concerned that given the lack of other viable options for master trusts in the Re-Proposal, such master trusts will be left with no options for satisfying the risk retention rules. Therefore, the SFIG membership generally recommends that the series, classes, subclasses or tranches of ABS designated as a separate group within a master trust be permitted to use the seller's interest option and that the seller's interest option be based on the securitized assets and servicing assets owned by the issuing entity that collateralize the particular group of ABS interests.

3. *Revolving master trusts may allocate excess concentration receivables differently than other receivables*.

In floorplan, auto, fleet-lease, commercial loan, servicing advance receivable, and home equity loan master trusts, the eligibility criteria for the securitized assets often include specified

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93 *See id*. at 58028.

94 *See id*. at 57942.

limitations on the maximum percentage of loans or receivables in the pool of assets that may share common characteristics (for example, receivables originated by the same dealer, loans owing by the same obligor, or receivables arising from the sale of goods within the same product line, etc.). Because receivables arising in a revolving account continue to be sold into the master trust even after the concentration limits may be exceeded, it is typically the case that receivables in excess of these concentration limits (excess concentration receivables) are permitted to remain in the master trust, but are disregarded for purposes of determining the aggregate amount of receivables held by the master trust or whether the minimum seller's interest requirement has been met. Because the sponsor does not receive any "credit" for such excess concentration receivables, master trusts are sometimes structured to treat the balance of and collections on these excess concentration receivables differently than other receivables held by the master trust. In this case, either (1) an identified subset of the excess concentration receivables (and the collections with respect to such receivables) or (2) a percentage of all receivables within such over-concentrated category of receivables (and a corresponding percentage of collections attributable to such receivables) may be allocated to the holder of the seller's interest and not allocated to any series of ABS interests or, alternatively, might be allocated solely to one or more ABS interests.

Accordingly, SFIG members are concerned that revolving master trusts that have special methods of allocating collections and losses on excess concentration receivables might not satisfy the requirement that all ABS interests be secured by a common pool of collateral or that the seller's interest be *pari passu* with respect to the allocation of distributions and losses on the securitized assets (since all distributions and losses attributable to all or a portion of the excess concentration receivables may be allocated only to the seller's interest). To address the concerns described in this section with respect to excess concentration receivables and the preceding section with respect to master trusts that hold two or more separate groups of common collateral, the SFIG membership requests that the definition of "seller's interest"[95] be revised to (1) exclude collateral allocated to less than all of the ABS interests secured by the common collateral rather than a "specific series"; and (2) require the seller's interest to be *pari passu* with, or subordinated to, each series of investors' ABS interests that will receive an allocation of distributions and losses with respect to the common pool of collateral that also collateralizes the seller's interest with respect to the allocation of all distributions and losses on the securitized assets "of such common pool" (as opposed to all securitized assets).

4. *If the definition of seller's interest is not better aligned with market practice, the seller's interest option will not be available for any existing master trusts.*

SFIG members have noted the clear expression of intent by the Joint Regulators to craft risk retention rules for master trusts in a manner that is consistent with market practice.[96] As

95 *See id*. at 58028.

96 "The Commission preliminarily believes that aligning the requirements with the current market practice will balance implementation costs for sponsors utilizing the master trust structure with the benefits that investors receive through improved selection of underlying assets by the sponsors. Maintaining current practice will be transparent and easy for the market to understand and will preserve current levels of efficiency and will also provide clarity to market participants and may encourage additional participation given the removal of previous uncertainty about potential changes to current practices, thereby increasing capital formation." *Id*. at

proposed, however, the definition of "seller's interest" and the related risk retention provisions are not aligned with market practice in a number of respects, and the Re-Proposal has not addressed certain concerns raised in prior comment letters with respect to the Original Proposal. We believe that if adopted as proposed, the seller's interest form of risk retention will be unavailable for virtually all master trusts. Indeed, we have not identified any existing master trusts that could utilize the seller's interest option as proposed.

a. Allocations of collections between investor interests and the seller's interest are *pari passu* only during revolving periods.

The Re-Proposal's definition of "seller's interest" requires a seller's interest to be *pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all distributions and losses with respect to the securitized assets *prior to an early amortization event* (as defined in the securitization transaction documents)."[97] However, virtually all securitizations that utilize master trusts provide for a similar subordination of the seller's interest during times of scheduled amortization or accumulation even in the absence of an early amortization event. We believe this issue with the proposed *pari passu* requirement was clearly articulated in a number of prior industry comment letters.[98] SFIG members are therefore hopeful that, given the Joint Regulators' expressed intent to make the seller's interest requirement consistent with current market practice, sponsors should be able to conclude that the *pari passu* requirement was not intended to preclude the normal "fixing" of allocation percentages during scheduled amortization and accumulation periods. However, this critical point was not addressed in the Re-Proposal or discussed in the Supplementary Information, which has left SFIG's members with continued uncertainty as to the intended meaning of "*pari passu.*" As a result, the proposed seller's interest option remains unusable to any revolving master trusts.

The following explanation of the typical cash flow allocations for a master trust during scheduled amortization and accumulation periods is offered by way of background. During a scheduled amortization period, principal payments are made to investors beginning on a scheduled date or in fixed amounts on a series of scheduled payment dates, whereas during a scheduled accumulation period, principal collections are set aside in trust accounts to make a single payment of principal on a targeted or expected payment date.[99] In any type of amortization period, the numerator used to determine the allocation percentage for interest and/or principal collections "fixes," *i.e.*, the numerator used to calculate such allocation percentage is

(cont'd)
58013. More specifically, the Joint Regulators' state: "The definitions of a seller's interest and a revolving master trust are intended to be consistent with current market practice…". *Id*. at 58013.

97 *See id*. at 58028 (emphasis added).

98 *See* June 10, 2011 ASF Comment Letter, *supra* note 87 at 107 (explaining that "virtually all credit and charge card securitization transactions fix the allocation of principal collections to the relevant investor interests during other periods, including scheduled principal accumulation or principal amortization periods, and in some cases may also subordinate collections allocable to the seller's interest to the investor interests")

99 For ease of reference, in this Part all types of scheduled amortization and accumulation periods, whether scheduled or triggered early due to a default or other trigger, are collectively referred to as "amortization periods."

based on the outstanding principal amount of the investors' ABS interests at the beginning of the amortization period, rather than the current outstanding principal amount of the investors' ABS interests at the time of allocation. In essence, a portion of the seller's interest in an amount equal to the difference between (1) the outstanding principal amount of the investors' ABS interests as of the beginning of the amortization period (which is used to determine the allocation percentage for collections throughout the amortization period) and (2) the current invested amount[100] of the investors' ABS interests on any payment date, becomes subordinated to investors' ABS interests solely with respect to the allocation of collections during the amortization period. In all periods, losses are typically allocated to the seller's interest on a *pari passu* basis. Therefore, in order to better reflect current market practice, the SFIG membership requests that any requirement in the final rule that the seller's interest be *pari passu*[101] be modified to require the seller's interest to be *pari passu* with respect to the allocation of collections with investors' ABS interests only during revolving periods.

In light of the Joint Regulators' statement that the seller's interest option was intended to be consistent with market practice,[102] many SFIG members are optimistic that the *pari passu* requirement was not intended to prevent existing master trusts as currently structured from being able to use the seller's interest option for revolving master trusts. The SFIG membership therefore believes that it would be appropriate for the Joint Regulators to clarify that the *pari passu* requirement was not intended to prevent the fixing of allocations during all amortization periods. If, however, the Joint Regulators did intend to prevent master trusts that use fixed allocations during amortization from relying on the seller's interest option, SFIG members wish to emphasize that such requirement would prevent <u>all</u> master trusts from utilizing the seller's interest form of risk retention. SFIG members also wish to highlight that the use of a fixed allocation percentage during amortization periods is protective of investors and that both investors and rating agencies have relied on this feature to provide for timely payment of principal. As a result, it would not be possible to amend existing series of ABS interests to provide for a *pari passu* (and therefore less protective) seller's interest as described in the Re-Proposal during scheduled amortization periods without the consent of investors, and in many cases, confirmation from applicable rating agencies that such an amendment would not result in the downgrade of the ratings of any outstanding investors' ABS interests. Neither investors nor the rating agencies would be likely to approve an amendment that would lengthen the amortization period for securities, and therefore cause a failure to pay principal by the respective expected principal payment dates for outstanding securities.

Further, it would be difficult (if not impossible) and, at the very least, highly inefficient to structure new series of securities without this feature, as it affects the fundamental way in which

[100] This Letter uses the term "invested amount" of a series to mean either (1) the outstanding principal amount of an ABS interests as reduced by principal payments made on such ABS interests or, (2) in the case of a series with an accumulation period, the outstanding principal amount of the ABS interests, as reduced by cash accumulated in a trust account for the payment of principal on the expected payment date, and in either case, as reduced by write-downs for losses as discussed in Section E.1 of this Part.

[101] As noted in the following Section B.2.b of this Part, the SFIG membership believes the seller's interest option of risk retention should be available for subordinated seller's interests.

[102] Re-Proposal, 78 Fed. Reg. at 58013(stating "The definitions of a seller's interest and a revolving master trust are intended to be consistent with current market practices …")

cash flows are structured to assure timely payment of principal on ABS interests issued by a revolving master trust. SFIG members strongly believe that effecting such a fundamental change in the cash flow allocations for master trusts would reduce efficiency in the securitization market by making it more difficult to structure securities with the desired payment terms and credit ratings, and reduce investors' willingness to invest in the market.[103]

b. A subordinated seller's interest that exposes the holder to a greater share of the credit risk should be recognized as an available form of risk retention under the final rule, and should not be treated differently than a *pari passu* seller's interest.

In the Re-Proposal, the Joint Regulators stated that they were "considering whether they should make additional provisions for subordinated seller's interests.[104] Since subordinated seller's interests are utilized as the primary form of credit enhancement in a number of master trust structures currently active in the securitization market, the SFIG members request that the final rule include provisions recognizing this form of risk retention.

As described in the preceding section, the "fixing" of allocation percentages during amortization involves a degree of subordination of the seller's interest that exists in virtually every master trust transaction. Accordingly, for purposes of distinguishing:

(1) a seller's interest that provides for only the limited subordination resulting from "fixing" of allocations during amortization, from

(2) a seller's interest that provides for additional forms of subordination (either in terms of subordination of collections or absorption of losses) for the benefit of investors' ABS interests,

we will refer to the former as a "*pari passu*" seller's interest and the latter as a "subordinated" seller's interest.

SFIG members wish to emphasize that there are many variations of subordinated seller's interests, and in many cases, such interests are not structured as series-specific horizontal interests. In certain master trust securitization transactions, collections initially allocated to the seller's interest may be made available to cover specified types of shortfalls in payments on investors' ABS interests under varying circumstances depending on the terms required by rating agencies or negotiated by investors, as applicable. For example, the seller's interest percentage

103 Such a result contradicts the intent expressed in the Re-Proposal: "The Commission preliminarily believes that aligning the requirements with current market practice will balance implementation costs for sponsors utilizing the master trust structure with the benefits that investors receive through improved selection of underlying assets by the sponsors. Maintaining current practice will be transparent and easy for the market to understand and will preserve current levels of efficiency and maintain investor's willingness to invest in the market. Codification of current practice will also provide clarity to market participants and may encourage additional participation given the removal of previous uncertainty about potential changes to current practices, thereby increasing capital formation." *Id*. at 58013.

104 *Id*. at 57943.

of principal collections[105] may also be made available to cover shortfalls in making targeted principal payments to the accumulation account or scheduled payments of principal during the amortization period. However, a master trust described in the preceding sentence might not provide for subordination of interest collections allocated to the seller's interest. Further, in many cases, even if a seller's interest is subordinated in terms of application of the current month's principal or interest collections as described in this section, such a seller's interest may not absorb losses allocated to investors' ABS interests, *i.e.*, losses allocated to the investors' ABS interests are not first applied to reduce the principal amount of the seller's interest rather than the invested amounts of the investors' ABS interests.

SFIG members also note that, as described in Section G of this Part, collections otherwise distributable to the holder of the seller's interest are often required to be deposited to an excess funding account or similar account to maintain a minimum seller's interest and satisfy other minimum asset balance requirements. SFIG members are concerned that this typical requirement would be considered a form of subordination that could prevent a sponsor from utilizing the seller's interest option.

Members have advocated that a subordinated seller's interest should be treated no differently than a *pari passu* seller's interest for two reasons:

First, a seller's interest that contains any feature of cash flow subordination will be precluded from satisfying the seller's interest option (because it is not a *pari passu* interest), while at the same time, such seller's interest will also be precluded from satisfying the horizontal interest options available to revolving master trusts if it is not structured as a typical series-specific horizontal interest that is subordinated with respect to distributions of both principal and interest collections. As noted above, even if a portion of the seller's interest's share of principal collections is reallocated to make required payments or deposits to ABS interests in their amortization periods, it may not necessarily be the case that the seller's interest's claim on interest and fee collections would also be subordinated to interest payments required to be made to senior ABS interests or that the seller's interest would absorb losses allocated to investor interests.

Second, a subordinated seller's interest represents a *greater* retention of risk by the sponsor than a *pari passu* seller's interest, and is more protective of investors. Therefore, it is difficult to rationalize a policy reason for not providing a risk retention option that would give credit for a subordinated seller's interest on the same basis as a *pari passu* seller's interest.

5. *Seller's interest option for risk retention should be available to a larger segment of the securitization market.*

   a. The restriction on premium bonds should be clarified and a full prohibition of premium bonds is not necessary.

[105] The seller's interest percentages of collections is used here to mean those collections initially allocated to the seller's interest rather than to investors' ABS interests. Such principal collections are in excess of the share of collections attributable to the seller's interest that are initially allocated to investors through the fixing of the investor allocation percentages during amortization and accumulation periods.

The Supplementary Information to the Re-Proposal indicates that the Joint Regulators would expect to include in the final rule a prohibition against using the seller's interest approach for any master trust that issues "senior interest-only bonds or premium bonds."[106] Many SFIG members believe that this restriction on premium bonds requires several refinements in the final rule.

First, the term "premium bonds" needs to be defined in the final rule. We assume that the term "premium bond" in the Re-Proposal refers to a bond that monetizes excess spread and that the Joint Regulators did not intend to prohibit master trusts from issuing a bond at a premium, *i.e.*, issuing a bond that trades above its par value because it offers a coupon rate that is higher than prevailing interest rates. In such cases, the "premium" is not attributable to monetizing excess spread, and in no way reflects an evasion of the sponsor's required risk retention.

Second, because existing master trusts will have ABS interests outstanding at the time when the final rule takes effect, SFIG members request that the Joint Regulators include a grandfathering provision that would allow master trusts that have issued senior interest-only or premium bonds prior to the effective date of the final rule to be able to use the seller's interest approach. This accommodation is necessary because there are no other viable risk retention options for master trusts in the Re-Proposal. The Joint Regulators have crafted the seller's interest option as "the specific risk retention option for master trusts"[107] and have not attempted to modify the other risk retention options in a way that makes them workable for master trusts.

Third, most SFIG members do not believe that a full prohibition on senior interest-only or premium bonds either issued prior to or after the effective date is appropriate or necessary. Prohibiting the use of the seller's interest approach is overly restrictive. Instead of such prohibition, we urge the Joint Regulators to instead modify the valuation of a master trust's seller's interest if such master trust issued senior interest-only or premium bonds. Requiring a master trust that issues senior interest-only or premium bonds after the effective date of the final rule to value its seller's interest based on the fair value of outstanding ABS interests would further the intent of the Dodd-Frank Act while maintaining flexibility for master trust sponsors.

b. The seller's interest option for risk retention should be available for non-master trusts and series trusts.

Under the Re-Proposal, the seller's interest option for risk retention is currently available only for revolving master trusts. Even if the definition of revolving master trust is revised as discussed above, there will be issuing entities that currently incorporate seller's interests into their structures that will not receive credit for this existing form of credit risk retention because they are not traditional "revolving master trusts." This will impact two common securitization structures, as discussed below.

First, there are issuing entities that issue only one series of ABS interests, but incorporate a seller's interest that adjusts for fluctuations in the receivables balance, often because the related securitized assets are revolving in nature or because the structure incorporates a revolving period

106 *See id*. at 57944.

107 *See id*. at 57942.

during which assets may be added to the securitized pool. Many home equity line of credit (HELOC)transactions fall within this category, and in fact, credit card securitizations have always incorporated a seller's interest, but were first introduced in the 1980's as "one-off" non-master trusts. In some cases, the seller's interest is *pari passu* to investors' ABS interests, and in other cases is subordinated, but in any event, such seller's interests represents a trust-wide form of risk retention.

Second, as noted by the Joint Regulators, the seller's interest form of risk retention as proposed would not be available to a series trust, *i.e.*, a trust that issues series of ABS at different times backed by segregated independent pools of securitized assets within the trust as a series trust." In such cases, the sponsor may retain a seller's interest in each independent pool of collateral.

The SFIG membership requests that the seller's interest option be available to both of these types of securitization transactions, and, further, that such option be available to both subordinated or *pari passu* seller's interests. In the case of subordinated seller's interests, the SFIG membership requests that such interests either be recognized and treated as seller's interests or, alternatively, that the Joint Regulators incorporate a horizontal form of credit risk retention that would be available for such seller's interests, as discussed in more detail below.

C. The Proposed Option for Combined Retention at the Trust and Series Levels Does Not Work for Many Master Trusts and Requires Clarification.

Although § __.5(f) allows a sponsor to reduce the 5% seller's interest required on each measurement date by retaining a corresponding percentage of the fair value of all ABS interests issued in each series in the form of an EHRI that meets the requirements of § __.4 or a horizontal interest meeting the requirements of § __.5(f),[108] neither alternative provides a viable horizontal risk retention option for master trusts for the reasons discussed below.

1. *Master trusts cannot comply with the requirements of the standard EHRI option found in § __.4.*

   a. The comparison of the closing date projected cash flow rate to the closing date projected principal repayment rate does not work for master trusts, or any revolving structure.

As discussed in Section B of Part I of this Letter, the SFIG membership has identified several structural issues with the requirement to compare the closing date projected cash flow rate and the closing date projected principal repayment rate that would be applicable to all asset classes, and to revolving structures in particular. As noted in more detail in Section B of Part I of this Letter, the calculations in this requirement fail to distinguish payments of interest on the related EHRI and other ABS interests from payments of principal on those same interests.

Due to the requirement that shortfalls reduce amounts paid to the EHRI prior to any reduction in the amounts paid to any other ABS interests (*see* clause (2) of the definition of

[108] *See id*. at 58028.

EHRI), many SFIG members believe that an EHRI for a master trust would need to include the sponsor's residual interest in excess spread, as such interest represents the first loss position that will be reduced prior to any reduction in the amounts paid to other ABS interests. However, the limitation on permissible cash flow would restrict the sponsor from receiving distributions of excess spread, which effectively precludes the residual interest in a master trust from meeting the requirements of the standard EHRI option in § __.4. The Joint Regulators acknowledged in the Re-Proposal that residual interests in master trusts are unlikely to meet the requirements for an EHRI in § __.4 when they stated: "The residual interest held by sponsors of master trusts at the series level typically does not meet the requirement of the proposed definition of EHRI, which would limit the rate of payments to the sponsor to the rate of payments made to the holders of the senior ABS interests."[109] However, given that such series-level residual interests, as the most subordinate interests in the master trust, would be required to be included in the EHRI, sponsors are not able to structure any other horizontal interests, for example retained trust-wide or series-level subordinated investor ABS interests, from separately meeting the restrictions on the distributions of cash flows and the other requirements for an EHRI. Therefore, unless master trusts are exempted from complying with the limitation on cash flows, or the requirements of § __.4 are modified to allow master trust sponsors to exclude the series-level interest in excess spread when determining whether other ABS interests qualify as EHRIs, the option to offset the 5% seller's interest requirement with an EHRI that meets the requirements of § __.4 provides no real alternative for master trust sponsors.

The SFIG membership also wishes to emphasize that the difficulties with the projections and certification requirements for EHRIs discussed in Section B of Part I of this Letter are particularly acute for master trust sponsors. As noted in such Section, a sponsor of a revolving securitization will not know on the closing date what the composition of the pool will be on any particular date, and in the case of a master trust, the sponsor also will not know what the characteristics of the outstanding ABS interests will be on any future date.

b. The EHRI definition does not accommodate separate series cash flows for master trusts or de-linked master trust structures.

The Joint Regulators do not appear to have attempted to draft the definition of EHRI to accommodate series-level allocations and cash flows for master trusts. For example, the requirement in clause (2) of the definition of EHRI would require payments to the EHRI to be reduced if there are insufficient funds to pay *all* contractual interest and principal due on all other investors' ABS interests, as opposed to ABS interests of the same *series*. Likewise clause (3) of the definition of EHRI requires the EHRI to have the most subordinated claim to payments of both principal and interest *by the issuing entity*, rather than payments of principal and interest on ABS interests for the same *series*. Such requirement also does not address the fact that in a de-linked structure, subordinated tranches of a series may be paid principal prior to later-maturing more senior tranches of the same series. If, as many in the SFIG membership believe, the Joint Regulators did not intend master trust sponsors to utilize § __.4 for series-level horizontal interests, then it is critical that the special option for horizontal risk retention described in § __.5(f) provide an alternative for master trusts that gives credit to the many forms of horizontal risk retention already used in the market, not just residual interests in excess spread.

109 *See id.* at 57944.

2. *The special horizontal interest option for master trusts in § __.5(f) does not accurately describe the features of horizontal interests retained by sponsors of existing master trusts and therefore fails to give credit for existing forms of credit risk retention.*

Existing master trusts already issue a number of trust-wide and series-level horizontal interests that represent a meaningful retention of credit risk by master trust sponsors. However, the requirements for the special horizontal interest option for master trusts as currently proposed would prevent master trust sponsors from receiving credit for such existing horizontal interests for the reasons discussed below.

a. The requirement relating to priority of distributions from interest and fee cash flows does not reflect typical master trust cash flows.

Clause (3) of § __.5(f) requires the horizontal residual interest's claim to any part of the series' share of the interest and fee cash flows for any interest payment date to be subordinated to "all accrued and payable interest *and principal due* on the payment date to more senior ABS interests."[110] However, in the great majority of master trust structures, the interest and fee cash flows are not available to make principal payments due on the payment date to ABS interests. Rather, interest and fee cash flows are typically applied to pay interest owed to ABS investors and certain transaction expenses (for example, servicing fees and trustee fees) and to cover losses allocated to the ABS interest, whereas principal cash flows from the assets are applied to make principal payments on the ABS interests. And with respect to principal payments, the requirement that the horizontal interest have the most subordinated claim to the principal repayment cash flow is already addressed in clause (4) of § __.5(f). Accordingly, many SFIG members believe that the reference to "principal payments due" should be deleted where it appears in clause (3).

A number of SFIG members also noted that the Supplementary Information describes the requirement in clause (3) as follows: "The sponsor's claim to any of the series' share of interest and fee proceeds each period pursuant to the horizontal residual interest is subordinated to all interest due to all ABS interests in the series for the period, and further reduced by the series' share of defaults on principal of the trust's securitized assets for that period (that is, charged off receivables)."[111] This description of clause (3) does not reference principal payments, and therefore SFIG members are hopeful that the inclusion of the reference to principal payments in the text of clause (3) was inadvertent.

SFIG members wish to highlight one additional structural feature with respect to the interest and fee cash flow waterfalls for certain securitization transactions that is inconsistent with the requirement in clause (3) that the horizontal interest's claim to interest and fee cash flows be subordinated to *all* accrued interest due to more senior ABS interests. In certain securitization transactions, the additional interest payable upon default (even to the most senior class of ABS interests) is in many cases subordinated to the payment of all regular interest on all classes of ABS interests (senior interest) and the coverage of losses. To the extent the interest

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110 *Id*. at 58029 (emphasis added).

111 *See id*. at 57945.

rate on an investor ABS interest increases above the maximum interest rate used by the applicable rating agency to model the cash flows for the securitization transaction, the additional interest (subordinated interest) that accrues due to the step-up in the interest rate after default is often not rated and will be payable below the priority in the interest and fee cash flow waterfall at which collections are applied to cover losses. Similarly, where the interest rate for a senior class of ABS interests is based on a floating index, the senior interest payable at the top of the interest and fee cash flow waterfall is sometimes limited to a capped rate of interest. This feature allows the rating agencies and investors to more accurately predict the cash flows that will be available to pay interest on rated classes of ABS, as well as the cash flows that will be available to cover losses.

Many master trust sponsors hold the most junior investors' ABS interest issued as part of one or more series and believe that they should receive credit for such horizontal interests under § __.5(f). In many cases, even the most junior of the retained investors' ABS interests is structured to receive a contractual rate of interest and such interest payments are rated at an investment-grade level (or, if not explicitly rated, are structured to an investment-grade level). For such retained ABS interests, it would not be consistent with rating agency requirements for subordinated interest due on more senior ABS interests to be paid prior to senior interest payable on all investment-grade ABS interests, including any such ABS interests retained by the sponsor. The SFIG membership therefore requests that a horizontal interest's claim to interest and fee cash flows for making interest payments on the horizontal interest only be required to be subordinated to all accrued *senior* interest due to more senior ABS interests.

b. The requirement that a horizontal interest's claim to any part of the series' share of losses should only apply to a residual interest in excess spread and not retained investors' ABS interests.

Clause (3) of § __.5(f) includes a requirement that the horizontal interest's claim to any part of the series' share of the interest and fee cash flows for any interest payment period is "further reduced by the series' share of losses, including defaults."[112] A significant number of SFIG members are concerned that the Joint Regulators intended to prohibit a horizontal interest from receiving a share of interest and fee cash flows prior to using interest and fee cash flows to cover the current month's defaults allocated to the series. If this was the intent of the referenced requirement, then such requirement would preclude most interest-bearing retained investors' ABS interests from meeting the requirements of clause (3). Many master trust sponsors hold the most junior investors' ABS interest issued as part of one or more series and, in many cases, even the most junior of the retained investors' ABS interests is structured to be interest-bearing and investment-grade. For such retained investors' ABS interests, it would not be typical (or consistent with rating agency requirements) that allocated losses would be covered by the interest and fee cash flows before interest payments are made on such retained investors' ABS interests. As noted above in Sections C.1 and C.2.a of this Part, because horizontal interests issued by master trusts are not able to meet the requirements for an EHRI under § __.4 of the proposed rule, master trust sponsors believe § __.5(f) should give credit to the subordinated classes and tranches of ABS retained by sponsors.

[112] *See id*. at 58029.

A very typical (and simplified) interest and fee cash flow waterfall for a revolving master trust would be as follows:

- First, to make deposits to the interest funding account to fund the payments of interest on the investors' ABS interests, with interest paid sequentially to each class.

- Second, to pay the servicing fee, plus any previously due and unpaid servicing fee, to the servicer.

- Third, to be treated as principal collections in an amount equal to the amount of defaults allocated to the series for the preceding month and to cover any previous write-downs in the ABS interests due to defaults.

- Fourth, to be treated as shared collections with other series, if any.

- Fifth, any excess spread to be paid to the issuing entity (or depositor).

As this waterfall illustrates, all classes of investors' ABS interests would receive interest payments prior to using interest and fee collections to cover losses. Therefore, we request that the provision in clause (3) of § __.5(f) requiring the horizontal interest's claim to any part of the series' share of the interest and fee cash flows to be "further reduced by the series' share of losses" not apply to horizontal interests that are subordinated classes and tranches of investors' ABS interests.

However, if a sponsor wishes to receive credit for its residual interest in excess spread, then SFIG members generally believe that it would be appropriate to require the residual interest in excess spread to be reduced by the series' share of losses. Therefore, SFIG members have proposed to add the following separate requirement for a horizontal interest in excess spread, as shown in the Appendix D to this Letter:[113]

> "If such horizontal interest is retained in the form of a residual interest in series-level interest and fee collections remaining after the payment of all accrued interest due on all investors' ABS interests for such series on any payment date, such residual interest's claim to any part of the series' interest and fee collections is further reduced by the series' share of defaults on the principal amounts of the securitized assets for the related period, to the extent that collections on such principal amounts would have been payable to more senior ABS interests in the series on such payment date."

c. The requirement to have the "most subordinated claim to any part of the series' share of the principal repayment cash flows" needs to be clarified for de-linked master trusts.

[113] *See* clause (3) of the proposed definition of eligible series-level horizontal interest in Appendix D.

Clause (4) of § __.5(f) requires the qualifying horizontal interest to have the most subordinated claim to any part of the series' share of the principal repayment cash flows.[114] In the case of de-linked trusts, tranches of the most subordinated ABS interests may have different expected payment dates and legal final maturity dates than senior tranches of the same series, and the expected payment dates and legal final maturity dates for certain subordinated tranches may occur *prior to* the expected payment dates or legal maturity dates for one or more senior tranches.

SFIG members wish to note that de-linked master trusts incorporate other structural features to ensure that adequate subordination for senior tranches is maintained notwithstanding the payment of principal to more subordinated tranches of ABS interests. Principal payments on subordinated tranches are generally restricted to the extent that the payment of principal on a subordinated tranche would cause a shortfall in the required subordination for any senior tranche. If a subordinated tranche cannot be paid because of the subordination provisions, principal collections generally will begin to be set aside in trust accounts for future payments of principal for senior tranches. Thereafter, the subordinated tranches typically may be paid only to the extent that:

- the principal funding accounts for senior classes of notes are prefunded in an amount such that the subordinated notes that have reached their expected principal payment dates are no longer necessary to provide the required subordination;

- new tranches of subordinated notes of the same series are issued or enough notes of senior classes are repaid so that the subordinated notes that have reached their expected principal payment date are no longer necessary to provide the required subordination; or

- the subordinated notes reach their legal maturity date.

On the legal maturity date of a tranche of subordinated notes, available principal amounts, if any, allocable to the subordinated tranche and proceeds from any sale of receivables will be paid to the noteholders of that tranche, even if such payment would reduce the amount of available subordination below the required subordination for the senior classes of that series.

The SFIG membership therefore requests that the requirement in clause (4) of § __.5(f) be revised to require that "the horizontal interest's claim to any part of the series' share of the principal collections on the common pool of the securitized assets for any period is subordinated to all principal payments due on the related payment date and all principal deposits required to be made *on the related payment date* to, or for the benefit of, other investors' ABS interests in the series that are in accumulation or amortization periods on such payment date." SFIG's members are requesting this change to avoid any implication that subordinated tranches issued by de-linked trusts may not receive principal payments before later maturing tranches of senior ABS interests. In addition, SFIG members have suggested that such requirement reference "principal collections" rather than the arguably broader "principal repayment cash flows" to avoid any

[114] *See id*. at 58029.

restriction on allowing a subordinated tranche to be repaid with the proceeds from any sale of receivables on the legal maturity date for such subordinated tranche.

d. Requirement that each series have separate interest and principal cash flow waterfalls is unnecessary and will prevent some master trusts from using the special horizontal risk retention option for master trusts.

There are a number of master trusts[115] that have unified cash flow waterfalls in which all interest and principal collections from the securitized assets are aggregated and then distributed to make interest and principal payments on the ABS interests. Such master trusts will be unable to receive any credit for the horizontal interests they issue under § __.4 for the reasons discussed in Section C of this Part. Therefore, the special horizontal interest option under § __.5(f) needs to be modified to accommodate series-level horizontal interests for which the related series do not distinguish between interest and fee cash flows and principal cash flows. The SFIG membership has proposed separate cash flow requirements for such horizontal interests in Appendix D.

e. Trust-wide horizontal interests and horizontal interests supporting multiple series should be recognized, including horizontal interests issued by legacy trusts.

Section __.5(f) allows a sponsor to reduce the 5% seller's interest required on each measurement date by retaining a corresponding percentage of the fair value of all ABS interests issued *in each series* in the form of a horizontal residual interest that meets the requirements of clauses (1) through (4) of § __.5(f).[116] The SFIG membership has two concerns with the reference to "in each series" in that provision.

First, the reference to "in each series" could be interpreted to require the sponsor to hold a horizontal interest for each series in the form of a class, subclass or tranche of each such series. Sponsors need the flexibility to be able to hold a horizontal interest issued as part of a separate series that would provide credit enhancement for the benefit of one or more, or even all, other series of ABS interests. For example, a master trust might issue a separate series that would provide credit enhancement to all other series of investors' ABS interests issued by the master trust.

Second, with respect to multiple-trust structures, the reference to retaining an interest "in each series" could be interpreted as referring only to those series issued by the same master trust that issues the ABS interests to investors. As recognized by the Joint Regulators in the Re-Proposal, a revolving master trust (legacy trust) may issue a collateral certificate representing a beneficial interest in all or a portion of the securitized assets held by that legacy trust to another revolving trust (issuing entity), which in turn issues ABS interests for which the collateral certificate represents all or a portion of the securitized assets. However, the Re-Proposal fails to recognize that the subordination for the ABS interests issued by the issuing entity and secured by

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[115] For example, many Canadian master trusts distribute cash flows through a unified waterfall, and a number of such issuers frequently issue to U.S. investors through the 144A market.

[116] *See id.* at 58028.

a collateral certificate may be provided by an ABS interest issued by the legacy trust, rather than in the form of one or more subordinated ABS interests in each series issued by the issuing entity. In such structures,[117] the subordinated ABS interest issued by the legacy trust provides credit enhancement to the collateral certificate that collateralizes the ABS interests issued by the issuing entity, and therefore such subordinated ABS interest should be considered a horizontal interest with respect to all series of ABS interests issued by the issuing entity that are secured by such collateral certificate.

The SFIG membership requests modifications in the final rule as shown in Appendix D to allow a horizontal interest in the form of an ABS interests issued by a legacy trust to qualify for credit under § __.5(f) so long as such horizontal interest is subordinated to the collateral certificate securing the related ABS interests issued by the issuing entity in a manner consistent with the requirements otherwise applicable for horizontal interests.

3. *The special horizontal interest option for revolving master trusts should be available for series trusts*.

The special horizontal interest option under § __.5(f) has been proposed as an offset to the 5 percent required seller's interest. However, as noted by the Joint Regulators,[118] the seller's interest form of risk retention as proposed would not be available to a series trust, *i.e.*, a trust that issues series of ABS at different times backed by segregated independent pools of securitized assets within the trust as a series trust." In such cases, an issuing entity may issue separate *series* of ABS interests that are each collateralized by independent pools of collateral.

As noted above in Section C.1.b of this Part, the Joint Regulators do not appear to have attempted to draft the definition of EHRI to accommodate series-level allocations and cash flows. For example, the requirement in clause (2) of the definition of EHRI would require payments to the EHRI to be reduced if there are insufficient funds to pay *all* contractual interest and principal due on all other investors' ABS interests, as opposed to ABS interests of the same *series*. Likewise clause (3) of the definition of EHRI requires the EHRI to have the most subordinated claim to payments of both principal and interest *by the issuing entity*, rather than payments of principal and interest on ABS interests for the same *series*.

For a series trust, there does not appear to be any horizontal risk retention option that is drafted in a manner that can accommodate separate series cash flows. The SFIG membership requests that the final risk retention rule include a horizontal form of credit risk retention for issuing entities that issue separate series of ABS interests, but that do not qualify as revolving master trusts, or alternatively, make the special horizontal interest option under § __.5(f) available to series trusts.

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[117] An example of such structure is illustrated in Appendix E.

[118] *See id*. at 57942.

D. Requested Modifications Relating to Valuation and Measurement of Horizontal Interests, and Proportional Credit for Horizontal Interests.

1. *The valuation of subordinated seller's interests and horizontal interests (other than residual interests in excess spread) should be based on the outstanding principal amount of such interests rather than fair value.*

The Original Proposal included a special "premium capture" mechanism designed to prevent a sponsor from structuring a securitization transaction in a manner that would allow the sponsor to offset or minimize its retained economic exposure to the securitized assets by monetizing the excess spread created by the securitization transaction. In response to industry concerns, the Joint Regulators have eliminated the premium capture provision in the Re-Proposal. In its place, the Joint Regulators introduced the new requirement to use fair value to measure the amount of risk retention as the primary method for sponsors to calculate their risk retention requirements, which as we noted above in Section A of Part I raises numerous concerns among the SFIG membership.

The Joint Regulators have proposed to use the principal balance instead of the fair value of outstanding ABS interests as the basis for the calculation of the minimum seller's interest requirement. The Joint Regulators have explained that they "consider this approach to be sufficiently conservative, because sponsors of revolving master trusts do not include senior interest-only bonds or premium bonds in their ABS structures."[119] However, the Joint Regulators do not offer an explanation for why it is necessary or desirable to require a subordinated seller's interest or a horizontal interest in a master trust to be valued on a fair-value basis, given the proposal to prevent master trusts that issue interest only or premium bonds from utilizing the revolving master trust option for risk retention. The requirement to measure retained interests at fair value would seem to be based on a desire to prevent the evasion of the risk retention requirements through deal structures that would not be eligible to use the special risk retention option for revolving master trusts. In addition, as the Joint Regulators note, for master trusts, "the fair value determination [for seller's interests] would create additional complexity and costs, especially given the frequency of the measurements required."[120] A fair-value determination for subordinated seller's interests and horizontal interests would likewise be burdensome, especially if master trust sponsors are required to perform such calculations monthly on every seller's interest measurement date, or to re-value previously issued ABS interests on each closing date.

For a master trust that does not issue premium or interest-only bonds and does not monetize excess spread, a retained ABS interest that is collateralized by a 5% interest in the securitized assets represents at least 5% of the credit risk of the securitized assets, regardless of whether the retained interest is *pari passu* or subordinate to other ABS interests. The fair value of a subordinated seller's interest or a subordinated horizontal interest will reflect the increased potential for losses and, in some cases, may reflect the fact that the subordinated interest will be paid at a later date than senior ABS interests. However, the reduction in the fair value of a

[119] *Id*. at 57944.

[120] *Id*.

retained interest due to these factors does not reduce the sponsor's "skin-in-the-game." In fact, from the standpoint of an investor, a retained interest that is subordinated to other ABS interests is a superior form of risk retention and is more protective. Therefore, SFIG members generally believe that it would be appropriate to value all retained investors' ABS interests issued by a master trust based on par value if the master trust does not issue premium or interest-only bonds and does not otherwise monetize excess spread, and the sponsor or a majority owned affiliate retains the residual interest in excess spread.

2. *Proportional credit should be given for all horizontal interests retained by the sponsor*.

To be eligible to combine the seller's interest with horizontal risk retained at the series level, the Re-Proposal requires the sponsor to maintain a specified amount of horizontal risk retention in *every* series issued by the trust. SFIG members request that sponsors instead be permitted to reduce the trust-wide risk retention requirement by a proportional amount of the retained horizontal interests based on the relative size of each series, regardless of whether the sponsor holds a minimum percentage of each series. For example, if there are two outstanding series, each having an outstanding principal amount of investors' ABS interests equal to $100, and the sponsor holds a horizontal interest in Series One representing 3% and a horizontal interest in Series Two representing 2%, the sponsor should be permitted to reduce the 5% trust-wide risk retention requirement by 2.5%, *i.e.*, by weighting each horizontal interest by the respective outstanding principal balance of the investors' ABS interests of the related series. If Series One were to mature first, the sponsor should be required to increase its trust-wide seller's interest requirement to 3% to reflect the reduction in the total risk retention held through horizontal interests. In Appendix D, the SFIG membership recommends that this weighting be accomplished by adding the outstanding principal balances of all horizontal interests (or, the fair value of any horizontal interest that does not have a principal amount), and expressing such total principal balance of horizontal interests as a percentage of the unpaid principal balance of all outstanding investors' ABS interests issued by the issuing entity.

We do not believe that it is necessary for a sponsor to retain the same percentage interest in each series in order to create the desired alignment between the interests of the sponsor and the interests of other ABS investors. The goal of the risk retention rules should be to create the required incentive for sponsors to originate high quality receivables, and given that the master trust represents one or more common pools of collateral, the fact that the sponsor retains credit risk in the securitized assets in the form of an ABS interest in one series versus another is irrelevant as long as the total amount of retained risk in each common pool of securitized assets represents 5% of the total principal amount of outstanding investors' ABS interests secured by each such common pool.

3. *SFIG members request clarification that a sponsor need not retain 100% of a horizontal interest that otherwise meets the requirements of § __.5(f).*

A sponsor will often retain less than 100% of the most subordinated classes or tranches of ABS issued in a particular series. Although the Re-Proposal does not explicitly require a sponsor to hold the entire class or tranche of a horizontal interest meeting the requirements of § __.5(f), SFIG members believe it would be helpful for the Joint Regulators to provide additional clarification that a sponsor is not required to retain 100% of a horizontal interest provided that the sponsor otherwise retains all other ABS interests that are subordinate to such horizontal interest. For example, if a sponsor retains 50% of the most junior class of ABS interests in a series (referred to as "class D" in this example), the SFIG membership believes that the sponsor should receive credit for such interest under § __.5(f). Likewise, if the sponsor retains 100% of the class D ABS interests and 50% of the next most junior class of ABS interests in the series (referred to as "class C" in this example), the SFIG membership believes that both the sponsor's retained class D ABS interests and class C ABS interests should collectively be a qualifying horizontal interest for purposes of § __.5(f). However, if a sponsor were to hold 50% of the class D ABS interests and 50% of the class C ABS interests in a series, we interpret § __.5(f) to allow the sponsor's 50% interest in the class D ABS interests to be a qualifying horizontal interest, but not the sponsor's 50% interest in the class C ABS interests, because the sponsor does not retain 100% of the ABS interests that are subordinate to the class C ABS interests. The SFIG membership requests confirmation that the interpretation illustrated by the examples in this section of the Letter is accurate.

4. *The SFIG membership requests that if sponsor retains multiple ABS interests that in the aggregate meet the requirements for a horizontal interest under § __.5(f), the sponsor need only disclose the valuation of the ABS interests for which it desires to receive offsetting credit.*

The Re-Proposal provides that a horizontal interest meeting the requirements of § __.5(f) may be a single or multiple classes, subclasses, or tranches that collectively meet the requirements of paragraph (f). The Supplementary Information makes it clear that the Joint Regulators believe that it would be appropriate to recognize the sponsor's residual interest in excess spread as a qualifying horizontal interest under § __.5(f). However, many of our members have expressed reluctance to seek credit for such residual interest in excess spread under § __.5(f) because of the burdensome requirement to determine the fair value of the residual interest and the related disclosure requirements. In addition, many sponsors retain not only the residual interest in excess spread, but one or more of the most junior investors' ABS interests issued in one or more series. We believe that where multiple interests qualify collectively as a horizontal interest under § __.5(f), it will be critical that sponsors be permitted to count the value of any subset of such horizontal interests as an offset to the seller's interest risk retention requirement, without the necessity of valuing each and every component of the aggregate horizontal interest. For example, if a sponsor retains a 4% horizontal interest in the form of a Class D certificate in each series, as well as the entire residual interest in excess spread for each series, such sponsor, if it desires to receive credit only for the risk it retains in the form of a Class D certificate, should be permitted to count the value of the Class D certificate towards its risk retention requirement, without the necessity of determining and disclosing the fair value of the residual interest in excess spread as well.

E. Measurement Date for Seller's Interest and Combined Risk Retention Options.

1. *If horizontal interests are valued using fair value, then the measurement date for each horizontal interest should generally be the date on which the eligible horizontal interest is issued.*

SFIG members generally believe that it is appropriate to measure the seller's interest monthly and that such a requirement would not be burdensome given the current market practice to test the seller's interest on a monthly basis. However, for purposes of the option to combine the seller's interest with series-level horizontal interests, it is unclear whether the Joint Regulators intended sponsors to calculate the fair value of each horizontal interest on a monthly basis. As discussed above in Section D.1 of this Part, the SFIG membership generally believes it would be appropriate to value each horizontal interest based on the outstanding principal amount of such horizontal interest, other than with respect to the valuation of the sponsor's residual interest in excess spread. If the request to use the outstanding principal amount to measure horizontal interests is incorporated into the final rule, it would be possible for sponsors to easily recalculate the offset to the seller's interest based on the outstanding principal amount of the horizontal interests on each monthly measurement date and on each date on which new ABS interests are issued. Requiring calculation of the fair value of horizontal interests issued by a master trust on a monthly basis would be inconsistent with the requirements for EHRIs under the standard horizontal risk retention option and would be extremely burdensome for sponsors. In addition, a sponsor should not be required to increase its risk retention for a series to the extent the horizontal interest declines in fair value after the closing date for the series. Doing so would effectively require the sponsor to hold a greater than 5% retained interest in the securitized assets, which would be inconsistent with the other risk retention options in the Re-Proposal and impose an unequal burden on sponsors of revolving master trusts in comparison to other securitizers.

The SFIG membership believes that if a sponsor were to receive credit for retention of the residual interest in series-level excess spread, it would be appropriate to re-value the sponsor's interest in excess spread on a monthly basis. As noted above in Section D.4 of this Part, given the complexity of valuing excess spread, the SFIG membership believes that most sponsors will elect not to claim credit for their retained residual interest in excess spread, despite the Joint Regulators' attempt to provide for this option. SFIG members are generally comfortable with this result, so long as the final rule otherwise allows sponsors to receive credit for other horizontal interests that they hold. This underscores the importance of the request made in Section D.4 of this Part. In determining whether a horizontal interest meets the requirements for an EHRI or the requirements under § __.5(f), a sponsor must be able to elect to disregard the residual interest in excess spread and receive credit for other horizontal interests that it retains for so long as such residual interest in excess spread is entirely held by the sponsor or a majority owned affiliate of the sponsor. The residual interest in excess spread will always represent the most subordinated claim to the cash flows of a master trust. Therefore, the requirements in the definition of EHRI and in § __.5(f) that the horizontal interest have the most subordinated claim to cash flows will cause all other horizontal interests issued by a master trust to fail to qualify for credit under the risk retention rules unless the residual interest in excess spread is aggregated with the other horizontal interests and treated as a single horizontal interest. The SFIG membership views such result as too time-consuming and complex to be a viable option under the risk retention rules for most sponsors.

Although the SFIG membership generally believes that horizontal interests (except for the residual interest in excess spread) should be measured based on outstanding principal balance and that it is not appropriate to require re-valuation of horizontal interests. If the Joint Regulators determine that a re-valuation of horizontal interests is required either monthly or on each issuance date in order to take into account losses on a horizontal interest, the SFIG membership wishes to propose an alternative method of valuation. Many master trusts use the invested amount[121] of a series, class or tranche of investors' ABS interests to measure such series', class' or tranche's claim on the assets of the master trust, and such invested amount is reduced for losses that are not otherwise covered out of the current month's interest and fee collections allocated to the particular ABS interests. SFIG members request that, if a re-valuation of horizontal interests is required by the final rule, then for master trusts that allocate losses in this manner, the value of the related horizontal interests be measured by their respective invested amounts rather than fair values.

SFIG members wish to provide the Joint Regulators with additional background as to the calculation of the "invested amount" for an ABS interest. Securitization transaction documents generally provide that a share of the interest and fee collections equal to the lesser of (a) the amount of monthly credit losses allocated to the series and (b) the amount of the series' share of interest and fee collections remaining after covering higher priority expenses (generally servicing fees and interest on some or all of the securities in the series) will be "treated as principal collections."[122] In other words, to the extent that a series has interest and fee collections available for this purpose, those interest and fee collections are substituted for the collections that should ultimately have been received on the principal receivables that were charged-off. If the amount of interest and fee collections available to cover credit losses is less than the amount of credit losses allocated to a series, class or tranche of investors' ABS interests, then the investors' ABS interest will be reduced by the amount of the deficit. For some master trusts that do not use de-linked structures, the series, rather than each separate class or tranche within the series, may be assigned an invested amount. In such cases, the most junior class or tranche absorbs losses first because principal is paid sequentially. To illustrate, if there are $50 of class A ABS, $25 of class B ABS and $25 of class C ABS in a series initially supported by $100 of principal receivables, and the series experiences write-downs for losses of $5, then the series will have a total invested amount of $95 and the class C ABS will absorb the entire $5 write-down (unless write-downs are later reversed). Accordingly, although the class C ABS does not have a separate invested amount as defined in the securitization transaction documents, its "invested amount" as described in this paragraph—meaning its outstanding principal amount as reduced by write-downs for losses—would be $20.

121 The Joint Regulators should be aware that the outstanding principal amount of an investors' ABS interest as reduced by write-downs is often referred to the "invested amount;" however the terminology used in securitization transaction documents differs. For example, the terms "collateral amount" or "nominal liquidation amount" are used in many transactions. For ease of reference, this Letter uses "invested amount" to generally refer to the principal amount of an ABS interest, as reduced by write-downs for losses.

122 This is illustrated in the third bullet point in the simplified waterfall described in Section C.2.b of this Part.

2. *The seller's interest measurement date should be revised to incorporate the cure periods provided for in transaction documents, and should be no more frequent than once per month*.

To the extent that the amount of a seller's interest falls below the minimum seller's interest, a sponsor would typically add additional assets to the master trust, deposit cash to an excess funding account, or reduce the amount of outstanding securities. All master trust transaction documents allow a cure period before a shortfall in the minimum seller's interest would cause an early amortization event. The SFIG membership requests that, consistent with market practice, sponsors have the flexibility to cure deficiencies in the minimum risk retention requirement within the same cure period used to determine whether an asset shortfall would cause an early amortization of the ABS interests pursuant to the securitization transaction documents.

The Re-Proposal requires the 5% test to be met at the closing of each issuance of ABS interests and at every seller's interest measurement date specified under the securitization transaction documents. A significant number of SFIG members are concerned that the reference to every seller's interest measurement date may, in some cases, require testing of the seller's interest for purposes of the risk retention rules on a daily basis. In some securitization transactions, the seller's interest is tested on a daily basis for purposes of determining whether cash may be released to the sponsor or, alternatively, deposited into an excess funding account. The seller's interest is also typically tested a monthly basis for purposes of determining whether assets are required to be added to the master trust, and whether a collateral deficiency would trigger an early amortization of the investors' ABS interests. The SFIG membership believes that this monthly measurement date is the appropriate measurement date for the risk retention rules, and that the seller's interest should not be tested more than once per month and at every issuance of ABS interests.

F. Grandfathering and Transition Issues for Revolving Master Trusts.

As noted by the Joint Regulators in the Supplementary Information, commentators on the Original Proposal advocated that a grandfathering provision is necessary and fair to avoid a retroactive application of the risk retention rules to ABS interests issued prior to the effective date of the final rule. SFIG members believe that it is possible to craft a grandfathering provision for master trusts that does not result in a dilution of the 5% risk retention requirement for ABS interests issued after the effective date of the risk retention rules. The SFIG membership agrees that a sponsor that relies solely on the 5% seller's interest option should be required to hold such 5% seller's interest based on the unpaid principal balance of all outstanding ABS interests issued by the issuing entity. To the extent that a form of risk retention takes the form of a trust-wide interest and is available for the benefit of all investors' ABS interests in the master trust, the SFIG membership agrees that it is appropriate to base the risk retention requirement on the principal amount of all investors' ABS interests.

However, where a sponsor relies on series-specific horizontal interests to satisfy the risk retention requirement, either in whole or in part, there is no compelling reason to impose a corresponding requirement to hold the same percentage of horizontal interests for the benefit of outstanding series issued prior to the effective date. To use the most extreme example, a sponsor may have issued many series of ABS interests prior to the effective date of the risk retention rules, and such series all may have the benefit of first-loss residual interests that were not structured in a manner designed to comply with the technical requirements of the risk retention rules. If the first series issued by such master trust after the effective date of the final rule has the benefit of a 5% series-specific horizontal interest, it is unclear why the Joint Regulators believe that it is necessary to impose a requirement that each previously issued series also have the benefit of a similar 5% first loss position. Similarly, if all new series of ABS interests issued after the effective date of the final rule have the benefit of a 3% series-specific horizontal interest, the SFIG membership believes that the risk retention requirements should be satisfied by a combination of 3% series-specific horizontal interests for each series issued after the effective date of the risk retention rules, together with a 2% trust-wide seller's interest based on the outstanding principal balance of all outstanding investors' ABS interests, whether issued before or after the effective date.

The Joint Regulators' view that risk retention should be applied retroactively on a trust-wide basis seems to be based at least in part on the assumption that the final rule will provide for a risk retention option that is consistent with current market practice for master trusts. In fact, although certain generalizations can be made concerning the market, there are still many variations among master trusts within the same asset class, and even greater variations among the asset classes that utilize the master trust structure. For example, many floorplan master trust structures do not include a *pari passu* seller's interest, and virtually no floorplan master trust has a seller's interest greater than 2%. As a result, such sponsors are likely to completely or at least primarily rely on series-specific horizontal interests to satisfy the risk retention requirements.

To the extent that the horizontal interests issued prior to the effective date of the final rule do not comply with the final rule and there is no grandfathering provision, such sponsors will be faced with two inefficient options, namely, to:

(1) add an additional 5% seller's interest on top of existing forms of series-specific horizontal interests, which are typically already well in excess of 5%; or

(2) amend existing horizontal interests for previously issued series or add new horizontal interests to previously issued series so that all outstanding series have a 5% series-specific horizontal interest that complies with the final rule.

Both of these options are burdensome to sponsors and inefficient for the securitization market, because they will likely result in a risk retention requirement well in excess of 5%. Instead, such sponsors should be permitted to satisfy the risk retention requirements of the final rule by structuring a 5% series-specific horizontal interest for each new series issued after the effective date of the risk retention rules, or through a combination of series-specific horizontal interests for all newly issued series, combined with a trust-wide seller's interest based on all outstanding investors' ABS interests issued by the master trust.

In addition, the proposed requirement that a sponsor maintain a specified amount of horizontal risk retention in *every* series issued by the trust would require the sponsor to do a fair-value calculation for all previously issued series of ABS interests issued by the master trust. No other standard risk retention option would impose a similar burden on sponsors.

G. The Offset for Pool-Level Excess Funding Accounts is Aligned With Current Market Practice.

The description of the function of excess funding accounts in master trust structures located in the Supplementary Information is generally consistent with market practice.[123] However, we do not know how to interpret the requirement in clause (2) of §__.5(e) that the excess funding account be "*pari passu* to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of losses with respect to the securitized assets prior to an early amortization event."[124] Losses and collections are not in any way allocated to the excess funding account, so it is unclear what the Joint Regulators intended to capture with the requirement in clause (2).[125] Many of SFIG's members have recommended that clause (2) be deleted because it does not reflect any feature that currently exists in master trust transactions.

In addition, some SFIG members believe that there is one nuance of current market practice that is not captured in clause (1) of §__.5(e). In the transaction documents for many master trusts, there are two tests that are used to determine whether the sponsor must add additional assets to support the ABS: (1) the minimum seller's interest test; and (2) the required principal balance test, which requires the principal balance of the assets to be not less than the sum of the numerators used to allocate principal collections to the ABS interests. As discussed above in Section B.4.a. of this Part, the numerator for the principal allocation percentage for a series typically "fixes" at the end of the revolving period, so the required principal balance test based on the sum of the numerators will require a higher minimum amount of principal receivables to be held in the master trust than the "minimum seller's interest test," which is based on the current invested amounts of the investors' ABS interests, rather than their invested amounts at the end of the revolving period. While some master trust transactions require collections that would otherwise be distributable to the holder of the seller's interest to be deposited to the excess funding account to satisfy only the minimum seller's interest test, other master trusts would require a deposit to the excess funding account to satisfy either of the asset sufficiency tests. Therefore, SFIG members request that clause (1) of §__.5(e) be revised as follows:

> "(1) Is funded in the event of a failure to meet the minimum seller's interest <u>or other minimum receivables balance</u> requirements under the securitization transaction documents by distributions otherwise payable to the holder of the seller's interest."

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123 *See id*. at 57945.

124 *Id*. at 58029.

125 We also note that the requirement that the excess funding account be *pari passu* with respect to the allocation of losses appears to be inconsistent with the sentence in the Supplementary Information that states:

"Under the proposed rule, the amount of the seller's interest may be reduced on a dollar-for-dollar basis by the amount of cash retained in an excess funding account triggered by the trust's failure to meet the minimum seller's interest, if the account is *pari passu* with (*or subordinate to*) each series of the investors' ABS interests and funds in the account are payable to investors in the same manner as collections on the securitized assets."

Id. at 57946 (emphasis added).

SFIG members have also noted that the requirement to fund an excess funding account to satisfy the minimum receivables balance requirements under the securitization transaction documents could be considered a form of subordination of the seller's interest with respect to the allocation of collections. As a result, this very typical feature could preclude a sponsor from satisfying the *pari passu* requirement for seller's interests in the proposed rule.

H. <u>Clarification is Required Regarding Event of Default Triggers in § __.5(h)</u> .

Section __.5(h) provides that a sponsor that relies on § __.5 to satisfy the risk retention requirements does not violate such requirements if the seller's interest falls below the required level after an event of default triggers early amortization, as specified in the securitization transaction documents, of all series of ABS interests.[126] As a technical matter, most master trusts provide for two distinct sets of triggering events: (1) events of default and (2) early amortization events. Early amortization events are events which trigger early amortization for investors' ABS interests, whereas events of default are events that typically give rise to the right to the exercise of remedies by a secured party in default, for example, commencing legal proceedings to collect the debt and foreclosure on the trust assets. Events of default are a narrower group of events and typically are also included in the early amortization events. Therefore, the SFIG membership requests that the reference to "event of default" in § __.5(h) be changed to "early amortization event."

I. <u>Disclosure of the Value of the Seller's Interest</u>.

Section __.5(g) requires a sponsor relying on the seller's interest option to disclose within a reasonable period of time prior to the sale of the ABS interests the value of the seller's interest expressed both as a percentage of the investors' ABS interests and a dollar amount.[127] Because the dollar amount of the seller's interest will change on a daily basis, it is not possible to disclose the dollar amount of the seller's interest to investors prior to the closing date. The SFIG membership therefore requests that the dollar amount of the seller's interest to be disclosed to investors be calculated as of the most recent measurement date provided in the securitization transaction documents prior to the date when such disclosure is provided to investors, as adjusted on a *pro forma* basis for the anticipated issuance of ABS interests on or prior to the closing date, and any reduction in the principal amount of any other outstanding ABS interests, if applicable, on or prior to the closing date. In addition, the SFIG membership suggests that value of the seller's interest to be disclosed should be adjusted on a *pro forma* basis to reflect any addition or removal of assets (other than through the creation of additional receivables in previously designated revolving accounts or the liquidation of previously designated assets) that will take place on or prior to the closing date (using the cut-off date balance for such addition or removal as determined in accordance with the securitization transaction documents or a more recent date).

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[126] *See id*. at 58029.

[127] *See id*. at 58029.

J. <u>The Requirement for a Holder to Be a Wholly-Owned Affiliate of the Sponsor is Inconsistent with the Restrictions on Permissible Transferees of Risk Retention and More Stringent than other Risk Retention Requirements</u>.

There is an apparent inconsistency between the requirement that the holder of the risk retention for revolving master trusts be a wholly-owned affiliate of the sponsor,[128] and the provision of § __.12,[129] which would allow a retaining sponsor to sell or otherwise transfer any required retained interest to an entity that is a majority owned affiliate of the sponsor. Given that footnote 54 of the Supplementary Information states that "[t]he requirement for the holder to be a wholly-owned affiliate of the sponsor is consistent with the restrictions on permissible transferees of risk retention generally required to be held by the sponsor under the rule,"[130] this would seem to be an unintended result.

Further, the SFIG membership believes that it is not necessary to apply the more stringent standard of a wholly-owned affiliate to master trusts. The definition of "majority owned affiliate" in the Re-Proposal ensures that the required risk exposure would remain within the consolidated organization and, therefore, would not reduce the organization's financial exposure to the credit risk of the securitized assets. SFIG members have also noted that the base risk retention requirement in § __.4 permits a sponsor's majority owned affiliate to retain the required economic interest, and it is unclear why a different standard would be proposed for revolving master trusts. SFIG members request that the references to wholly-owned affiliates in § __.5 be replaced by "majority-owned affiliates."

128 *See id*. at 58029 (§__.5(c)(2)).

129 *See id*. at 58035.

130 *See id*. at 57943 n.54.

V. COLLATERALIZED LOAN OBLIGATIONS.

The members of SFIG appreciate the Joint Regulators' efforts with respect to CLOs in the Re-Proposal and their expressed understanding that a rule requiring collateral managers to be the sole sponsors of CLOs and to satisfy risk retention requirements would result in fewer CLO issuances and less competition in this key $285 billion market that facilitates critical funding to businesses. We are also aware of the broad range of comments and record evidence establishing that the Re-Proposal would materially and adversely affect the formation and continued operation of the CLO market.[131]

The CLO market is key to a well-functioning commercial loan market which provides significant capital to businesses and fosters economic growth and job creation. By providing substantial credit capacity to the commercial loan market, CLOs generally serve to lower interest rates for corporate borrowers that may not have ready access to alternative capital markets financing. In fact, CLOs represent the largest non-bank segment of the commercial loan market and, unlike many other segments (*e.g.*, loan mutual funds and hedge funds), are not mark-to-market investment vehicles. Consequently, CLOs do not contribute significantly to price and market volatility or the systemic risk resulting from such volatility.

SFIG's members note that the resurgence of the CLO market commencing in 2010 has contributed substantially to avoiding the "refinancing wall" in the commercial loan market that was widely expected to occur in 2010-2012. Projections by CLO researchers show that, if risk retention were applied to CLOs in an unworkable manner, the resulting dramatic reduction in CLO issuance will likely create a new and material "refinancing wall" for the commercial loan market between 2017 and 2020.[132] Given the enormity of the expected amounts to be refinanced, there is no certainty that banks, mutual funds and other funding providers will be able or willing to provide all of the amounts necessary to effect such refinancing. The continued viability of CLOs is key to avoiding the dramatic negative effects on the economy caused by a "refinancing wall." Even if alternative funding sources to CLOs were to become available, expected alternative funding providers are likely to have far greater mark-to-market sensitivity, resulting generally in higher costs, increased market volatility and greater systemic risk.

In light of these and other concerns discussed herein, SFIG's members do not believe that risk retention is either necessary or desirable for CLOs.

Section A of this Part V provides a general overview of CLOs and describes the characteristics of CLOs and how existing market practices already satisfy the goals of risk

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131 *See* LSTA Letter Comment, Aug. 1, 2011 at 14–17; LSTA Letter Comment, Apr. 1, 2013 at 14–16; LSTA Letter Comment, July 29, 2013 at 3–9; SIFMA Letter Comment, June 10, 2011 at 70; American Securitization Forum Letter Comment, June 10, 2011 at 137; JP Morgan Chase & Co. Letter Comment, July 14, 2011 at 50; Financial Services Roundtable Letter Comment, Aug. 1, 2011 at 32; Bank of America Letter Comment, Aug. 1, 2011 at 29-30; Wells Fargo Letter Comment, July 28, 2011 at 29; White & Case Letter Comment, June 10, 2011 at 2.

132 *See The CLO Salmagundi: Risk Retention Consequences*, Wells Fargo Research (Dave Preston and Jason McNeilis), September 20, 2013. *See* also *CLO Weekly: Loan Performance Solid*, Bank of America Merrill Lynch Securitized Products Research (Chris Flanagan, Ryan Asato, Justin Borst and Collin Chan), October 18, 2013, p.7.

retention. If the Joint Regulators nevertheless determine that risk retention will be applied to CLOs, Sections B through I of this Part V describe suggested modifications to the Re-Proposal to provide necessary flexibility for risk retention compliance and to mitigate the negative impacts that the Re-Proposal will have on the CLO market and its ability to facilitate the broad availability of reasonably priced and responsibly underwritten financing for corporate borrowers. Section J concludes this Part V by describing the legal and practical reasons why the members of SFIG believe that risk retention should not be applied to CLOs.

A. Overview of CLOs

1. *General.*

CLOs are long-term investment vehicles that provide institutional investors with access to the commercial loan market and, through a CLO's tranched capital structure, the ability to choose particular risk/return profiles that suit their investment objectives.[133] CLOs have dynamic portfolios managed by an asset manager experienced in investing and trading portfolios of commercial loans (typically a registered investment adviser under the Investment Advisers Act of 1940 (Advisers Act)). The CLO manager selects each asset to be included in a CLO portfolio after a rigorous credit review and actively manages the portfolio in order to maximize investment returns, including by monetizing gains on performing assets and mitigating losses on non- or poorly-performing assets.

The assets eligible for inclusion in a CLO are predominantly senior secured commercial term loans, which typically make up at least 90% of the CLO portfolio. Loans included in broadly syndicated CLOs[134] must be issued by companies that are audited by a reputable accounting firm, report financial information on a quarterly basis to the bank loan investors, have a rating from at least one publically recognized rating agency and are capable of borrowing a minimum of $125 million from one of the large syndicated loan originating banks. CLOs are also permitted to invest in limited "buckets" (generally expressed as a percentage of the portfolio) of senior secured bonds, second lien loans, senior unsecured loans, revolving and delayed draw loans and high yield bonds. CLOs also have portfolio limitations applicable to, among other things, the concentration of portfolio assets by obligor, individually and by industry classification and domicile.[135]

CLOs typically operate in three distinct periods: (1) an initial 3-to-6 month period after closing[136] to "ramp-up" or invest the remaining net cash proceeds received from the sale of its

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133 CLOs usually issue multiple tranches of secured debt and a single tranche of unsecured equity, with the most senior tranche of secured debt (which bears the least risk of loss) at the top of the capital structure and the most subordinated, equity tranche (which bears the most risk of loss) at the bottom of the capital structure.

134 References in this section to "broadly syndicated CLOs" refer to typical managed CLOs comprising primarily broadly syndicated commercial loans and to "balance sheet financing CLOs" refer to typical CLOs comprising primarily middle-market loans originated by the CLO manager or an affiliate thereof and consolidated under GAAP into the financial statements of the related sponsor. Both are described in more detail in Section A.2. below.

135 *See* Appendix F, note 5.

136 At closing, a CLO issuer typically has acquired 50% or more of the expected target par amount of its initial portfolio assets.

securities in additional loan assets until the CLO portfolio has reached its expected target par amount;[137] (2) a subsequent 3-to-4 year reinvestment period during which the CLO expects to reinvest all principal proceeds it receives from loan repayments and permitted sales of portfolio assets in additional eligible loans that, on a portfolio basis, satisfy specified reinvestment criteria, including portfolio concentration limitations and collateral quality tests disclosed to investors and set out in the CLO transaction documents (or, if such criteria are not satisfied, the CLO is generally permitted to reinvest so long as it does not decrease the level of compliance with such criteria);[138] and (3) a final amortization period during which the CLO issuer is required to begin paying down its rated debt, in order of seniority, using (i) scheduled principal payments received on portfolio assets as the underlying loans and other collateral mature and (ii) proceeds from the sale of portfolio assets other than credit-risk collateral. A CLO is typically permitted to continue to invest during the amortization period all or a specified portion of principal proceeds it receives from unscheduled loan principal payments and certain permitted asset sales so long as it satisfies a more stringent set of reinvestment criteria than what is applicable during the reinvestment period (*e.g.*, no increase in the weighted average life of the portfolio) and coverage tests are maintained or improved.[139]

Within the framework described above, active trading and reinvestment takes place in CLOs. Commercial loan repayment rates have a significant impact on such trading and reinvestment activity and have from 2002 to the first half of 2013 averaged from a low of 6% in 2008 to a high of 52% in the first half of 2013.[140] As a result, it is relatively common for CLO portfolios to turnover up to 40% per year during the reinvestment period. Because CLOs are long-term cash flow financing vehicles that reinvest principal proceeds in accordance with the CLO transaction documents, CLOs facilitate funding to businesses when other sources of funding (such as from loan mutual funds and banks) may not be in a position to lend due to market or regulatory reasons. CLOs, therefore, moderate commercial loan market volatility and, as a result, contribute to a more stable, lower cost of debt capital financing for U.S. businesses. Specifically, CLOs do not permit liquidity draws by investors which enables the manager to continue investing during difficult economic times. CLOs also have a pre-determined orderly wind-down without requiring market access at the end of its life.

Unlike some cash flow ABS transactions, CLOs track interest collections and principal collections separately and make payments to the holders of the CLO securities in accordance with two separate priorities of payment or "waterfalls"—an interest waterfall and a principal waterfall.[141] The equity investors (and, as described more fully below, the CLO manager for any

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137 If a CLO is unable to successfully complete its ramp-up by acquiring its target par of collateral that satisfies the specified criteria in its transaction documents, the transaction must be de-levered until ratings confirmation of the CLO debt is obtained or the CLO manager must invest in additional collateral. Very few CLOs fail to meet ramp-up.

138 *See* Appendix F, note 5.

139 During the reinvestment period if the collateral manager is unable to reinvest principal prepayments and sales proceeds in accordance with the CLO transaction documents, it may elect either to pay down CLO debt or to continue to hold the cash in a transaction account held by the trustee for the transaction for future reinvestment. Collateral managers typically do reinvest these proceeds.

140 *See* Appendix F, note 9.

141 *See* Appendix F, note 11.

incentive fee that it has earned) are paid at the bottom of each waterfall only after all other holders of the CLO debt securities, all service providers and hedge counterparties (if any) are paid what they are then due. Generally, interest collections are paid out on a current basis, but, as described above, during the reinvestment period principal collections are expected to be used to acquire new assets (although principal collections are also available to pay interest on non-deferrable classes of CLO debt to the extent available interest collections would be insufficient to pay such amounts). Once the CLO amortization period commences, amounts flowing through the principal waterfall are used first to pay in full all CLO debt sequentially in order of seniority before any such amounts are paid to the CLO equity.

Besides setting out the relative payment priorities to the various stakeholders in the CLO, waterfalls also contain mechanisms for credit enhancement in the form of early amortization of CLO debt and the acquisition of additional collateral using interest proceeds. First, if any of the transaction overcollateralization tests or interest coverage tests fall below specified levels, interest collections that would otherwise flow through the waterfall to pay the CLO equity (and more junior classes of CLO debt, as well as subordinated fees and expenses of the CLO) and, if necessary, principal collections, are diverted to repay the CLO's debt in order of seniority until compliance with the applicable test is restored. In calculating these tests, the par outstanding of certain types of assets that are considered to be of greater than normal credit risk will be significantly haircut, in order to provide further protection to holders of the CLO's senior debt from potential losses on portfolio collateral.[142] Second, during the reinvestment period, the CLO manager has the discretion to repay the CLO's debt in order of seniority using principal proceeds otherwise available for reinvestment if it determines that no suitable loans are appropriate for purchase by the CLO. This permits a CLO manager to de-lever the CLO rather than being forced to reinvest in circumstances it determines not to be in the best interest of the CLO investors. Third, many CLOs contain a reinvestment overcollateralization test (calculated in a similar manner to the overcollateralization test but having a higher trigger level) that, if not satisfied, requires that a portion of interest collections (typically 50%) otherwise available for distribution to the CLO equity be used instead to purchase additional collateral in order to build the par amount of collateral and, as a result, the overcollateralization of the CLO debt.

CLOs typically have a capital structure that requires an equity tranche (*i.e.*, a tranche that does not bear a coupon but is entitled to cash flows remaining after the full payment when due of amounts owed on the CLO's rated debt) at closing that is between 8% and 12% for broadly syndicated CLOs (and a slightly higher range for middle market balance sheet financing CLOs) of the expected target par amount of the CLO portfolio.[143] In broadly syndicated CLOs, this tranche is marketed and sold in the capital markets primarily to third parties who participate in the negotiations of the terms and conditions of the CLO transaction documents based on their expectations of realizing a return on their investment. In balance sheet financing CLOs, this tranche is directly or indirectly retained by the sponsor. The resulting overcollateralization of the CLO issuer's portfolio in relation to its debt and, correspondingly, the percentage of the capital structure represented by the CLO equity, typically increases over the life of the

142 *See* Appendix F, note 8.

143 *See* Appendix F, note 7. Under current market convention, most new CLOs are required to have approximately 10% of their capital structure in the equity tranche.

transaction due to permissible active trading of the portfolio and structural features in the transactions, even though the equity investors are expected to receive periodic cash distributions throughout the life of the transaction from excess interest collections.[144]

2. *Types of CLOs; motivations for investments in CLOs.*

There are generally two types of CLOs: broadly syndicated CLOs in which asset managers select broadly syndicated commercial loans for purchase by the CLO issuer in the open market, and balance sheet financing CLOs used by sponsors of securitizations such as middle market loan originators and private loan funds to provide term financing for their business platforms and loan portfolios.[145] Except for the general descriptions of CLOs in this letter, and as otherwise specified, references to CLOs in this Part V are to broadly syndicated CLOs.[146]

Many institutional investors (primarily U.S. and foreign banks, insurance companies, pension funds, business development companies and private funds) want exposure to the U.S. commercial loan market through investments in CLOs for a number of reasons: (1) broadly syndicated commercial loans to businesses are well underwritten; (2) broadly syndicated commercial loans are typically syndicated to a variety of institutional investors including banks, insurance companies, pension funds, investment funds and CLOs and, in light of the active secondary markets that exist for commercial loans, are viewed as relatively liquid; (3) historically, broadly syndicated commercial loans have a relatively low default rate[147] and relatively high recovery rate (and, as a result of these factors and active portfolio management by CLO managers, CLO collateral has a low default rate[148] and high recovery rate); (4) rated CLO debt securities have suffered very few losses;[149] (5) CLOs have had low default rates and performed well during the financial crisis;[150] (6) CLOs have structural features that provide significant protection to the CLO debt and equity investors (including, among others, the option of equity investors to cause a redemption or refinancing of the CLO debt at any time after the expiration of a contractually negotiated and market-driven non-call period (typically, two years));[151] (7) the tranched capital structure of CLOs permits investors to choose from different risk/reward investment profiles; and (8) actively managed CLOs have historically provided equity investors with attractive risk-adjusted returns.[152]

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144 *See* Appendix F, note 8.

145 A loan originator or loan fund using a CLO for balance sheet financing purposes is a sponsor as defined in 15 U.S.C. § 78o-11(a)(3) because it "organizes and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."

146 Broadly syndicated CLOs are also referred to within the CLO industry as "cash flow arbitrage CLOs." The Joint Regulators refer to these transactions in the Re-Proposal as "Open Market CLOs."

147 *See* Appendix F, note 1.

148 *See* Appendix F, note 2.

149 *See* Appendix F, note 3.

150 *See* Appendix F, note 4.

151 *See* Appendix F, note 5.

152 *See* Appendix F, note 6.

By contrast, balance sheet financing CLOs are typically entered into by non-bank middle market sponsors who use CLOs as long term financing for their loan portfolios. Among other things, these balance sheet financing CLOs: (a) provide leverage at efficient market rate spreads on the primarily floating rate CLO liabilities supported by the floating rate loans in these CLOs; (b) do not contain market value triggers which could cause forced sales of CLO assets during a market disruption; (c) provide balance sheet funding to sponsors appropriately matched to the underlying loans in the CLO; and (d) with proceeds available for reinvestment, provide additional capital so that the sponsor may add loans to the CLO. Balance sheet financing CLOs are consolidated on the balance sheet of the sponsor who typically acquires and holds all or a controlling portion of the equity in the transaction directly or indirectly through one or more special purpose subsidiaries.

3. *Distinguishing CLOs from other forms of ABS securitizations.*

CLOs are different from the "originate-to-distribute" models of securitization that performed poorly during the financial crisis. CLOs already contain significant alignment of interests between the CLO manager and investors, which promotes higher quality underwriting of assets included in CLOs. In addition, CLOs are actively managed, with the CLO manager able to buy and sell assets in response to changing market conditions. Moreover, if active management of portfolio assets is insufficient to prevent a material deterioration in the credit quality of the portfolio, CLOs contain automatic early amortization mechanics that de-lever the deal to ensure the protection of the CLO debt. Finally, the assets held by CLOs are significantly more transparent than the assets held by many other forms of ABS transactions.

a. Alignment of Interests.

CLO managers' interests are strongly aligned with the interests of CLO investors (*i.e.*, CLO managers have "skin-in-the-game"). First, the typical CLO includes a fee structure in which the CLO manager receives the bulk of its compensation only if the CLO performs for the benefit of all CLO investors.[153] One portion of the CLO manager's fee is paid senior to the CLO's rated debt; another portion of the fee is subordinated to payments owed to investors in the CLO's rated debt; and an incentive fee is paid only after investors in the CLO's equity have received back all of their investment plus a specified, market-driven return.[154]

Second, a CLO manager selects the loans to be acquired by a CLO issuer and manages and sells loans on behalf of the CLO issuer in accordance with specified criteria disclosed to investors and set out in the CLO's transaction documents. In standard documents, a CLO manager that breaches its obligations to the CLO or otherwise fails to perform its duties with the requisite level of care may be removed for cause, typically by one or more specified classes of CLO debt holders (the controlling class) or by the CLO equity investors, with both the

[153] Unlike originators or asset sellers in other ABS securitizations, CLO managers do not profit from the sale of assets to the CLOs they manage at the time of sale. CLO managers receive compensation only when and if the CLO performs well over time.

[154] The Joint Regulators have acknowledged that this compensation structure "incorporate[s] credit risk sensitivity and contribute[s] to aligning the interests of the CLO manager and investors with respect to the quality of the securitized loans." Re-Proposal, 78 Fed. Reg. at 57963.

controlling class and the equity investors typically participating in the selection of a successor or replacement collateral manager.

Third, as a result of the Dodd-Frank Act's amendment to the Advisers Act, most managers of CLOs sold to U.S. investors are required to be registered with the SEC under the Advisers Act and are subject to the recordkeeping, disclosure, supervision, Code of Ethics and other regulatory requirements applicable to SEC-registered investment advisers, as well as to SEC examinations and oversight. Moreover, under the Advisers Act and general fiduciary principles, most CLO managers (whether or not SEC-registered) have duties (1) to act in the best interests of their clients and to provide investment advice in their clients' best interests, (2) of undivided loyalty and utmost good faith, (3) to eliminate or disclose all conflicts of interest, (4) to provide full disclosure of all material facts to their clients and prospective clients and to present those disclosures in a fair manner and (5) to comply with restrictions with respect to principal trades and agency cross transactions.[155]

Lastly, as professional investment advisers operating in a competitive environment, CLO managers have their own reputational incentives to meet the expectations of CLO investors.

b. Role of CLO Manager; Active management.

Perhaps the most significant feature of a CLO that distinguishes it from other types of ABS securitizations is that CLOs are investment vehicles whose assets are actively managed by experienced investment managers. CLO managers significantly contribute to the quality of the underwriting of commercial loans acquired by CLOs. CLO managers have dedicated portfolio management teams which perform a thorough credit analysis of each asset before it is acquired by a CLO and then monitor the performance of each asset for the duration that it is held by the CLO. Because a CLO typically owns only approximately 100-150 loans, a CLO manager is very familiar with each individual commercial loan. Of course, it is this feature that banks, insurance companies, pension funds and other institutional investors find particularly attractive in CLOs. In addition, the ability of the CLO manager to actively manage the CLO portfolio within the parameters of the underlying transaction documents provides obvious benefits to CLO investors in that CLO managers have the tools to mitigate losses on defaulted or credit impaired assets and recognize gains on performing assets. As noted previously, CLOs are capable of increasing the amount of overcollateralization during the reinvestment period. Also, unlike in static pool ABS transactions, the gains earned by CLOs on the sale of collateral items, once reinvested, have the potential to offset par erosion that may occur as the result of the sale of defaulted or credit impaired collateral. Accordingly, a CLO has the ability to preserve or even increase the par amount of collateral in the CLO and, as a result, effectively increase or maintain the equity cushion supporting the CLO debt.

c. "Self-correction" Mechanism.

As previously discussed, CLOs are designed to "self-correct" for any material deterioration in the credit quality of the underlying portfolio assets. If at any time during the life

[155] *See* Advisers Act, 15 U.S.C. § 80b-6(3) (requiring the consent of a client for principal trades) and Rule 206(3)-2 promulgated thereunder (prescribing certain requirements for agency cross-trades).

of the CLO the overcollateralization tests or interest coverage tests are not satisfied, available collections must be applied to de-lever the transaction until compliance with such tests is restored. As a result, very few CLOs experience events of default. This particular feature of CLOs provided significant support to investors in CLO debt during the financial crisis and led to many receiving an early return of principal on their investment. Also, this particular structural feature serves as a constant and on-going protector of the credit worthiness of the CLO's debt, even in times of significant disruption in the credit markets generally.

d. Transparency

Transparency is a function of several characteristics of CLO assets. The active secondary market for most of the commercial loans acquired in CLO portfolios permits CLO investors to obtain a true portfolio net asset value (NAV) (daily quotes are available from independent pricing services). Substantially all broadly syndicated commercial loans are issued by sophisticated borrowers that have audited financial statements and report performance quarterly or monthly to the loan holders. Further, many of the loans in a typical CLO portfolio have been made to public companies that file regular financial reports with the SEC, which can be a significant source of data for underlying credit analysis. Furthermore, obligors of loans in broadly syndicated CLOs typically have assigned monitored ratings by one or more of the principal credit rating agencies.

B. Concerns With the Re-Proposal's Requirements for EHRIs.

Broadly syndicated CLOs and balance sheet financing CLOs are structured with the equity investors owning what, but for the newly imposed cash flow restrictions discussed below, would otherwise be EHRIs as defined in the Re-Proposal. Due to the operation of the priority of payments in the CLO interest waterfall and principal waterfall, "on any payment date on which the issuing entity [*i.e.*, the CLO issuer] has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the EHRIs prior to any reduction in the amounts paid to any other ABS interest. . . .; and . . . that has the most subordinated claim to payments of both principal and interest by the issuing entity."[156] As noted by the Joint Regulators in the Re-Proposal, "the horizontal form of standard risk retention essentially creates a fully subordinated equity tranche and represents the option that is most exposed to credit risk."[157] In addition, one of the stated goals of the Joint Regulators is to ensure meaningful risk retention in a manner customary for the related ABS market so as to minimize the effect of the credit risk retention requirements to the access of consumers and businesses to credit on reasonable terms.

However, in the Re-Proposal, the Joint Regulators added a new restriction on projected cash flows to be paid to the holders of the EHRIs which would not allow the holder of the horizontal risk to receive cash at a faster rate than the rate at which principal is paid to investors in all ABS interests issued in the securitization or, in a possible alternative, at a rate faster than the rate at which all payments are paid to such investors based on projections made by the

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[156] Re-Proposal § __.2 Definitions, 78 Fed. Reg. at 58,025-26.

[157] 78 Fed. Reg. at 58012.

sponsor at the issuance of the ABS interests.[158] The impetus for this appears to be concerns on the part of the Joint Regulators that (1) without such a restriction, cash flow could be paid to the equity and not be available to provide protection for the CLO debt and (2) not all ABS transactions distinguish interest proceeds from principal proceeds and between principal losses and other losses. However, as discussed below, the proposed restriction on cash flow to holders of the EHRI is unnecessary and commercially unworkable for CLOs.

As previously noted, CLOs do distinguish interest proceeds from principal proceeds. In accordance with a CLO transaction's priority of payments, distribution of such proceeds to holders of CLO equity under both the interest and principal waterfalls are fully subordinate in right of payment to amounts due to holders of the CLO debt. Under no circumstances are principal proceeds paid to holders of CLO equity until all CLO debt has been repaid in full. Furthermore, excess interest proceeds otherwise available for payment to the CLO equity on any distribution date are diverted to the mandatory prepayment of the CLO debt, in order of seniority, if any of the overcollateralization tests or interest coverage tests are not satisfied. As a result of the foregoing structural features, losses fall on the CLO equity before affecting any class of CLO debt. Moreover, such features already provide significant, meaningful and sufficient protection for CLO debt holders without the need for additional–restrictions on distributions to the holders of the EHRI of a CLO.

Due to the reinvestment period in a CLO, a sponsor of a CLO could not make the certification required by Re-Proposal § __.4(b)(2) that the "Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date."[159] During a CLO's reinvestment period, none of the ABS interests issued by a CLO is repaid principal (other than, in the case of the CLO debt, to the extent necessary to satisfy any non-compliant coverage test or, at the discretion of the CLO manager, if no suitable investments are available for purchase). As a result, no CLO equity as historically or presently structured could qualify as an EHRI under the Re-Proposal notwithstanding the fact that CLOs in the market historically and currently require between 8-12% equity in their capital structure for broadly syndicated CLOs and typically a slightly higher percentage for balance sheet financing CLOs. Moreover, such horizontal risk retention is the customary risk retention for the CLO market and otherwise meets the definition of an EHRIs.

The proposed restriction on cash flow to holders of the EHRI is commercially unworkable for CLOs. Equity investors in CLOs, whether third-party investors or CLO managers, investing in broadly syndicated CLOs, or sponsors investing in balance sheet financing CLOs, require that excess interest spread (that is, interest collections received on the portfolio in excess of amounts required to pay all debt service, expenses and other more senior payments) be paid to them currently pursuant to the interest waterfall priority of payments. If that excess spread cannot be currently paid or if it is paid at a significantly reduced rate (as SFIG's members understand would be the potential consequence of the proposed EHRI cash flow limitation), neither equity investors in broadly syndicated CLOs nor sponsors of balance

158 Re-Proposal § ___.4(b) at 58206-27; Alternative Eligible Horizontal Residual Interest Proposal at III.B.1.c., 78 Fed. Reg. at 57941.

159 78 Fed. Reg. at 58027.

sheet financing CLOs will find CLOs attractive investments and, as a result, CLO issuances will be dramatically reduced. The proposed limitation on current distributions of excess interest to the equity would significantly reduce the returns to equity holders and the resulting return would not fairly compensate these equity holders for the risk they take in the first loss position of a CLO. In addition, the cash not distributed to the equity presumably would be retained in the deal and would, at the expense of these equity holders, effectively increase overcollateralization and provide additional credit enhancement over and above the credit risk retention required by Dodd-Frank Act under circumstances which have nothing to do with promoting sound underwriting of assets going into the CLO. Furthermore, U.S. taxable persons that own the equity of a CLO that is organized offshore or that has elected to be treated as a partnership for U.S. federal income tax purposes are typically subject to current taxation on their *pro rata* share of the CLO's earnings, regardless of whether such earnings are distributed or are utilized for other purposes. The adverse impact of such "phantom income" issue would be exacerbated if the distribution of otherwise available cash flows is precluded.

We note that other acceptable forms of credit risk retention in the Re-Proposal including vertical retention and retention of seller's interests in revolving master trust securitizations do not restrict cash paid to the holders of such risk retention.

For the reasons described above, the Re-Proposal, including the new proposed restriction on the cash flow to be paid to holders of EHRIs of CLOs, would result in a dramatic reduction in CLO issuance and negatively impact the amount and cost of capital available to corporate borrowers. It would also restrict the ability of institutional investors to participate in the commercial loan market. For these reasons we agree with the definition of EHRI in the Re-Proposal but believe CLOs should be exempted from the certification required by Re-Proposal § __.4(b)(2) (that the "Closing Date Projected Cash Flow Rate for each payment date does not exceed the Closing Date Projected Principal Repayment Rate for such payment date") and the restrictions on cash flow to the EHRI of CLOs should be eliminated.

C. **The Lead Arranger Option as Proposed is Unworkable, is Inconsistent With Bank Regulatory Requirements and Would Have Adverse Systemic Risk Consequences.**

SFIG's members appreciate the Joint Regulators' evident attempts to assist the CLO market by devising the CLO-eligible loan tranche concept. However, due to the concentration of potential lead arrangers in the broadly syndicated loan market, the option may be inconsistent with current bank regulations, could contribute illiquidity that is not currently in the market, and could have adverse systemic risk consequences.

Under the Re-Proposal, if a lead arranger of a syndicated credit facility - defined as the party that holds 20% or more of the aggregate principal balance at origination, so long as no one holds more at closing - agrees to hold 5% of a specified tranche of the related syndicated credit facility for the life of the financing, the tranche would be a CLO-eligible loan tranche. An "open market CLO" solely comprised of CLO-eligible loan tranches and related servicing assets would not require risk retention by the CLO manager.

We have three market-based concerns regarding the Re-Proposal: (1) currently 10 banks are the lead arrangers for nearly 85% of all broadly-syndicated loan syndications (and only

3 banks are the lead arrangers for nearly 49% of all syndications);[160][161] (2) the loss of CLO-provided liquidity for the other tranches of such a syndicated credit facility (versus the CLO-eligible loan tranche) would likely cause increased borrowing costs to corporate borrowers; and (3) the universe of "CLO-eligible loan tranches" would be very limited.

Our first concern is that there is currently only a very small number of arrangers of broadly syndicated loans that could meet the definition of "lead arranger" as currently proposed (assuming that they were willing to hold the required investments that such definition proposes). Even if this definition were revised to mean the arranger who has the business role as the lead arranger, the universe of banks is limited to a relatively very small number of large banks. If these banks had to retain 5% of each tranche of a syndication that CLOs desired as "CLO-eligible loan tranches" they would need, under Basel III (which will be applicable by the time the risk retention rules are final and become effective), an enormous increase in their risk-based capital.[162] In addition, such retained portions also demand a higher premium rate be paid by banks for depository insurance making such assets very expensive for banks to hold. All of these additional costs, if not absolutely prohibitive for most if not all institutions, would be passed on to the borrowers, greatly restricting access to and cost of capital, with all of its consequences. Perhaps most importantly, the requirement of holding 5% of a broadly syndicated loan for its life without hedging would force arrangers into a credit strategy that is strongly opposed by both their regulators and common prudential risk management practices. For all of the foregoing reasons, these banks have indicated to us they cannot conceive of originating any material volume of "CLO eligible loan tranches" as currently defined.

The second concern we have is that making one tranche out of a syndicated facility the only "CLO-eligible loan tranche" would significantly affect the pricing of the other tranches due to the decreased liquidity of such tranches in relation to the "CLO-eligible loan tranche" as they would have binary risk retention consequences and be less desirable to the CLO market.

The third concern is that the universe of "CLO-eligible loan tranches" would be very limited, thereby effectively restricting the CLO manager's ability to invest in a diverse number of credits and to make the best credit decisions when purchasing or reinvesting in eligible underlying loans.

In addition, there are operational issues with this aspect of the Re-Proposal. It is unclear how a CLO or the CLO manager would be able to monitor whether their "CLO-eligible loan tranches" continued to meet the necessary criteria. They would have no obvious ability to determine whether a lead arranger continued to hold the required 5% retention in this tranche or had hedged their required retention.

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160 Assuming no event of default or other event that would permit the lead arranger to sell or hedge its investment.

161 *See* Appendix F, note 12.

162 Assuming an average "B" rating, 5-year life and 45% LGD, the Basel II requirements would be a 20.7% capital requirement. *See* FDIC, Risk-based Capital Requirements for Commercial Lending: The Impact of Basel II (Apr. 21, 2003).

Lastly, we also question why the lead arranger would have to hold its risk retention for the life of the syndication.[163] Even sponsors of securitizations have the ability to transfer and hedge their retention prior to the final maturity of a securitization under the Re-Proposal's sunset provisions.

D. The Definition of Qualified Commercial Loan Should be Expanded to Include Well-Underwritten Commercial Loans.

SFIG's members believe that a viable definition of a "qualified commercial loan" would contribute significantly to the workability of subjecting CLOs to required risk retention. SFIG members find the Re-Proposal's definition unduly restrictive and believe that it effectively excludes other well-underwritten commercial loans that should be included. Unfortunately, due to the truncated period for comments on the Re-Proposal, SFIG's members have not had sufficient opportunity to formulate and propose an alternative, but are interested in a discussion with the Joint Regulators regarding such an alternative.

SFIG's members also believe that CLOs of qualified commercial loans should not be static pools, but afforded the same active management as other CLOs.

SFIG's members are aware that the LSTA in its comment letter to the Re-Proposal makes specific suggestions to ensure that this concept is workable for the CLO market. Without repeating the analysis and reasoning for such proposals in this letter, SFIG's members support the LSTA's specific suggestions and urge the Joint Regulators to adopt them in the final rule.

E. A Third-Party Retention Holder Option Would Provide Additional Flexibility for Open Market CLOs to Satisfy Required Risk Retention.

SFIG's members believe that the Joint Regulators should adopt a third-party retention holder option as a way for broadly syndicated CLOs to meet their risk retention obligation. We note that the Joint Regulators have indicated that in some cases an entity that is a third party to a transaction may be an appropriate entity to satisfy a securitization's risk retention, such as the proposed lead arranger for a CLO-eligible loan tranche or holders of subordinate classes of CMBS transactions. In both CLOs and CMBS, investors actively negotiate the quality and parameters of the securitization's asset pool, either through negotiation of the portfolio constraints of the managed CLO asset pools in the case of CLOs or through negotiation of the specific assets to be included in the asset pool in the case of CMBS. As a result, we believe that CLOs would be another appropriate asset class for a third-party retention holder option. In fact, in CLOs historically and currently, third-party institutional investors own a significant portion of the equity of the CLO. However, as a result of the different structures for CMBS and CLOs, a CLO third-party retention holder option would need to be different than the CMBS third-party retention option described in the Re-Proposal. We therefore propose a third-party retention holder option for CLOs that has the following characteristics:

Third Party Retention Holders and Eligible Retention Interests. We propose that the CLO third-party purchaser retention option permit up to two third-party purchasers to jointly

[163] Assuming no event of default or other event that would permit the lead arranger to sell or hedge its investment.

satisfy some or all of a CLO's risk retention requirements. Any portion of such CLO's risk retention requirements satisfied by the CLO manager holding either an EHRIs or an eligible vertical interest (EVI) would reduce the amount required to be held by the third-party retention holders. We think that it is appropriate to permit multiple parties to be able to jointly satisfy such CLO's risk retention requirements due to the nature of the market for CLO securities and the active involvement of investors in the structuring of such CLOs.

Asset Pool Composition and Third Party Review. In order for an open market CLO to be eligible to utilize the third-party purchaser retention option, such CLO's asset pool would be required to be comprised primarily of commercial loans and servicing assets. The Joint Regulators have asserted that risk retention should be held by collateral managers when no other party is the sponsor of the CLO as the Joint Regulators consider the collateral managers to be the parties that determine the credit risk profile of the securitized assets in a CLO. Although CLO managers do select the specific assets to be included in a CLO asset pool, they do so in accordance with set parameters laid out in the transaction documents for each CLO. Due to the revolving nature of a CLO asset pool and the number assets in the typical CLO asset pool, it is not practical, nor commercially desirable by other CLO investors, for a third-party retention holder to approve each asset selected by the CLO manager before it is acquired by a CLO issuer. However, we believe that it is possible for a third-party retention holder to materially influence the selection of the assets in an open market CLO in a manner that will satisfy the Joint Regulators' goal of improving the quality of the assets in securitization asset pools without reviewing and approving each asset.

As a proxy for reviewing each asset, each third-party retention holder would be required to conduct a review of, and approve, the "Transaction Portfolio Terms" applicable to the open market CLO's portfolio. The Transaction Portfolio Terms would encompass each of the following parameters set forth in the CLO transaction documentation and disclosed in the related offering documents: (1) asset eligibility criteria, (2) concentration limits, (3) collateral quality tests, (4) interest and principal coverage tests, (5) reinvestment criteria and (6) any other material terms related to the acquisition and disposition of the CLO's assets. As the Transaction Portfolio Terms cover the transaction parameters most key to determining the make-up of a CLO's portfolio, a third-party retention holder approving the Transaction Portfolio Terms will be incentivized to negotiate Transaction Portfolio Terms that maximize the quality of the assets chosen for the CLO's portfolio. Once the Transaction Portfolio Terms have been approved, the CLO manager will be permitted to trade portfolio assets without additional approvals from the third-party retention providers so long as trades are made in accordance with the Transaction Portfolio Terms. After the third-party retention holders have approved the initial Transaction Portfolio Terms, no material change to any of the Transaction Portfolio Terms may be effected without the prior written consent of each third-party retention provider.

Additionally, to satisfy our proposed third-party retention holder option, the CLO issuer will be required to have acquired or entered into binding commitments to acquire by the CLO's closing date at least 50% of the initial target par amount CLO portfolio assets. This will help ensure that the third-party retention holders are able to gauge the CLO manager's ability to comply with the Transaction Portfolio Terms prior to the closing of the CLO.

***CLO Managers*.** We propose that any broadly syndicated CLO relying on the third-party retention holder option be required to be managed by a CLO manager that is a registered investment adviser under the Advisers Act. As previously discussed in Section A.3.a of this Part V, the fact that a CLO is managed by a registered investment adviser helps it avoid some of the conflicts of interest inherent in other types of securitizations. Under the Advisers Act and general fiduciary principles, a CLO manager will have fiduciary duties (1) to act in the best interest of the CLO issuer (and, indirectly, all of its investors), (2) of undivided loyalty and utmost good faith, (3) to eliminate or disclose all conflicts of interest, (4) to provide full disclosure of all material facts to CLO investors and (5) to comply with restrictions with respect to principal trades and agency cross transactions. Also, as a registered adviser, a CLO manager will need to comply with the various regulatory requirements applicable to SEC-registered investment advisers and be subject to SEC examinations and oversight.

***Retention Period*.** As described in Section F below, we believe a shorter holding period than proposed in the Re-Proposal would be appropriate for third-party retention holders, after which the EHRI or EVI would be freely transferable. Additionally, we also propose that during such holding period third-party retention holders be subject to the restrictions on hedging and transfer applicable to a sponsor holding an EHRI or EVI in order to ensure that such third-party retention holder is fully exposed to the credit risk of such broadly syndicated CLO.

F. Reduce the Period for which Risk Must Be Retained Since it Substantially Exceeds the Period in which Poor Underwriting Will be Revealed.

SFIG asks for clarification as to the basis for the Joint Regulators' determination that an appropriate retention period for broadly syndicated and balance sheet financing CLOs is the latest of (1) 2 years, (2) when the CLO securities have been amortized to less than 33% of their original principal amount, or (3) when the outstanding principal balance of the underlying loan portfolio is less than 33% of its original amount. Due to the typical reinvestment period of 3-4 years required in CLO structures and the weighted average life of the loans in the underlying portfolio of approximately 2.5 years, it is the view of SFIG's members that inferior selection of the underlying loan portfolio will be evident far earlier than the proposed minimum retention period (which would, as proposed, likely fall in the last year of a CLO's life given the lack of significant principal amortization on the CLO's portfolio before then). In addition, CLO structures typically include an option for the CLO equity to call for an early optional redemption after a specified non-call period provided that expected collateral proceeds will be sufficient to repay all senior CLO tranches in full.

Accordingly, SFIG's members urge the Joint Regulators to reconsider the required minimum retention period and respectfully suggest that a minimum retention period of the later of (1) 2 years after the closing date and (2) the end of the applicable non-call period (if any) as being far more appropriate for CLOs.

G. CLOs Will Need Flexibility and Should be Able to Combine Any and All Forms of Permissible Risk Retention so Long As Minimum Retention Is Satisfied.

The final rule should permit any combination of otherwise permissible methods of meeting the minimum required risk retention. As the LSTA explained in its April 1, 2013 comments (at 5), the Joint Regulators' proposed rules permitting "L-shaped" risk retention option acknowledge that it is possible to "mix and match" different forms of risk retention while still ensuring that, in the aggregate, a securitizer retains interests equal to at least five percent of the credit risk of the assets collateralizing the related securitization transaction.[164]

H. The Amount of Risk to Be Retained for CLOs Should Be Reduced Since 5% of Fair Value Substantially Exceeds 5% of the Credit Risk in a CLO.

SFIG's members acknowledge that Section 15G permits the amount of risk required to be retained to be at least 5% of the related credit risk; however they also note that the LSTA's April 1, 2013 comments (at App. A) included an analysis by Professor Victoria Ivashina of the Harvard Business School showing that, for a typical CLO and using conservative assumptions, approximately 99.6% of the likely losses are borne by the bottom 20% of the CLO capital structure.[165] Importantly, Professor Ivashina's analysis concludes as follows: "by holding *5% of the CLO's total equity*[166] CLO manager is exposed to *4.55% of CLO credit risk* in the 6-year scenario and 4.45%-4.47% of CLO credit risk in the 10-year scenario."[167]

SFIG's members respectively suggest that Professor Ivashina's analysis is correct and that the Re-Proposal's requirement to hold an EHRI of 5% of the fair value of the CLO would require holding approximately 10 times the minimum required credit risk without any possible justification for such a grossly disproportionate requirement.

The Re-Proposal makes no mention of Professor Ivashina's analysis, even though the Re-Proposal challenges Professor Ivashina's calculation of the amount of risk represented by the unfunded Class M securities described in the same comment letter suggesting that such securities only represented less than a 1% horizontal tranche.[168]

Accordingly, SFIG's members urge the Joint Regulators to reconsider Professor Ivashina's analysis and conclusion and to set a required risk retention that is much more proportionate and far closer to the statutory minimum. SFIG's members recommend that the Joint Regulators set the minimum amount of required risk retention for an EHRI for a CLO to equal 1% of the notional amount of the entire CLO capital structure, which is equivalent to approximately 10% of the CLO equity tranche based on current CLO capital structures. As such, the retained equity interest would represent exposure to almost 10% of the credit risk of the related CLO.

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[164] Original Proposal, 76 Fed. Reg. at 24103-04, 24159.

[165] LSTA Letter Comment, Aug. 1, 2013, App. A at 4.

[166] The equity tranche of a CLO typically represents 10% of the CLO's capital structure and therefore 5% of such tranch typically represents 0.5% of the CLOs capital structure.

[167] LSTA Letter Comment, Aug. 1, 2013, App. A at 6 (emphasis added).

[168] 78 Fed. Reg. at 57,963.

I. Grandfathering of Legacy CLOs that Permit Issuances of Additional Notes or Refinancings/Re-Pricings After the Effectiveness of the Final Rule Without Complying With Risk Retention.

SFIG's members note that the final rule for risk retention will become effective 2 years after publication in the Federal Register under Section 15G(i)(1). As noted above, CLOs have long lives due to reinvestment periods and, in addition, many CLOs include options that allow for the CLO to issue "Additional Notes" of one or more tranches under specified circumstances and to "Refinance" and/or "Re-Price" one or more tranches of the CLO from time to time subject to specified conditions. Given the uncertainty of the date of publication, there is a risk of legacy broadly syndicated and balance sheet financing CLOs outstanding on the publication date could be "caught" by the intervening effectiveness of the risk retention requirements and that important transaction options may not be able to be exercised when investors expected that they could. SFIG's members respectfully suggest that applying risk retention to prevent these transaction options would not serve the core legislative purpose of Section 15G. Accordingly, the final rule should include an unequivocal grandfathering for such legacy CLOs (including these options for Additional Notes and/or to Refinance and/or Re-Price tranches) without being required to comply with any otherwise applicable risk retention requirements.

J. Risk Retention is Not Necessary or Desirable for CLOs.

Although SFIG's members are suggesting ways to improve the Re-Proposal's application of risk retention requirements to CLOs in the Letter, SFIG's members do not believe that the Joint Regulators should apply these requirements to broadly syndicated CLOs in the first instance.[169]

§ 941 of the Dodd-Frank Act requires the Joint Regulators to "jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset backed security, transfers, sells, or conveys to a third party."[170] § 941 defines "securitizer" to mean:

(A) the issuer of an asset backed security; or

(B) a person who organizes and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.[171]

Section 941 also requires the Joint Regulators to establish separate asset classes with separate risk retention rules as the agencies deem appropriate,[172] and to provide for total or partial

169 This section does not apply to a balance sheet financing CLO with a sponsor directly or indirectly through an affiliate retaining credit risk retention

170 15 U.S.C. § 78o-11(b)(1).

171 *Id.* § 78o-11(a)(3).

172 *Id.* § 78o-11(c)(2)(A).

exemptions for a particular asset class "as may be appropriate in the public interest and for the protection of investors."[173]

SFIG's members agree with the Joint Regulators that the application of standard risk retention requirements to "Open Market CLOs" is problematic[174] and appreciate the Joint Regulators' attempt to provide an alternative to the CLO manager holding the required risk retention. Nevertheless, as discussed below, SFIG's members have serious concerns whether such an option complies with the Joint Regulators' statutory mandate under § 941 of the Dodd-Frank Act or is truly viable or desirable.

1. *SFIG's members support prior LSTA comments on statutory authority and regulatory burdens.*

As the Joint Regulators are well aware, the LSTA has submitted several sets of comments to the Original Proposal, including comments dated August 1, 2011, September 2, 2011, April 1, 2013, and July 29, 2013. SFIG's members agree with the points raised by LSTA with respect to CLOs and believe that the Re-Proposal does not adequately address the LSTA's concerns. SFIG's members highlight some of those concerns here.

a. The vast majority of CLO managers are not "securitizers."

As the LSTA explained in its August 1, 2011 comments (at 7-14) and April 1, 2013 comments (at 16-19), § 941's definition of "securitizer" cannot be construed to include most CLO managers.[175] As noted herein, the actively managed nature of CLOs make them unique when compared to other types of ABS. In a CLO, the CLO manager acts as an investment adviser to the CLO and individually selects loans from a large assortment of sophisticated and audited debt issuers that are rated by publically recognized rating agencies. The CLO acquires these selected loans in constructing its portfolio in accordance with agreed upon criteria set forth in the transaction documents, monitors the performance of the loans, and directs the sale of loans by the CLO. The CLO manager thus may organize and initiate a securitization transaction, but it does so by selecting assets for the CLO to purchase from the open market, not by selling or transferring assets that the CLO manager or its affiliates have originated or funded. The CLO manager generally does not profit from the transfer of the loans to the CLO, but rather derives the bulk of its compensation from the successful performance of the CLO. Indeed, in many respects, a CLO manager is much more like a mutual fund manager than a typical securitizer.

In the Re-Proposal, the Joint Regulators nonetheless assert that a CLO manager meets the statutory definition of "securitizer" because it "organizes and initiates a securitization transaction by indirectly transferring assets to the issuing entity." The Joint Regulators also argue that to the

173 *Id.* § 78o-11(c)(1)(G)(i).

174 As discussed above, in the Re-Proposal, the Joint Regulators correctly "recognize[d] that the standard forms of risk retention . . . could, if applied to . . . CLO managers, result in fewer CLO issuances and less competition in this sector," and proposed the lead arranger alterative "to avoid having the general risk retention requirements create unnecessary barriers." 78 Fed. Reg. at 57962.

175 White & Case LLP and Invesco made similar points in their comments dated June 10, 2011 and August 1, 2011, respectively.

extent there is any ambiguity in the definition of "securitizer," they may rely on basic canons of statutory construction—reading the statute as a whole and giving effect to all of its provisions. SFIG's members do not believe these interpretive tools support the Joint Regulators' broad interpretation of the definition of "securitizer"; and the Joint Regulators do not cite any other provisions of the statute to support their interpretation. Instead, the Joint Regulators argue in general terms that Congress intended for risk retention to be held by collateral asset managers (such as CLO managers) who determine credit risk profiles and therefore need regulatory incentives to monitor the quality of the assets they cause to be transferred to an issuing entity.

SFIG's members agree that § 941 should be read as a whole, giving effect to all of its provisions. Ultimately, of course, courts are bound by "one, cardinal canon before all others. [The Supreme Court has] stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there."[176] Read as a whole, the language of § 941 clearly illustrates that Congress never intended to treat CLO managers as "securitizers" subject to risk retention requirements. First, a CLO manager is neither the issuer of an ABS nor, as the LSTA has explained in detail, does it organize and initiate an ABS transaction "by selling or transferring assets, either directly or indirectly . . . to the issuer," and therefore does not fit within § 941's definition of "securitizer."[177] Second, the Joint Regulators' core statutory directive under § 941 is to prescribe regulations requiring that securitizers retain credit risk "for any asset that the securitizer, through the issuance of an asset backed security, transfers, sells, or conveys *to a third party*."[178]

We understand that, in the view of the Joint Regulators, a CLO manager is a "securitizer" because it selects loans for the CLO to purchase and therefore "indirectly transfer[s] assets" to the CLO. [1795] However, the CLO manager is an investment adviser and agent for the CLO, acting on its behalf. The CLO manager is not transferring assets—directly or indirectly—to a third party through the issuance of an ABS transaction. The CLO, acting through its manager, is purchasing assets for itself, taking into account the expertise of its manager and its fiduciary duty to the CLO, the interests of its investors and the relevant transaction investment criteria.

b. The Commission did not perform an adequate required economic analysis.

As LSTA explained in its August 1, 2011 comments (at 3 n.7), and as the Joint Regulators acknowledge,[180] the Commission is required to engage in a cost-benefit analysis for new rules. Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider "the impact any such rule or regulation would have on competition" and "not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]."[181]

176 *Conn. Nat'l Bank,* 503 U.S. at 253-54.

177 15 U.S.C. § 78o-11(a)(3).

178 15 U.S.C. § 78o-11(b)(1) (emphasis added).

179 78 Fed. Reg. at 57,962.

180 78 Fed. Reg. at 58,004.

181 15 U.S.C. § 78w(a)(2).

Section 3(f) of the Exchange Act also requires the Commission to consider whether a proposed rule "will promote efficiency, competition, and capital formation" when determining whether the rule is necessary or in the public interest.[182] If the Commission fails to adequately assess the economic effects of a new rule, the rule will be vacated.[183]

In the Re-Proposal, the Commission acknowledges that the costs and benefits of the proposed risk retention requirements depend largely on the specific market and asset characteristics for each asset class.[184] Yet, the Commission's economic analysis says little about CLOs. At one point, the agencies acknowledged that the standard risk retention requirement could result in fewer CLO issuances and less competition in the sector.[185] But the Commission does not sufficiently analyze the costs and benefits of treating a CLO manager as a securitizer and never analyzes the costs and benefits of the newly proposed lead arranger alternative. The Commission also does not set forth any reasonable basis for concluding that the substantial burdens that it proposes to impose on CLOs are necessary and appropriate to advance the core legislative purposes of Section 15G when measured against the negative consequences that imposing risk retention on CLOs will cause.

Subjecting CLOs to risk retention requirements in an unworkable manner will have real economic impacts and will significantly reduce the amount and materially increase the costs of borrowing for businesses, reducing capital investment and, as a result, impeding job creation in many U.S. industries. In 2013, there was more than $625 billion in outstanding syndicated commercial loans in the U.S. held by non-banks, and CLOs alone provided $285 billion of loan capital to companies that benefit from CLO financing.[186] Many of these businesses depend to a material extent on the CLO market for access to capital.

According to LSTA's recent survey of CLO managers, the Joint Regulators' standard risk retention rules could reduce new CLO formation by 75 percent. Five managers predicted the requirement would cut the U.S. CLO industry in half, while the rest thought the rule would cause the industry to decline by 75% (26 managers) or to cease altogether (four managers).[187] And as discussed more fully above, the Joint Regulators' lead arranger option, as currently proposed, does not provide a workable alternative to the standard risk retention requirements.

2. *The underlying purposes of § 941 do not support the application of risk retention to CLOs.*

As the Joint Regulators explain in the Re-Proposal, although securitization markets have important benefits, problems arise when incentives are not properly aligned and there is a lack of

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182 *Id.* § 78c(f). *See also* 15 U.S.C. § 77b(b).

183 *See, e.g., Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).

184 78 Fed. Reg. at 58,006.

185 *Id.* at 57962. *See also id.* at 58,015.

186 *See The CLO Salmagundi: Risk Retention Consequences* at Exs. 5 & 7, Wells Fargo Research (Dave Preston and Jason McNeilis), October 25, 2013).

187 *See* LSTA July 29, 2013 Comments at 3-10.

discipline in the credit origination process.[188] During the financial crisis, some securitization transactions—particularly those involving the "originate-to-distribute" model, such as residential mortgage backed securities—were vulnerable to issues arising from a lack of transparency and misaligned incentives.[189] Congress intended the risk retention requirement to help address these problems in the securitization markets.[190] Thus, "the credit risk retention requirements of section 15G are an important part of the legislative and regulatory efforts to address weaknesses and failures in the securitization process and the securitization markets."[191]

The concerns behind § 941 of the Dodd-Frank Act do not implicate CLOs, which are not "originate-to-distribute" securitizations. In particular, as discussed in detail in Section A above, (1) the interests of CLO managers and CLO investors are already strongly aligned, (2) CLOs are actively managed by experienced investment managers, (3) the syndicated commercial loans that make up a CLO's portfolio are the product of quality underwriting, (4) CLOs are designed to "self-correct" for any material deterioration in the credit quality of the underlying loan portfolio, and (5) there is significant transparency for the loans in a CLO's portfolio. Notably, the Joint Regulators have not cited any evidence to the contrary. In fact, not only are these issues absent from CLOs, but as an asset class CLOs actually performed well relative to other ABS securitizations throughout the financial crisis and thereafter. This fact has strongly contributed to the significant number of CLOs issued post-crisis and the substantial par amount of commercial loans held by them.[192] As a result, we believe that Congress never contemplated a need to impose additional "regulatory incentives" on CLOs.

3. *Existing regulations and regulatory oversight make risk retention unnecessary and burdensome on the CLO and commercial loan markets without attendant benefit.*

In addition to the market-based incentives for CLO managers to construct quality portfolios of broadly syndicated commercial loans that are discussed above, existing regulations promulgated by several of the Joint Regulators already provide additional and meaningful protections against imprudent or inferior underwriting. These regulations further contribute to making the proposed risk retention requirements unnecessary.

First, in March 2013 (and effective May 2013), the FRB, the FDIC, and the OCC issued their Interagency Guidance for Leveraged Lending (the Guidance). The Guidance "is designed to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner."[193] The Guidance contains underwriting and risk management standards for leveraged loans and encourages originating institutions to be mindful of the reputation risk associated with poorly underwritten leveraged transactions—just as CLO managers take

188 78 Fed. Reg. at 57931.

189 *Id.* at 57,931-32. *See also id.* at 58,005 ("The 'originate-to-distribute' model was blamed by many . . ., as the originators and securitizers were compensated on the basis of volume rather than quality of underwriting.").

190 *Id.* at 57932.

191 *Id.*

192 *See* Appendix F, note 4.

193 Guidance at 1.

reputational risk into account.[194] The Guidance therefore only further underscores that additional regulatory incentives are unnecessary in the context of CLOs.

Second, as previously discussed in Section A.3.a. of this Part V, most CLO managers are registered investment advisors subject to regulation under the Advisers Act with fiduciary and other obligations to serve the best interests of CLO investors. These duties create a powerful legal obligation that obviates the need to align investment advisers' interests with those of their clients by mandating risk retention (or, more accurately, risk acquisition, which itself may create conflicts that the CLO manager is otherwise required to avoid).

K. Conclusion

In conclusion, while SFIG's members do not believe that it is necessary or desirable to subject CLOs to risk retention requirements, they nevertheless appreciate the evident focus of the Joint Regulators on risk retention solutions for the CLO market. SFIG's members believe that a combination of the following changes to the Re-Proposal would possibly mitigate the otherwise significant negative effects of subjecting CLOs to risk retention requirements and potentially preserve the important role and function of CLOs in the crucial commercial loan market that provides critical funding to businesses: (a) eliminating the additional restriction on cash flow distributions to EHRIs; (b) expanding the definition of qualified commercial loan; (c) adding a third party risk retention holder option; (d) reducing the amount of required risk retention; (e) reducing the risk retention period; (f) allowing for blended pools of more than 50%; and (g) grandfathering of legacy CLOs that permit issuances of additional notes or refinancings/re-pricings after the effectiveness of the final rule without complying with risk retention. We look forward to discussing these proposals in more detail with the Joint Regulators in the coming weeks.

194 In the Guidance (at 15), the issuing agencies explain: "Leveraged lending transactions are often syndicated through the financial and institutional markets. A financial institution's apparent failure to meet its legal responsibilities is underwriting and distributing transactions can damage its market reputation and impair its ability to compete. Similarly, a financial institution that distributes transactions which over time have significantly higher default or loss rates and performance issues may also see its reputation damaged."

VI. ASSET BACKED COMMERCIAL PAPER.

A. Summary

We thank the Joint Regulators for the considerable changes that have been made since the Original Proposal to the ABCP safe harbor, bringing it closer to a workable solution. However, we question the framework of the Re-Proposal with respect to ABCP issuers generally in light of the significant bank support already provided to ABCP programs and the types of ordinary customer banking activities in which most ABCP issuers engage. To the extent that the Joint Regulators would like ABCP issuers and the sponsors thereof to be subject to risk retention requirements,[195] there are a number of revisions to the Re-Proposal that are necessary to ensure that the ABCP markets are not unnecessarily disrupted. In the discussion that follows, we address issues with respect to the ABCP safe harbor and the grandfathering of existing customer transactions currently funded by ABCP. We focus solely on the characteristics of typical ABCP issuers (ABCP Conduits) as distinguished from structured investment vehicles (SIVs) and other aggregators of secondary market positions. We note that this discussion on ABCP should be read in conjunction with a proposed markup to § __.6 of the Re-Proposal, attached hereto as Appendix H.

B. Background

The typical ABCP Conduit is established by a large bank or other regulated financial institution, often referred to as its "sponsor." These sponsor "banks" generally fit the description of a "regulated liquidity provider" as defined in the Re-Proposal. ABCP Conduits finance the same sort of secured lending and other asset backed customer transactions that its bank sponsor funds directly for its own account.[196]

The purpose of ABCP Conduits is to provide bank customers with access to the capital markets without the expense and administrative burden of requiring such customers to establish their own funding vehicles. ABCP Conduits have been financing a portion of the secured customer transaction portfolios arranged by their bank sponsors since the 1980s.[197] Although the regulatory capital benefits of banks funding transactions through ABCP Conduits, rather than directly, have largely been eliminated with the changes in Basel II, Basel III, and FAS 167, some

195 As a preliminary matter, the base risk retention requirement set forth in §__.3 of the Re-Proposal, which applies to sponsors of securitization transactions, does not, on its face, apply to most sponsors of ABCP conduits. §__.2 of the Re-Proposal defines a "sponsor" as one who organizes and initiates a securitization transaction by selling or transferring assets to an issuing entity. This is consistent with the requirement of Section 941 of the Dodd-Frank Act that risk retention applies to "securitizers," which is defined in the same manner that the Re-Proposal defines "sponsor." However, bank sponsors of ABCP programs with multiple originator-sellers do not typically sell or transfer assets to the issuer and therefore are not "sponsors" under the Re-Proposal subject to the base risk retention requirement.

196 Bank customers include the types of entities defined as "originator-sellers" in the Re-Proposal.

197 Some ABCP Conduits are established by a non-bank entity to facilitate bank customer funding needs for multiple banks. These "non-bank sponsored" ABCP Conduits still enjoy 100% liquidity support, with respect to each transaction, provided by the relevant bank that utilizes such ABCP Conduits for its customer funding needs. In the context of "non-bank sponsored" ABCP Conduits, all references to "sponsor" herein mean the relevant bank with respect to its related customer assets and commercial paper.

banks and many "Main Street" customers still value their ability to use ABCP Conduits as efficient means of accessing the short-term capital markets. Many bank customers that utilize ABCP Conduits are middle market businesses that do not have the financial, technological, or human resources necessary to obtain efficient financing in the capital markets on their own. Other customers are some of the largest equipment and vehicle manufacturers and other industrial companies that already have significant direct exposures in the capital markets but seek ABCP funding as a means to obtain additional liquidity available from more diversified capital markets investors. Bank customers often cite multiple reasons for utilizing the ABCP market, including lower cost of funds, funding diversification, and funding stability and durability. Such customers rely on this reliable and efficient source of funding both for their day-to-day working capital needs and for longer-term investments in infrastructure.

Risk retention with respect to ABCP Conduits has already been in place, captured primarily through (1) already-existing customer underwriting practices by bank sponsors, (2) 100% committed backstop liquidity coverage provided by a bank in all ABCP Conduits [198] to ensure timely payment of ABCP at maturity, and (3) credit enhancement provided by the bank sponsor equal to at least 5% of the ABCP Conduit's assets. In the four decades across which commercial paper has been issued by ABCP Conduits, there have been zero losses to ABCP investors in this market. Any losses in respect of underlying customer transactions funded by these conduits have been borne by those designed to retain risk—the bank customers themselves, in the first instance, and thereafter, by bank-provided credit enhancement—and never by the commercial paper investors.[199] This makes perfect sense when one considers that one of the purposes of ABCP is to provide an alternate way for banks to fund high quality asset backed lending originations for the benefit of their customers.

Bank sponsors underwrite each and every transaction funded by ABCP Conduits as if such transaction was funded by the bank directly. This is not driven by any requirement for risk retention; rather, this is driven by the fact that the bank sponsor typically provides, with respect to any program or transaction, (i) a commitment to provide backstop liquidity at least equal to 100% of all outstanding commercial paper (hereinafter referred to as "backstop liquidity") and (ii) unconditional credit enhancement equal to at least 5% of the ABCP Conduit's assets (hereinafter referred to as "credit enhancement").[200] The provision of committed bank support equaling at least 100% of the issued and outstanding ABCP is the economic equivalent of a funded ABS interest. Bank regulators certainly take that view in other respects as illustrated by the fact that banks are typically required to hold capital as if their commitments were funded and to report such funding commitments on their financial statements and call reports.

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198 Some ABCP Conduits calculate liquidity as a percentage of its investment in assets, but in all of these cases, the backstop liquidity covers at least the dollar amount of all commercial paper issued by such ABCP Conduits.

199 Since the 2008 financial crisis, certain ABCP Conduits have drawn on their liquidity facilities, which often consist of several liquidity providers, in the aggregate of tens of billions of dollars to insulate investors from any losses.

200 It is important to note that backstop liquidity and credit enhancement always have longer horizons than the tenors of the ABCP issued.

Some ABCP Conduits utilize backstop liquidity that includes no reduction in the amount of required bank funding for non-performing assets (hereinafter referred to as "non-asset-tested" liquidity facilities). ABCP Conduits with non-asset-tested liquidity facilities effectively have 100% credit enhancement provided in the form of backstop liquidity. Other ABCP Conduits use backstop liquidity that includes a "borrowing base" (hereinafter referred to as "asset-tested" liquidity facilities). With respect to asset-tested liquidity facilities, the required amount of liquidity funding starts with a borrowing base equal to the amount of commercial paper outstanding, but such borrowing base can be reduced by the amount of non-performing assets that exceed all of the credit enhancement provided by the bank's customer for the related transaction. Because banks underwrite the customer transactions to the equivalent of at least investment grade, there is more than ample customer-provided credit enhancement to cover all reasonably foreseeable non-performing assets. As a result, any borrowing base reduction is remote. However, to fill any potential borrowing base gap when asset-tested liquidity facilities are used, the related bank sponsor is required to provide credit enhancement at least equal to 5% of all of the ABCP Conduit's assets. If drawn, such credit enhancement, in order to retain the required rating of the related ABCP, must be replenished if the amount of available credit enhancement drops below such 5% level. Such program-wide credit enhancement (PWCE) cross-collateralizes every transaction in the ABCP Conduit and may be drawn to cover any shortfall in any transaction, no matter the size of that shortfall in such transaction. The PWCE is often sufficiently large to cover more than 100% of the entire amount of one or more whole transactions funded by the ABCP Conduit. Even as the ABCP Conduit shrinks in any liquidation or run-off of deals, this remains true as all PWCE has a floor in dollar amount below which it is not allowed to fall.

In addition to the coverage provided by liquidity facilities and the already-existing underwriting practices of ABCP bank sponsors as described above, the ABCP Conduit structure protects commercial paper investors because there are no creditors of an ABCP Conduit with priority over such investors (other than service providers with respect to de minimis expenses). There is minimal third party equity in an ABCP Conduit and no full recourse creditors aside from the commercial paper investors. As a result, an ABCP Conduit is bankruptcy remote, and its commercial paper enjoys the benefits of the ABCP Conduit's assets as though it were secured by such assets, whether or not it is in fact secured. As a result of all of the foregoing, the bank sponsor and the bank customers themselves typically retain substantially all risk associated with the customer transactions funded by an ABCP Conduit, and commercial paper investors are accordingly insulated from losses.

C. The ABCP Safe Harbor.

Although the ABCP safe harbor has come closer to a workable solution than the Original Proposal, several issues remain as follows—some technical but all critical to the efficient functioning of ABCP markets, both for banks and for the "Main Street" customers financed by ABCP.

The permitted business activities of an eligible ABCP conduit do not reflect current market practice and are too limited. The definition of "eligible ABCP conduit" requires, in essence, that an eligible ABCP conduit be collateralized solely by asset backed securities that are, in turn, collateralized solely by assets originated by an originator-seller and acquired in initial issuances by or on behalf of intermediate SPVs. The SFIG membership believes that this is far too limiting, as almost no ABCP Conduits currently in existence would meet this definition. There are several reasons why this is so.

First, as described above, ABCP Conduits fund the same types of asset backed customer transactions that banks do. And just like banks, ABCP Conduits often originate assets that are not asset backed securities as defined in the Exchange Act. For example, many conduits enter into secured credit agreements under which the conduits make loans to the originator-seller or an intermediate SPV. Although these transactions are structured to function, in substance, the same as asset backed securities as defined in the Exchange Act, they would not technically comply with that definition. ABCP Conduits also often finance the bank's customers' receivables portfolios through purchasing those portfolios in whole. Additionally, ABCP Conduits enter into secured financing arrangements with customers of the bank that may not even constitute securitization transactions.

Second, a number of ABCP Conduits hold assets that have been acquired by their originator-sellers from third parties. Unlike SIVs and other conduits that act as aggregators of secondary market positions, however, the originator-sellers to such ABCP Conduits acquire such assets upon origination and in accordance with their own underwriting guidelines that have been reviewed and approved by such ABCP Conduits and their bank sponsors. For example, a bank customer may acquire a company and add the receivables of the acquired entity to an existing securitization transaction. These third party asset purchases are not "open market" or secondary market purchases, and there is no difference from a risk perspective between these assets and assets that are directly originated by the originator-seller.

Third, just like the business activities of banks, ABCP Conduits may take assignments of transactions from another bank or ABCP Conduit. This is not a secondary market trade of a security; rather, this is part of the normal syndication process or, in the case of assignments among different ABCP Conduits sponsored by the same bank, part of the bank's efforts to optimize diversification in each of its ABCP Conduits. Consistent with the Joint Regulators' clear desire not to include aggregator vehicles in the definition of "eligible ABCP conduit," we understand a limitation on secondary market securities trading. However, we do not see a reason to require that the financing be limited to the original origination of the related financing so long as the financing provided by the ABCP Conduit is the same type, and underwritten in the same manner, as the related bank's non-ABCP Conduit financings for its bank (not trading) book.

Fourth, the definition and use of the term "intermediate SPVs" is too limiting for the business of ABCP Conduits, just as it would be for the ordinary asset backed financing activities of banks. As discussed above, intermediate SPVs are not always involved in asset backed financings. Some forms of fund financings do not utilize SPVs at all. For example, an ABCP Conduit may make a secured loan to a business development fund secured by some or all of the loan portfolio of such fund. Moreover, in transactions that do utilize intermediate SPVs, not all are wholly owned by any of the originator-sellers. Many ABCP Conduits finance a substantial amount of receivables generated by multinational businesses. Intermediate SPVs used in such cross-border securitization transactions often are established as "orphan" SPVs for non-US tax or other local law reasons. An orphan SPV has nominal equity owned by a charitable trust or company that specializes in providing independent ownership of SPVs.

The Joint Regulators are clearly trying to ensure that conduits that act as aggregators of secondary market positions (*e.g.*, SIVs and securities arbitrage conduits) are caught outside of the safe harbor, but as illustrated above; however, the SFIG membership firmly believes the Joint Regulators have cast too wide a net. Notwithstanding all of the various forms that ABCP Conduit transactions may take, it is important to understand that the existence of 100% backstop liquidity and the general principles described above regarding backstop liquidity and credit enhancement provided by related banks do not change. Preserving the functioning of healthy ABCP markets for banks and their "Main Street" customers is critical, though the membership is also cognizant of the Joint Regulators' desire to implement a well-defined, objective standard that addresses their concerns. We propose a solution to reconcile these competing principles in Appendix H hereto, which contains a markup of § __.6 of the Re-Proposal.

100% non-asset-tested liquidity coverage is inconsistent with general risk retention requirements. The Re-Proposal made a significant shift from the Original Proposal's requirement of 100% backstop liquidity for safe-harbored ABCP Conduits. The Re-Proposal now indicates that 100% backstop liquidity (which is not characteristic of SIVs and other aggregators of secondary market positions) must also be 100% credit enhancement. The SFIG membership views this requirement as inconsistent with a large portion of the ABCP Conduit market and incongruous with the risk retention requirements expressed in Section 941 of the Dodd-Frank Act and the rest of the Re-Proposal. For one, it would require all ABCP Conduits to present investors with the same risk profile of a covered bond. Covered bonds are not considered Exchange Act asset backed securities and would not be subject to any risk retention requirement. For another, ABCP Conduits with asset-tested liquidity facilities would not qualify for safe harbor treatment.[201]

The requirement of 100% credit enhancement is inconsistent with the approaches taken by the various bank regulators with respect to regulation of risk-based capital, liquidity coverage, and leverage ratios. The biggest reason why ABCP Conduits no longer afford banks a less capital-intensive method of funding their customer businesses is the elimination of the credit conversion factor in Basel I for liquidity facilities. Throughout Basel II and Basel III, the US banking regulators have consistently drawn no distinction between drawn and undrawn backstop liquidity or credit enhancement facilities. Instead, banks are required to hold the exact same amount of regulatory capital against these facilities irrespective of usage. It would follow that

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201 Although we cannot quantify the cost to ABCP Conduits of implementing only non-asset-tested liquidity facilities, from an investor standpoint, asset-tested liquidity facilities are in many instances preferred to their non-asset-tested counterparts. Most ABCP are purchased by money market funds (MMFs), which are subject to Rule 2a-7 of the Investment Company Act of 1940 and the diversification requirements set forth therein. Such diversification requirements, among other things, prohibit an MMF from investing more than 10% of its assets in securities that are subject to guarantees from any single bank or institution. Under Rule 2a-7, an MMF generally would not be able to invest in an ABCP Conduit if, immediately after such investment, such MMF would hold more than 10% of its assets in securities issued or guaranteed by the sponsor of such ABCP Conduit. However, the sponsor would not be deemed to guarantee the ABCP if the MMF does not rely on the sponsor's financial strength to determine the quality of the ABCP. This exception to the proposed Rule 2a-7 diversification requirements can only apply in respect of sponsors that provide asset-tested liquidity.

bank regulators view banks as being at risk (and thus to have "skin-in-the-game") under those unfunded facilities just as much as in their funded states. Because these other regulatory regimes treat unfunded credit enhancement as risk retention, the SFIG membership asks that the Joint Regulators conform to this perspective and require banks to provide unfunded, unconditional credit enhancement facilities at the same 5% level as other forms of horizontal risk retention. The Re-Proposal should not force bank sponsors to hold 100% risk retention against ABCP Conduit assets when all other sponsors are required to retain no more than 5% risk.

In sum, the SFIG membership sees rationale to require backstop liquidity facilities to act also as credit enhancement so long as some form of unconditional bank sponsor credit enhancement is provided in an amount of at least 5% of the ABCP Conduit's assets. The market has developed such that rating agencies and ABCP investors alike insist that ABCP Conduits that are supported by asset-tested liquidity facilities have credit enhancement equal to at least 5% of the ABCP Conduit's assets provided in some other form by the bank sponsor. We therefore propose that, so long as either (i) one or more regulated liquidity providers provide non-asset-tested liquidity at least equal to 100% of all outstanding commercial paper, or (ii) (a) one or more regulated liquidity providers provide asset-tested liquidity in the aggregate equal to 100% of all outstanding commercial paper and (b) the bank sponsor provides credit enhancement equal to at least 5% of the ABCP Conduit's assets, the requirement in clause (4) of the definition of "eligible ABCP conduit" is satisfied.[202]

There should be no limit on the number of liquidity providers. The definition of "eligible ABCP conduit" seems to require that all of the required liquidity support be provided by only one provider. SFIG members respectfully point out that this is not consistent with market practice. Just as banks do, ABCP Conduits may fund transactions that are syndicated to multiple banks and/or other ABCP Conduits. One way to do this is for the ABCP Conduit to acquire a loan from another ABCP Conduit or bank.[203] Another way for ABCP Conduits to effect a syndication, however, is to syndicate the backstop liquidity provided for the customer transaction. In this way, a customer that wants ABCP funding for 100% of a transaction can get its wish even if it wants to fund that transaction with multiple relationship banks, including some that do not themselves sponsor ABCP Conduits. The SFIG membership sees no rationale for limiting the number of liquidity providers to an eligible ABCP conduit and, accordingly, proposes that there should be no limit on the number of liquidity providers as long as either (1) one or more regulated liquidity providers provide non-asset-tested liquidity at least equal to 100% of all outstanding commercial paper, or (2) (a) one or more regulated liquidity providers provide asset-tested liquidity in the aggregate equal to 100% of all outstanding commercial paper and (b) the bank sponsor provides credit enhancement equal to at least 5% of the ABCP Conduit's assets.

The requirement to disclose fair value is unduly burdensome to bank sponsors. The SFIG membership sees the proposed requirement in § __.6(d)(2)(C) to report the fair value of each of

[202] We emphasize that we fully appreciate and support the need for other restrictions that the Re-Proposal places on ABCP Conduits, such as those set forth in § __.12. We are simply asking that regulated liquidity providers be able to provide unfunded support as discussed.

[203] In this regard, please refer to our discussion above regarding the expansion of permitted business activities of eligible ABCP conduits.

the ABCP Conduit's interests as unduly burdensome to a bank sponsor, given the dynamic nature of an ABCP Conduit's assets. Given the breadth of a typical ABCP Conduit's business, as described above, an ABCP Conduit's assets change literally every day. The ABCP Conduit will be entering into or exiting customer transactions frequently, but those customer transactions often will be revolving transactions that change every day. Requiring a bank sponsor to provide the fair value of each asset would therefore require a great deal of work and may not be possible at all. Bank sponsors' exposures to customer transactions (whether in the form of liquidity facilities, credit enhancement facilities, drawn loans, or consolidated assets) are generally held in the banking book, subject to accrual accounting, rather than in the trading book, which is commonly fair-valued along the lines of what is required by the Re-Proposal. The SFIG membership therefore proposes that a bank sponsor be required to report to investors only those items that are identified as "currently report" in the spreadsheet attached hereto as Appendix G, with the understanding that the items identified as "could report if required" therein could be reported if the Joint Regulators think they are necessary.

The bank sponsor's compliance monitoring requirements are duplicative and unnecessary. The Re-Proposal requires that a bank sponsor (i) maintain policies and procedures that are reasonably designed to monitor compliance by each originator-seller that sells assets to the ABCP Conduit and (ii) report instances of non-compliance with the risk retention requirements by any originator-seller. In light of the fact that a bank sponsor already underwrites each transaction funded by an ABCP Conduit as if such transaction was funded by the bank directly, the SFIG membership does not believe it is necessary for a bank sponsor to develop separate policies or procedures to actively monitor each originator-seller. We propose that in satisfying its compliance monitoring requirements, a bank sponsor may rely on representations and warranties given by each applicable originator-seller regarding such originator-seller's compliance with its own risk retention requirements. In addition, we see no benefit in requiring a bank sponsor to notify investors of any one originator-seller's failure to comply with its risk retention requirements, if any, given the extensive support provided by regulated liquidity providers. We therefore also propose that a bank sponsor be required to notify only regulators upon the actual discovery or knowledge of any such failure to comply.

The tenor limit for ABCP should be extended. The Re-Proposal defines "ABCP" to include commercial paper with tenors of up to only nine months. Consequently, bank sponsors of ABCP Conduits that issue commercial paper with maturities of greater than nine months would not qualify for the safe harbor. However, the SFIG membership believes there is little justification for such a limit where the proposed liquidity and credit enhancement requirements outlined above are satisfied. In fact, such backstop liquidity and credit enhancement provided in ABCP Conduit programs have longer horizons than the tenors of the commercial paper themselves.

We note that the Joint Regulators acknowledged the prior comments of the industry on this topic but declined to make changes given the lack of any market prevalence of ABCP with maturities of longer than nine months. Although the SFIG membership generally agrees with this observation as it relates to historical ABCP issuance, the SFIG members anticipate the need for bank sponsors of ABCP Conduits to provide for longer-dated ABCP in order to satisfy the liquidity requirements under Basel III, which are currently scheduled to go into effect starting in 2015. Indeed, Basel III contemplates the implementation of two complementary liquidity stress tests: (1) a liquidity coverage ratio (LCR), which will require banks to satisfy a thirty-day liquidity stress test, and (2) a net stable funding ratio (NSFR), which will require banks also to satisfy a longer, one-year liquidity stress test. With respect to the LCR, any obligation—including an obligation to fund pursuant to a liquidity facility—that may be drawn within a thirty-day window must be cash collateralized by the obligor. To avoid such a collateralization requirement, ABCP Conduits will likely stray from issuing ABCP with maturities of thirty days or less. With respect to the NSFR, holding liabilities with effective maturities of one year or greater will provide a more favorable ratio for the bank, whereas liabilities with effective maturities of less than one year will make it more difficult for the bank to comply with the NSFR requirement. Along with the LCR requirement, the NSFR requirement will likely incentivize ABCP Conduits to issue ABCP with maturities of greater than one year. Consequently, the historical experience of ABCP issuances with tenors of nine months or less is not indicative of likely future experience in this market. The SFIG membership therefore proposes that the definition of "ABCP" be revised to include commercial paper with tenors of up to 397 days.[204]

D. Grandfathering Mechanics.

In order for a bank sponsor to qualify for the safe harbor outlined in § __.6 of the Re-Proposal, each originator-seller whose asset backed interests are sold through an intermediate SPV must meet the risk retention requirements set forth in § __.4. Such requirements, however, would be impossible to satisfy with respect to transactions entered into prior to the effective date of the Re-Proposal because the bank sponsor would have no contractual means by which to impose such requirements on such originator-sellers. Just as banks do so for their own account, conduits enter into revolving facilities for several years with bank customers. In the case of facilities that were established before the effective date of the Re-Proposal, a conduit may be able to restructure the transaction to comply with the Re-Proposal only when the relevant pre-existing commitments are renewed.[205] Thus, it would not be practical to impose a time limit for compliance as the Joint Regulators have mentioned in their request for comments. The SFIG membership therefore proposes that transactions existing prior to the effective date of the Re-Proposal are exempted from such requirements unless such transactions have been renewed after the effective date of the final rule.

[204] This is the same tenor limit imposed by Rule 2a-7 with respect to an MMF's investment in any security.

[205] Please note that we will provide in a supplemental letter data in respect of transactions where the duration of the sum of their related commitments plus time to liquidate would exceed the two-year compliance period.

VII. INTERNATIONAL ISSUES.

A. Introduction.

The safe harbor for foreign securitization transactions contained in § __.20 of the Re-Proposal (the Crossborder Safe Harbor) provides a limited exemption for non-U.S. issuers selling or otherwise transferring not more than a specified percentage of the U.S. dollar value (or equivalent amount in the currency in which the ABS is issued, as applicable) of all classes of ABS interests in the securitization transaction to, or for the account or benefit of, U.S. persons. The Joint Regulators' stated objective in proposing the Crossborder Safe Harbor is to exclude those transactions with limited effect on U.S. interests, underwriting standards, risk management practices or U.S. investors. For the Crossborder Safe Harbor to achieve this objective and provide meaningful relief to market participants, however, SFIG believes the trigger percentage of the Crossborder Safe Harbor should be increased. SFIG also recommends several clarifications regarding the eligibility calculation methodology to ensure the Crossborder Safe Harbor will function as intended. These recommendations are discussed in more detail below.

In addition, this section provides responses to the Joint Regulators' specific requests for comments related to the Crossborder Safe Harbor. As discussed further below, SFIG believes it is important to minimize the potentially adverse effects resulting from differences in risk retention requirements among major markets, and therefore proposes the adoption of a substituted compliance framework.

1. *The Importance of a Well-Functioning Crossborder Securitization Market.*

Securitization is an important tool for economic recovery.[206] It serves as an efficient technique for raising capital and transferring risk from originators of financial products (which drive growth in the real economy) to the capital markets. Due to the global nature of our financial system, securitization—in order to be most effective—requires seamless operation across borders. Specifically, crossborder marketing of securitizations allows originators of credit to consumers and businesses to finance in an efficient and cost-effective manner a wide range of assets that drive real economic growth—such as auto loans, residential and commercial mortgages, and credit card receivables—by offering securities backed by pools of these assets to a broad range of domestic and international investors.

In addition, capital markets are able to accomplish better price discovery when as many originators of credit as possible have access to as many potential investors as possible. Sophisticated investors—such as credit institutions, investment firms, insurance companies, pension funds, and money managers—benefit from being able to select from a wide range of investments, including securitized investment products, which best match their investment objectives and thus thereby enable them to maintain well-diversified portfolios with a range of risk exposures. As banking institutions are increasingly constrained in the amount and type of

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206 *See, e.g.*, International Organization of Securities Commissions, *Global Developments in Securitisation Regulation: Final Report*, at 9 (Nov. 16, 2012), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf (the "IOSCO Final Report"). This report is part of a larger effort by the Financial Stability Board, acting upon the request of the G20, to develop recommendations to strengthen oversight and regulation of the securitization sector.

credit they can supply, the ability of these other investors to provide an alternative source of financing for consumers and businesses is highly dependent upon seamless crossborder capital markets.[207]

2. *Importance of Privately Issued Safe Assets*.

One clear policy response to the recent global financial crisis has been to make financial institutions more resilient, in part by incentivizing these institutions to hold safer financial assets.[208] Safe financial assets (safe assets) are used as a source of steady income and capital preservation in portfolio construction. Safe assets also serve a critical function as high quality, liquid collateral in a wide range of financial transactions. Privately issued assets, such as high quality ABS interests, represent an important source of safe assets.[209] The International Monetary Fund (IMF) has reported that demand for safe assets is increasing at the same time that the supply of safe assets is generally decreasing.[210] Since the global financial crisis, "[t]otal private sector securitization issuance declined from more than $3 trillion in the United States and Europe in 2007 to less than $750 billion in 2010."[211] The overall decline in privately issued safe assets has contributed to an imbalance of supply and demand for safe assets. Unmet demand for safe assets drives up the price of safety, leading investors that are unable to pay the higher cost of safety to settle for assets that embed higher risks than desired.[212] According to the IMF, "Demand-supply imbalances in safe asset markets could also lead to more short-term volatility jumps, herding, and cliff effects."[213] Regulators in the U.S., appreciating the role of safe assets in a well-functioning economy, have generally sought to be sensitive to market concerns about balancing increased soundness with practical concerns that unduly burdensome regulatory changes could have a significant negative impact on the creation of privately issued safe assets.

3. *Risks of Misaligned Regulatory Approaches*.

In a November 2012 report on global developments in securitization regulations, which was produced at the direction of the Financial Stability Board, the IOSCO states that "[c]ross border activity is an important component of global securitization markets, and policy makers and regulators should be conscious of not adding to the cost of cross border activity through requirements that are duplicative of, or inconsistent with, requirements in other jurisdictions."[214] Accordingly, IOSCO's report includes the following recommendation: "Regulators should seek to minimize the potentially adverse effects to cross border securitization transactions resulting

207 *See*, *e.g.*, *id.* at 9–10.

208 *See* International Monetary Fund, *Global Financial Stability Report: The Quest for Lasting Stability*, Ch. 3 (April 2012) (available at http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/text.pdf).

209 *Id . at 88* (reporting that securitized instruments accounted for 17% of the global aggregate supply of safe assets).

210 *Id*. at 105-112.

211 *Id.* at 108-09.

212 *Id. at* 112.

213 IMF Report at 113.

214 IOSCO Final Report at 10.

from differences in approaches to incentive alignment and risk retention."[215] If the U.S. regulatory approach to risk retention differs significantly from those adopted by other major jurisdictions, such as the European Union, non-U.S. securitizers seeking to sell ABS interests in crossborder transactions to U.S. investors would need to comply simultaneously with non-aligned risk retention requirements of multiple jurisdictions. Even if securitizers are able to comply with multiple sets of regulations, it is very likely that the related increased compliance costs will be ultimately passed on to consumers and the real economy. This could include an increase in financing costs and a decrease in credit availability to consumers of goods exported by U.S. businesses. Non-U.S. securitizers that choose to comply with multiple regimes to gain access to U.S. investors would need to compare and analyze the applicable risk retention regimes and apply the most onerous compliance standards. This may result in market participants being unable to rely on portions of a relevant regime that provides needed operating flexibility. This could result in unnecessary rigidity and discourage otherwise beneficial innovation in the securitization marketplace. In addition, it is possible that a significant number of non-U.S. securitizers would choose to avoid offering their ABS interests to U.S. investors, which could negatively impact the U.S. market by: (1) decreasing the diversity of assets available to US investors; (2) decreasing the supply of safe assets available in the US market; and (3) impeding efficient price discovery.

The Re-Proposal presents a critical opportunity to reduce crossborder transactional frictions. Some SFIG members recommends that the Joint Regulators take this opportunity to reduce the potential pressure placed on the securitization markets from non-aligned regulatory structures. To accomplish this, these SFIG members recommend adopting a framework for "substituted compliance" with other comparable risk retention regimes, recognizing that financial regulators in major jurisdictions around the world share similar policy objectives. Recently, in other contexts, both the SEC and the U.S. Commodity Futures Trading Commission (CFTC) reaffirmed their interest in cooperating closely with regulators in the European Union and other counterparts to encourage greater harmonization of their respective regulatory regimes.[216] It would therefore seem to be an opportune time for the Joint Regulators to seek to reduce challenges and complications of regulatory non-alignment for crossborder securitization transactions that have significant potential to inhibit or preclude beneficial economic activity. A reduction in crossborder transactional frictions with respect to risk retention and securitization would provide benefits to the real economy as well as the structured debt markets generally.

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215 *Id*. at 49.

216 The SEC has recently signed a Memorandum of Understanding with a number of EU member state regulators to enhance clarity in regulations pertaining to the asset management industry. Press Release, SEC, SEC, European Regulators Establish Supervisory Cooperation Arrangements Related to the Asset Management Industry" (July 19, 2013) (available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539728294).

The CFTC's efforts have primarily been focused in the area of derivatives, with a special emphasis on regulations relating to transparency and risk mitigation, in order to minimize opportunities for regulatory arbitrage. Press Release, CFTC, "The European Commission and the CFTC reach a Common Path Forward on Derivatives" (July 11, 2013) (available at http://www.cftc.gov/PressRoom/PressReleases/pr6640-13).

B. ABS Interests Sold in an "Offshore Transaction" in Compliance with Regulation S Should be Considered Not Sold to a U.S. Person for Purposes of the Eligibility Calculation.

Some SFIG members recommend adding a clarification to the Crossborder Safe Harbor to the effect that ABS interests initially sold by a non-US issuer in an "offshore transaction" in compliance with the issuer safe harbor provided by Rule 903 of Regulation S under the Securities Act of 1933, as amended (Securities Act), would be considered not sold to a U.S. person for purposes of the eligibility calculation, regardless of any secondary market transfers of such ABS interests subsequent to issuance. For over twenty years, Regulation S has been extensively relied upon by market participants to establish clear boundaries with respect to the extraterritorial application of US federal securities law affecting new issuances of securities (including ABS interests).

With the adoption of Regulation S in 1990, the SEC established a clear and widely-relied upon jurisdictional boundary with respect to the reach of U.S. Federal securities laws related to registration requirements. The territorial approach reflected in Regulation S was "intended to protect the U.S. capital markets and investors purchasing in the U.S. market, whether U.S. or foreign nationals."[217] Pursuant to Regulation S, offshore transactions would be governed by the relevant non-U.S. legal framework. "Principles of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore. The territorial approach recognizes the primacy of the laws in which a market is located."[218] Furthermore, the SEC recognized that investors had the right to choose the markets in which they would participate and, therefore, the applicable regulatory regime.[219] The extra territorial application of the Re-Proposal beyond the jurisdictional boundaries clearly articulated in Regulation S to a sale of ABS interests sold in an offshore transaction would be only loosely related to the Joint Regulators' policy goals. Such transactions have, at best, an attenuated connection to U.S. capital markets and U.S. underwriting standards. As discussed above, if the Re-Proposal were to be enforced with respect to such offshore transactions, it would cause transactional challenges and complications resulting from non-aligned regulatory regimes, which could reduce investment options for U.S. investors and impede price discovery and efficiency in the securitization market.

In addition, issuers face significant practical as well as legal limitations in ascertaining the identity and nationality of holders of its securities after issuance. SFIG believes that it would be unduly burdensome and, in many cases, impossible for issuers to continuously monitor and analyze the nationality of holders of ABS interests after issuance, especially in the case of beneficial ownership of ABS interests via securities accounts established with non-U.S. broker-dealers. Furthermore, SFIG believes that the clarification recommended above would provide much needed certainty regarding the timing of the eligibility determination when relying on the Crossborder Safe Harbor.

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[217] Press Release No. 33-6863, SEC, Offshore Offers and Sales, at 5 (Apr. 24, 1990) (the Reg. S Adopting Release)

[218] *Id*. (internal footnotes omitted)

[219] *Id*.

C. **<u>Recommendations for Clarifications to the Eligibility Calculation for the Crossborder Safe Harbor</u>.**

SFIG appreciates that, in light of the joint nature of the Joint Regulators' rule-making authority with respect to the Re-Proposal, the Joint Regulators have endeavored to provide specificity and clarity in the Re-Proposal to avoid conflicting interpretations or uncertainty. Some members are concerned, however, that the inclusion of the terms "value" and "transferred" in the revised eligibility calculation in § _.20(b) poses a significant risk of conflicting interpretations and uncertainty. Market participants require certainty as to qualification for the Crossborder Safe Harbor at the time they structure a securitization transaction. After ABS interests are issued, securitizers would likely not be able to bring an ABS structure that was intended to qualify for the Crossborder Safe Harbor into full compliance with U.S. risk retention requirements. Accordingly, we recommend the following three clarifications that we believe would make compliance with the Crossborder Safe Harbor workable for, and provide certainty to, market participants.

a. *The eligibility conditions should only be required to be met as of the issuance date of the ABS interests.* SFIG recommends adding a clarification (which could appear in the form of an instruction following § _.20(b)(2)) to the effect that percent triggers related to U.S. persons and assets collateralizing the ABS interests provided in § _.20(b)(2) and § _.20(b)(4) should only be determined and evaluated as of the issuance date for the relevant ABS interests. Alternatively, clarification could be provided by adding "as of the date of the securitization transaction" immediately after "all the following conditions are met" in § _.20(b).

b. *The value of a class of ABS interests (including ABS that is amortizing, callable or extendible) should be measured only as of its issuance date for purposes of the eligibility calculation.* SFIG recommends adding a clarification (which could appear in the form of an instruction following § _.20(b)) to the effect that if an ABS issuer offers and issues multiple classes of ABS interests in a securitization transaction, the value of any particular class of ABS interests (including ABS that is amortizing, callable or extendible) should be measured only as of the issuance date of the ABS for purposes of the eligibility calculation. Especially in the case of ABS that is amortizing, callable or extendible, the relative value of one class of ABS interests relative to another class of ABS interests issued in the same securitization transaction may fluctuate over time.

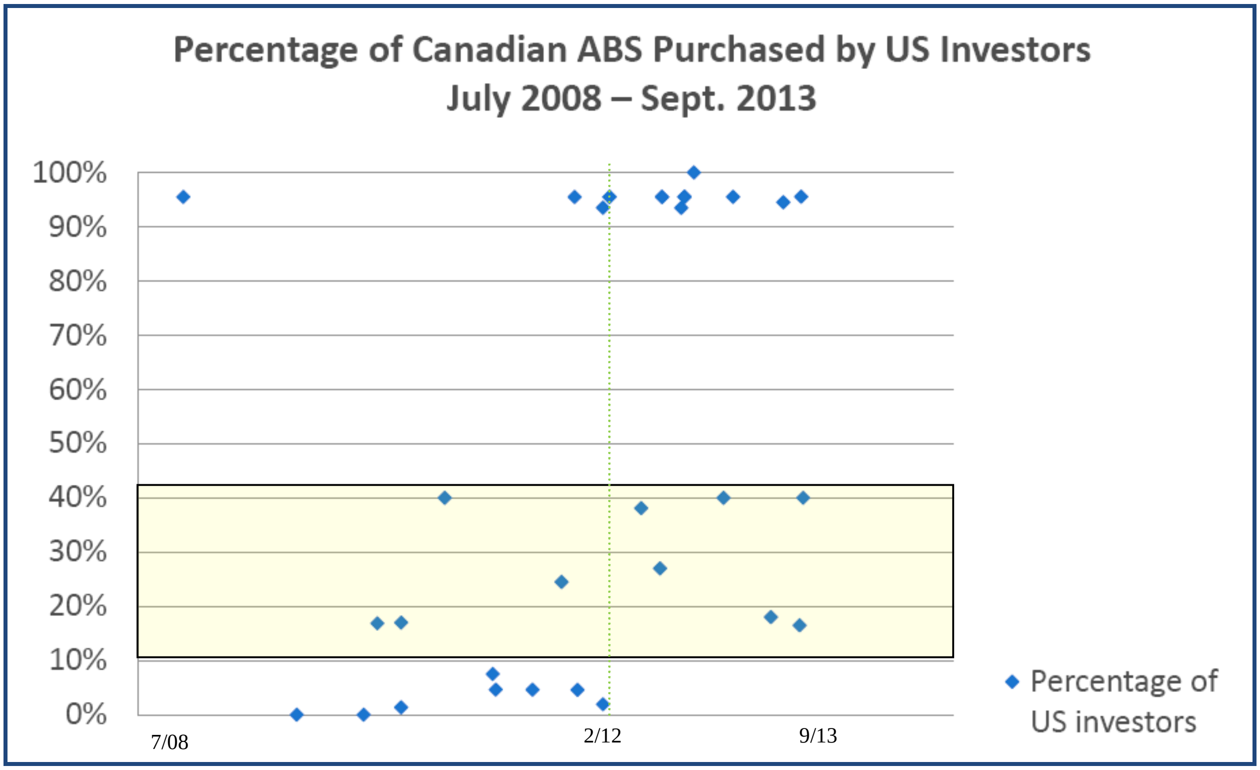
c. *Secondary market transfers of ABS should not impact the eligibility calculation.* SFIG recommends adding a clarification —which could appear in the form of an instruction following § _.20(b)—to the effect that any secondary market transfers of ABS interests subsequent to issuance should not affect the eligibility calculation. We note that issuers face significant practical as well as legal limitations in ascertaining the identity and nationality of holders of its securities after issuance. We believe that it would be unduly burdensome and, in many cases, impossible for issuers to continuously monitor and analyze the nationality of holders of ABS after issuance, especially in the case of beneficial ownership of ABS via securities accounts established with non-U.S. broker-dealers).

If wider interpretations than those recommended above were applied, it would be unlikely that any market participants would seek to rely on the Crossborder Safe Harbor at the time they structure and price non-U.S. securitization transactions. If market participants perceive the Crossborder Safe Harbor not to be workable, they will likely weigh the costs of complying with the U.S. risk retention regime against the cost of finding investors in other jurisdictions. This could result in U.S. investors losing access to a significant range of non-U.S. ABS investment opportunities, which, as discussed in more detail in the introduction to this section, could impair portfolio diversification and efficient price discovery in the U.S. market.

D. The Trigger Percentage Included in the Eligibility Calculation for the Crossborder Safe Harbor Should Be 40%.

As demonstrated by a case study (presented below) of all Canadian ABS offered to U.S. investors since the Canadian withholding tax was eliminated in 2008, many SFIG members believe the trigger percentage in § _.20(b) should be 40%. These members believe that even with this higher US investor threshold in § _.20(b), the Crossborder Safe Harbor would remain appropriately aligned with the Joint Regulators' stated objective of excluding only those transactions from the scope of the Re-Proposal that have a limited effect on U.S. interests, underwriting standards, risk management practices or U.S. investors. Due to the exclusion of SEC-registered transactions from the Crossborder Safe Harbor in § _. 20(b)(1), the non-U.S. ABS interests at issue would be sold in the United States in most cases only to "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) or institutional "accredited investors" (as defined in Rule 501 under the Securities Act). These types of investors are generally recognized as having a high level of sophistication, being capable of maintaining appropriate risk management practices, and making informed investment decisions. These sophisticated investors likely have sufficient influence in the securitization market to demand discounted pricing for ABS interests that are offered without adequate risk retention. In addition, an increase in the U.S. investor threshold would not materially impact underwriting standards and risk management practices in the United States among originators because many SFIG members believe this policy objective is primarily served by limiting the percentage of assets that collateralize the ABS interests acquired from a U.S. source to 25% in § _.20(b)(4).

In the case of Canadian ABS, as illustrated by the chart below, only eight out of a total of 32 ABS transactions (representing all Canadian ABS offered to U.S. investors since the Canadian withholding tax was eliminated in 2008) had U.S. investor participation rates of 10% or lower at the time of initial issuance. Ten out of a total of 32 Canadian ABS transactions had U.S. investor participation rates that fell in the range between 10% and 40%.



Source: RBC Capital Markets

In addition, we note that after January 2012 there have been no Canadian ABS transactions with U.S. participation rates below 17%. (The aggregate dollar value of the Canadian ABS transactions fell in the range between 10% and 40% U.S. investor participation was approximately $5.17 billion, while the aggregate dollar value of the Canadian ABS transactions that had above 90% U.S. investor participation was approximately $9.36 billion.) Without a significant increase in the trigger percentage for the Crossborder Safe Harbor, this case study demonstrates that U.S. investors risk losing access to a significant number of non-U.S. ABS investment opportunities originated in Canada.

E. Recommendation for a Substituted Compliance Framework.

To mitigate the impact of differing regulatory approaches on crossborder securitizations, some SFIG members recommend adopting a framework for recognizing substituted compliance pursuant to which non-US securitizers that offer ABS interests at least in part in a non-U.S. jurisdiction that maintains ***comparable*** risk retention requirements to those of the United States (Qualified Non-U.S. Jurisdiction) may choose to satisfy U.S. risk retention requirements by complying with the risk retention regime of such Qualified Non-U.S. Jurisdiction. Specifically, many SFIG members recommend that non-U.S. securitization transactions should be permitted to comply with comparable risk retention requirements of a Qualified Non-U.S. Jurisdiction when:

a. the ABS transaction complies with the risk retention regime of a Qualified Non-U.S. Jurisdiction with respect to which a designated taskforce (composed of representatives of the Joint Regulators with delegated authority) has made a comparability determination;

b. the ABS are also offered to persons in such Qualified Non-U.S. Jurisdiction; and

c. the ABS are offered in the United States pursuant to an offering document that contains an affirmative undertaking by the relevant non-US sponsor or originator to retain a net economic interest in accordance with the risk retention regime of the relevant Qualified Non-U.S. Jurisdiction.

In making comparability determinations, some SFIG members recommend that the designated taskforce take a holistic approach, ultimately focusing on regulatory outcomes rather than a rule-by-rule comparison. This approach would be consistent with the two substituted compliance frameworks that have been proposed or adopted recently in the United States. These are the result of laudable international consultation and coordination efforts, made pursuant to a mandate in the Dodd-Frank Act intended to promote the establishment of consistent international standards with respect to the regulation of swaps and security-based swaps.[220] For your reference, we provide a brief summary of both substituted compliance frameworks below.

2. ***SEC's Proposed Substituted Compliance Framework***. To reduce the likelihood that market participants would be subject to potentially conflicting or duplicative sets of rules regarding security-based swaps, the Commission has proposed a substituted compliance framework for four specified categories of regulatory requirements applicable to crossborder security-based swaps.[221] If adopted as proposed, this framework would permit a non-US registered security-based swap dealer to apply to the Commission for a determination that a non-US swap regulation regime is **comparable** to the Commission's rules. In making comparability determinations, within each category of requirements, the Commission would take a holistic approach, ultimately focusing on regulatory outcomes rather than a rule-by-rule comparison. To make a comparability determination, the Commission would consider whether the requirements of the non-US regulatory system "are comparable to otherwise applicable requirements,

220 *See* Section 752(a) of the Dodd-Frank Act.

221 *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968, 30,975 (May 23, 2013) (available at http://www.gpo.gov/fdsys/pkg/FR-2013-05-23/pdf/2013-10835.pdf) (the SEC Proposal) ("[W]e recognize the potential, in a market as global as the security-based swap market, that market participants who engage in cross-border security-based swap activity may be subject to conflicting or duplicative compliance obligations. To address this possibility, we are proposing a 'substituted compliance' framework under which we would consider permitting compliance with requirements in a foreign regulatory system to substitute for compliance with certain requirements of the Exchange Act relating to security-based swaps, provided that the corresponding requirements in the foreign regulatory system are comparable to the relevant provisions of the Exchange Act. The availability of substituted compliance should reduce the likelihood that market participants would be subject to potentially conflicting or duplicative sets of rules." (internal footnotes omitted)).

after taking into account such factors as the [Commission] determines are appropriate, such as the scope and objectives of the relevant [non-US] regulatory requirements, as well as the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by a [non-US] financial regulatory authority or authorities in such system to support its oversight of such [dealer]."[222] The Commission would have discretion to issue a comparability determination subject to various conditions, and may make a determination with respect to only a subset of its rules or only certain classes of dealers. The Commission would only make a comparability determination after it enters into a supervisory and enforcement memorandum of understanding or other arrangement with the relevant non-US financial regulatory authority or authorities. If the Commission issues a comparability determination with respect a particular non-US regulatory system and a particular class of dealers under the proposed framework, then non-US dealers that are part of the relevant class would be able to rely on that determination to satisfy a specified US rules by complying with the corresponding requirement of such regulatory system, provided they satisfy any conditions specified in the relevant determination.

3. ***CFTC's Adopted Substituted Compliance Framework***. The CFTC recently adopted a substituted compliance framework in connection in connection with specified regulatory requirements applicable to crossborder swaps.[223] A non-US regulator, an entity subject to CFTC regulation (or a group of such entities) or a trade association may apply to the CFTC for a determination that a non-US swap regulation regime is comparable and comprehensive. To make a comparability determination, the CFTC will evaluate whether the requirements of the non-US jurisdiction are comparable and comprehensive compared to the applicable US requirements, which will be based on a consideration of all relevant factors, including the comprehensiveness of the non-US regulator's supervisory compliance program and its authority to support and enforce its oversight with regard to the activities to which substituted compliance would apply. The CFTC has discretion to issue a comparability determination subject to various conditions and expects most comparability analyses to involve consultations with foreign regulators. In addition, the CFTC expects to enter into a memorandum of understanding or similar arrangement regarding information sharing and enforcement with the relevant non-US regulator in connection with making a comparability determination. If the CFTC issues a comparability determination with respect a particular jurisdiction, it will apply to all entities or transactions in such jurisdiction, to the extent provided in such determination. The CFTC has already received, and is in the process of considering, substituted compliance applications with respect to the following jurisdictions: Australia, Canada, the European Union, Hong Kong, Japan and Switzerland.

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222 § 240.3a71–5 as proposed in the SEC Proposal, 78 Fed. Reg. at 31,207-08 (emphasis added).

223 *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013) (available at http://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf).

A regime permitting substituted compliance would permit the Joint Regulators to evaluate whether another jurisdiction's risk retention regime is comparable to that of the U.S. on a jurisdiction-by-jurisdiction basis upon application by an interested party, such as an ABS sponsor or originator. For making comparability determinations efficiently, many SFIG members recommend that the Joint Regulators create a taskforce having delegated authority. Such a taskforce generally should consider following the methods for making substituted compliance determinations as outlined in the Commission proposed substituted compliance framework for security-based swaps. In that context, the Commission proposed to take a holistic approach, focusing on regulatory outcomes rather than a rule-by-rule comparison.[224] The taskforce could have discretion to issue a comparability determination subject to various conditions, and to make a determination with respect to only a subset of its rules or only certain asset classes or types of issuers. Such a regime would be not only be in keeping with principles of international comity, but would also avoid costly and unnecessary regulation of ABS transactions when they are simultaneously subject to regulation that is comparable to that in the U.S.

F. Conclusion.

Given the important benefits that accrue to open, unhindered crossborder markets for ABS interests, absent compelling domestic policy considerations, pragmatic alternatives to inconsistent national regulatory regimes should be considered in order to facilitate the operation of efficient international capital markets. In the context of comparable regulatory regimes, SFIG notes the absence of compelling domestic policy considerations that would justify increasing transactional frictions (such as increased costs of compliance and loss of flexibility) caused by potentially inconsistent regulatory regimes that unintentionally may limit the amount, and increase the cost, of credit available to consumers and businesses, reduce the diversity of assets available to U.S. investors, decrease the supply of safe assets and impede efficient price discovery.

[224] § 240.3a71–5 as proposed in the SEC Proposal.

VIII. AUTOMOBILE, EQUIPMENT, AND FLOORPLAN SECURITIZATIONS

A. Importance of Vehicle and Equipment Securitization to the Economy.

Securitization of vehicle and equipment loans and leases provides much of the financing today for automobiles, trucks and motorcycles (collectively, vehicles) as well as tractors, farm and construction equipment and large commercial vehicles (collectively, equipment).[225] This financing supports and is critical to manufacturing companies, dealers, farmers and other small, medium and large businesses, thus promoting job creation and economic growth.

Vehicle and equipment ABS are among the oldest asset classes in the securitization market. The very first asset backed securities offering in 1985 was backed by auto loans. Many vehicle and equipment ABS issuers that regularly securitize have been active in the securitization market for decades. Securitization is a relatively cost-effective funding channel for vehicle and equipment issuers, especially when corporate ratings are lower or non-investment grade or the sponsor is unrated. Securitization allows vehicle and equipment sponsors to diversify funding channels, attract new investors and provides liquidity.

Vehicle and equipment sponsors generally do not operate on an "originate to distribute" basis. They typically either do not securitize every asset they originate or do so on a delayed basis (often many months or years after origination). Servicing personnel typically do not know if an asset is securitized and apply the same collection standards and processes to all assets whether or not they are securitized. Additionally, for most vehicle and equipment sponsors, most of their securitized assets remain on their balance sheets and, as a result, the performance of their securitizations generally is reflected in their financial performance.

Vehicle and equipment ABS sponsors typically are also the originators and servicers of the securitized assets included in their ABS transactions and usually hold the first loss residual interest in the transaction. The vast majority of these residual interests to date would not satisfy the requirements of the current re-proposal.

B. Vehicle and Equipment Sponsors Request that the Joint Regulators Permit Additional Methods of Calculating Retained Risk.

1. *Limitations on Eligible Horizontal Residual Interest Distributions*

The SFIG vehicle and equipment sponsors wish to emphasize their concern with the Closing Date Projected Cash Flow Rate and the Closing Date Projected Principal Repayment Rate calculations and the potential liability associated with disclosures of projections. The SFIG vehicle and equipment sponsors support the proposed solutions a. and b. in Section B.2 of Part I of this Letter.

[225] Vehicle and equipment issuers include banks, independent finance companies and captive finance subsidiaries of manufacturers.

2. *Simplified Approach*

The SFIG vehicle and equipment sponsors support the adoption of the "Simplified Approach" described under Section A.4 of Part I of this letter (Joint Regulators Should Allow a Simplified Approach For Simplified Structures with Obvious Retention of At Least 5% of the Credit Risk), which would achieve this result. Any SFIG vehicle and equipment sponsors would be able to benefit from this approach.

3. *Representative Sample and Participating Interests*

SFIG's vehicle and equipment sponsors, particularly the banks, believe it is essential that the final rule include the representative sample alternative. It is very important to vehicle and equipment sponsors to have some version of the representative sample method as an alternative. We believe that most vehicle and equipment loan or lease transactions over $100 million in assets would have a sufficient amount of securitized assets that the selection of a random sample would be sufficiently representative to satisfy and concerns about the representativeness of the sample.

The vehicle and equipment sponsors would find the Participating Interest a particularly valuable and useful form of determining a representative sample.

4. *Revolving Transactions; Self-Adjusting Horizontal Option*

Most vehicle and equipment issuers not only use the asset backed securities markets, but also use securitization financing provided by banks and ABCP conduits. These transactions tend to be revolving warehouse facilities. In addition, some vehicle and equipment issuers use revolving periods for term ABS notes issued in the ABS markets. Unfortunately, the EHRI method of risk retention does not really contemplate or work well for revolving transactions. For that reason, the SFIG vehicle and equipment issuer members strongly support the self-adjusting horizontal option described in Section B.1 of Part I of this Letter.

C. The Risk Retention Rules should be Modified To Accommodate Certain Structural Features of Auto and Equipment Floorplan Securitizations.

1. *Structural features of floorplan master trusts must be taken into consideration in crafting a final risk retention rule for revolving master trusts.*

Several of SFIG's vehicle and equipment sponsors also make floorplan finance loans to dealers and securitize those receivables through revolving master trusts. While these SFIG members generally support the comments made regarding revolving master trusts in Part IV of this Letter, they wish to emphasize to the Joint Regulators certain comments made in Part IV which are of particular importance to the floorplan sponsors.

Commentators on the Original Rule provided the Joint Regulators with summaries of the typical structures used in floorplan securitizations,[226] but SFIG members believe it may be

[226] *See* Business Law Section of the American Bar Association Comment Letter on Risk Retention (July 20, 2011), at 101-102.

helpful to provide the Joint Regulators with additional background information about certain structural features specific to floorplan securitizations. While floorplan master trust structures share many characteristics with the master trust structures in other asset classes, such as credit cards, they do not use de-linked structures and typically do not have multiple trusts or other legacy structures, making the floorplan structures simpler and less complex. A structural diagram illustrating the structure and credit enhancement for a typical floorplan securitization is set forth in Appendix I to this Letter.

First, it is important that the Joint Regulators recognize that floorplan securitizations do not typically require a minimum *pari passu* seller's interest. In fact, the typical minimum *pari passu* seller's interest for floorplan securitizations is 0%, and SFIG members are not aware of any floorplan securitization with a *pari passu* seller's interest higher than 2%. Therefore, unlike credit card securitizations, floorplan securitizations cannot utilize the *pari passu* seller's interest option as their primary form of risk retention. For that reason, floorplan sponsors among the SFIG members have questioned whether the *pari passu* seller's interest option should be the "general requirement" for revolving master trusts, as proposed by the Joint Regulators, as opposed to one of a number of potential options for revolving master trusts.

In the Re-Proposal, the Joint Regulators stated that they were considering whether they should make additional provisions for subordinated seller's interests. Since subordinated seller's interests are utilized as the primary form of credit enhancement in a number of master trust structures currently active in the securitization market, the SFIG members request that the final rule include provisions recognizing this form of risk retention. As explained in more detail below, many floorplan master trust structures utilize a subordinated seller's interest as their primary form of credit enhancement, so the inability to rely on this form of risk retention would leave many floorplan sponsors without a viable alternative for risk retention.

In all floorplan securitizations, the depositor holds a residual interest either in certificated or uncertificated form that provides a specified level of credit enhancement for each series. In floorplan securitizations, this residual interest is often called the "available subordinated amount." The available subordinated amount provides credit enhancement to investors in two ways. First, collections on the available subordinated amount are made available to cover shortfalls in payments to investors, and second, to the extent losses are allocated to the investors' ABS interests and such losses would result in a write-down of the invested amount of the investors' ABS interests,[227] the available subordinated amount absorbs write-downs that would otherwise reduce investors' ABS interests. The available subordinated amount for a series is generally a specified dollar amount and would be reduced during the life of the transaction to the extent collections are used as described in the preceding sentence or losses are absorbed by the available subordinated amount.

In floorplan structures, the subordinated portion of the seller's interest (*i.e.*, the available subordinated amount) represents a *greater* retention of risk by the sponsor than a *pari passu* seller's interest, because such interest provides credit enhancement for investors. As noted in Part IV of this Letter, floorplan sponsors among the SFIG members believe a subordinated

227 *See* Section E.1 of Part IV of this Letter for a discussion of how subordinated interests in a series absorb losses for the benefit of more senior ABS interests.

seller's interest should be recognized on the same basis as a *pari passu* seller's interest, and should be valued at par value rather than fair value. For floorplan master trusts that do not issue premium or interest-only bonds and do not monetize excess spread, the principal amount of the overcollateralization represents a corresponding amount of the credit risk associated with the securitized assets. In fact, floorplan receivables have much lower interest rates than credit card receivables, and excess spread is given little credit, if any credit, by rating agencies in structuring floorplan enhancement. Instead, floorplan enhancement is measured by principal amount, and enhancement levels are significantly higher than in other asset classes due to concerns about the possibilities of manufacturer bankruptcies, resulting in hard enhancement (*i.e.*, principal amount) often in excess of 15-20% and straightforward structures that maintain this level of leverage throughout the life of the transaction.

While the fair value of a subordinated seller's interest or subordinated horizontal interest may be reduced below par to reflect the increased potential for losses, the sponsor has not reduced its exposure to the credit risk of the related securitized assets and, in fact, by subordinating its retained interest has increased its credit risk exposure. From the standpoint of an investor, a retained interest that is subordinated to other ABS interests is a superior form of risk retention. Therefore, floorplan sponsors among SFIG members believe that it would be appropriate to value all retained investor ABS interests issued by a master trust based on par value if the master trust does not issue premium or interest-only bonds and does not otherwise monetize excess spread, and the sponsor or a majority-owned affiliate retains the residual interest in excess spread, which is the case in floorplan master trusts.

2. *Requested modifications relating to series-level horizontal interests and grandfathering for existing securitizations.*

The floorplan sponsors among the SFIG membership request that the Joint Regulators accept the recommendations made in Sections C and D of Part IV of this Letter concerning the special horizontal risk retention option for master trusts and the valuation of such horizontal interests. If floorplan sponsors are not able to utilize a seller's interest or a subordinated seller's interest option, it is critical that the special horizontal interest option for master trusts be modified as described in Section C of Part IV, or else such floorplan sponsors will have no workable option for risk retention.

Floorplan sponsors among SFIG members are also concerned that if the requirements for seller's interests and horizontal interests in the final rule do not give credit for the types of subordinated seller's interests and retained horizontal interests used in the market, then floorplan sponsors would be required to add additional risk retention on top of the significant credit enhancement already provided by floorplan sponsors in these securitizations. These SFIG members believes this result creates an unfair burden for master trust sponsors, and sponsors of floorplan securitizations in particular. Therefore, the floorplan sponsor SFIG members request that ABS interests issued by master trusts prior to the effective date of the final rule be grandfathered as discussed in more detail in Section F of Part IV of this Letter.

3. *Allocations of excess concentrations.*

Virtually all floorplan securitizations incorporate eligibility criteria and concentration limits for the securitized assets as discussed in Section B.3 of Part IV. For example, such structures may limit the percentage of loans in the pool of assets that may be originated by the same dealer. Because receivables arising in a revolving account continue to be sold into the master trust even after the concentration limits may be exceeded, it is typically the case that receivables in excess of these concentration limits (excess concentration receivables) are permitted to remain in the master trust and such receivables may be pledged as collateral for the benefit of investors, but such receivables are often disregarded for purposes of determining the aggregate amount of receivables held by the master trust. Accordingly, SFIG's floorplan sponsor members are concerned that revolving master trusts that have special methods of allocating collections and losses on excess concentration receivables might not satisfy the technical requirements of either the definition of seller's interest or revolving master trust. Therefore, floorplan sponsors among the SFIG membership request that the Joint Regulators be mindful of such features when crafting the final rule, as discussed in more detail in Section B.3 of Part IV.

4. *Excess Funding Accounts.*

The floorplan sponsors request that the Joint Regulators accept the recommendations made in Section G of Part IV of this Letter concerning excess funding accounts. The floorplan sponsors agree that losses are not allocated to excess funding accounts in master trust structures, as excess funding accounts are assets of the master trust, not interests in the master trust to which losses can be "allocated."

D. Eligible Horizontal Residual Interests Should Be Permitted to Receive Interest Distributions.

The definition of EHRI currently does not give sufficient flexibility to vehicle and equipment issuers that will enable those issuers to continue to structure transactions in the same manner as they are currently structured. Further, it results in sub-optimal results later in the securitization transaction when the sponsor is ultimately able to transfer or hedge the retained risk.

It is common for vehicle and equipment sponsors to structure and retain subordinated bonds and to have those bonds rated by rating agencies. An advantage of a rating is that it is easier and cost effective if the issuing entity later decides to sell those bonds. SFIG vehicle and equipment sponsors would like the ability to more effectively sell these subordinated bonds when it becomes permissible to sell or transfer the retained risk. To get those bonds rated, it is necessary to assure that the bonds will receive timely interest each month and that such payments of interest will not be subordinate to payments of principal. Such members request that a subordinated bond can be counted as part of an EHRI if (1) its rights to interest are subordinated each month to all distributions of interest on all ABS interests sold to third parties and (2) its rights to principal are subordinated each month to all distributions of principal on all ABS interests sold to third parties. However, it would not be necessary, prior to any event of default or amortization event, for interest on the EHRI to be subordinated to principal on the ABS interests sold to third parties.

E. The Duration of Transfer and Hedging Limitations Should be Reduced to Reflect the Relatively Short Terms of Auto and Equipment Loans.

We very much appreciate that the Joint Regulators have permitted the transfer and hedging of the retained risk at some point prior to the end of the life of the securitization transaction. For vehicle and equipment issuers, however, due to the short lives of these assets, these provisions are not as useful for vehicle and equipment securitizations as they are for other asset classes.

First, under § __.12(f)(1) of the Re-Proposal, the prohibitions on sale and hedging would expire on or after the date that is the latest of (1) reduction of unpaid principal balance of the securitized assets to 33% of closing date balance, (2) reduction of unpaid principal obligations under ABS interests to 33% of closing date balance and (3) two years after the closing date. However, most auto loans have maturities between 2 to 6 years, which results in a weighted average life for a pool of auto loans that falls somewhere within that range. Due to the much shorter average life of a typical vehicle or equipment securitization, we request that vehicle and equipment sponsors be permitted to sell or hedge their retained interests at an earlier point in time.

Second, the test described above uses the "unpaid principal balance of the securitized assets as of the closing of the securitization transaction." As discussed above, virtually all vehicle and equipment sponsors use a cutoff date, often at the end of a calendar month, to determine the balances of the securitized assets for purposes of the securitization transaction. Most sponsors have difficulty determining information about the securitized assets at other times during the month, including on the closing date. We request that the Joint Regulators permit the use of the cut-off date balance of the securitized assets rather than the closing date balance.

Third, SFIG vehicle and equipment issuer members would like to clarify that the "total unpaid principal obligations under the ABS Interests issued in the securitization transaction" includes only the ABS interests sold to third parties. If that's not correct, SFIG members would appreciate further clarification on how the Joint Regulators would like sponsors to calculate the amount of the unpaid principal obligations of the residual interest in the transaction, which does not typically have a nominal "principal" balance, for purposes of this test.

To accommodate the foregoing concerns, we request that the prohibitions on sale or transfer instead expire on or after the date that is the *earlier* of (i) two years after closing date and (ii) the later of (A) the reduction of unpaid principal balance of the securitized assets to 33% of *cut-off date* balance and (B) reduction of unpaid principal obligations under ABS Interests *sold to third parties* to 33% of closing date balance

F. The Qualifying Auto Loan Exemption Should be Modified to Reflect Market Realities.

SFIG members appreciate that the Joint Regulators attempted to include an exemption for QALs. However, the proposed exemption in the Original Proposal would not have been useful to auto originators, and the Joint Regulators received many comments to that effect. Although the Re-Proposal addressed some of these concerns, the Re-Proposal still has many shortcomings rendering it unusable for SFIG's auto ABS sponsors. SFIG auto issuer members would welcome the opportunity to meet with the Joint Regulators to help develop an exemption that would meet the Joint Regulators' requirements and also work for auto issuers.

The auto finance industry supports a "prime" standard for QALs. However, we are not able to support underwriting standards that either are not helpful in analyzing the creditworthiness of an auto loan, or requirements which cannot realistically be applied either in the origination process of an auto loan for a sale of a vehicle at a dealership or which cannot reasonably be complied with at the time of a securitization.

Perhaps the most important concern SFIG auto issuer members have with the proposed exemption was the lack of recognition that the entire auto lending business must work in connection with the sale of a vehicle by an auto dealer while the customer is present at the dealership

Below we provide our specific concerns with the proposed exemption.

1. *Debt-to-Income (DTI) Verification is Unnecessary and Unworkable, But Auto Issuers Could Make DTI Calculations Without Verification*[228]

In their comments to the Original Proposal, a large group of vehicle originators commented that auto loan originators do not regularly use borrower DTI ratios as a key component in determining whether to originate a prime auto loan because it is not a significantly predictive factor to determine whether a prime auto loan borrower will repay its loan. They also commented that they believe that focusing on DTI ratios is inappropriate for prime auto loan borrowers because they have found that these borrowers often prioritize payment of their auto loans over other debt obligations, both because their auto loan payments are often lower than their other monthly obligations (*e.g.*, mortgage payments) and because they require automobiles for their day-to-day lives and cannot risk having their vehicles repossessed.

The SFIG auto ABS sponsors believe it is unduly burdensome on the auto originators for the Joint Regulators to set requirements for an auto loan exemption that are not used in the origination of the most creditworthy auto loans originated in the U.S. Further, the SFIG auto issuers cannot understand how the regulatory agencies could have concluded that DTI is a meaningful figure in calculating a customer's ability to repay the loan when originators typically do not use DTI as part of their origination standards. For SFIG's auto ABS sponsors, only less credit-worthy obligors would have a DTI calculation because the originator would need to perform additional work to assure that the loan was a satisfactory loan.

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[228] Recent data indicates that consumers in the United States prioritize vehicle loan and lease payments above other debt obligations. *Payment Hierarchy Analysis: A Study of Changes in Consumer Payment Prioritization from 2007 through 2011*, Trans Union (2012). Vehicles are an essential part of everyday life, and are often the only practical way for consumers to get to work. For this reason and many others, U.S. consumers often will sacrifice their homes and other credit obligations in order to keep their vehicles. Similarly, in the case of equipment, customers typically are financing or leasing equipment or vehicles that are essential to the conduct of their ongoing businesses and are a source of income.

The SFIG auto issuers certainly agree that "assessing a borrower's ability to repay is important in setting underwriting criteria to identify automobile loans that would not be subject to risk retention."[229] The auto issuers believe they do this for every auto loan they originate, including every prime auto loan they originate. For prime auto lending, the ability to repay is the most important underwriting criterion, while subprime lending must to a greater extent take into account the value of the vehicle because of the somewhat greater likelihood of default.

The problem with the Joint Regulators' requirement to use DTI is not the requirement to calculate the DTI for an obligor. Instead, the problem is that the requirement to verify the items of debt and income are impractical in the context and timing of typical auto sales because auto loans are typically originated and approved while a customer is purchasing a vehicle on a weekend or in the evening at a dealership. Auto purchasers typically do not bring debt verification documents with them to the dealership when they go shopping. Auto loan originators rely on the information in the obligor's credit application and the corresponding information in credit bureau reports. A DTI calculation could work for the auto finance industry if auto loan originators are permitted to rely on the information in the credit application and credit bureau report rather than a separate independent verification.

2. *Down Payment Requirement is Inconsistent with Prime Obligors*

Prime auto loans do not require down payments. This is due to four reasons:

<u>First</u>, new vehicles are a depreciating asset. When a new vehicle is sold and leaves the dealership, it becomes a used vehicle and suffers an immediate decline in value. As a result of this decline in value, auto lenders rely primarily on the ability of an obligor to repay the auto loan rather than rely significantly on the value of the vehicle. Therefore prime auto lenders have created underwriting criteria intended to result in only a relatively small number of defaults and repossessions. As the creditworthiness of the obligor decreases, the likelihood of a potential default and repossession increases, and therefore there is a greater reliance on the value of the vehicle.

<u>Second</u>, because the vehicle is a depreciating asset, obligors don't expect their vehicles to have value as an investment, and obligors do not have "strategic defaults" when their investment turns out not to have been profitable. A down payment does not prevent "strategic defaults."

<u>Third</u>, auto loans tend to have a much shorter weighted average life than real estate mortgages. Most auto loans have a weighted average life of approximately 2.5 to 3 years. As a result, there is far less time for the obligor's circumstances to change before most of the loan is repaid. A down payment is less necessary because much of the loan is repaid quickly.

<u>Fourth</u>, most auto loans are originated at dealerships for an obligor who is then seeking to purchase a vehicle. The entire auto loan business is structured around a simple principle: when the customer is a prime obligor who meets high underwriting standards, don't let the obligor walk out and buy from another dealer because of a failure to timely and quickly approve a loan. Automobile loans are often "on-the-spot" applications that are completed, submitted and

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[229] *Id.*

approved (or denied) at the automobile dealership. Automobile purchasers generally walk into a dealership ready to contract for and finance an automobile. For these prime customers, the auto lenders compete for the dealer's business based on, among other things, how quickly they can auto-decision or otherwise quickly approve the loan, the favorability of their loan terms and avoiding customer inconvenience. No prime auto lenders require any down payment for prime customers. For the Joint Regulators to require otherwise is impractical because the dealers would select other lenders.

We request that the Joint Regulators eliminate the down payment requirement from the QAL exemption because it would not be helpful to sponsors, the industry or investors.

We note that the Joint Regulators are currently considering not requiring a down payment for QRMs. As explained above, down payments are far less important to the level of credit risk associated with depreciating assets such as automobiles and equipment than they are to investment assets such as residential real estate. Accordingly, SFIG auto issuers believe that the Joint Regulators should treat QALs consistently with QRMs and not require a minimum down payment for QALs and would be surprised if the final rule required no down payment for QRMs but continued to require a down payment for QALs.

3. *Has any Qualifying Automobile Loan Ever Been Originated?*

The Joint Regulators intend that a significant portion of the mortgage market will qualify as QRMs. However, the SFIG auto issuers are not aware that any of them have ever in the past originated even one auto loan that would have qualified for the QAL exemption.

There is nothing in the Dodd-Frank Act or the Re-Proposal that suggests that either Congress or any of the Joint Regulators believed there were important deficiencies in the origination of auto loans that would require important changes to underwriting standards for prime auto loans. The DTI verification and down payment requirements of the proposed QAL exemption would require an overhaul of the auto financing business to be useful to any auto originator. Most auto originators would be unwilling to undertake that overhaul because it would be inconsistent with their business model.

4. *Risk Retention for Blended Pools*

SFIG auto issuer members very much appreciate that the Joint Regulators have considered prior comments and have made allowances for blended pools in the proposed exemption. As currently proposed, a pool with 90% QALs and only 10% non-QALs would still require 2.5% risk retention. SFIG auto issuer members believe that such a pool should have a risk retention requirement of only 0.5%. They believe that the "cliff effect" in the proposed rule is far too dramatic, and as a result, issuers would never have an incentive to have more than 50% of their pools composed of QALs unless they could achieve pools that are 100% qualifying auto loans.

SFIG auto issuer members therefore request that blended pools with qualifying assets be allowed the benefit of decreased risk retention proportionately to the pool's qualifying asset ratio. In other words, a pool with 90% QALs would have a risk retention requirement of 0.5% and a pool with 45% QALs would have a risk retention requirement of 2.75%.

5. *Sponsors Have No Ability to Determine that Payments are "Contractually Current" at the Securitization Closing*

In the Re-Proposal, the Joint Regulators stated:

"The agencies are proposing the same requirements as in the original proposal for verification that the automobile loan is current when it is securitized. The agencies believe a securitization exempt from risk retention should contain only current automobile loans."[230]

We certainly agree that QALs should be current as of the latest date when information about the auto loan pool is determined when those loans are securitized. However, there are important problems with a requirement that any determination be made as of the closing date for the securitization.

First, the Joint Regulators' requirement ignores the basic timing of and legal rules surrounding a typical ABS offering, particularly Rules 159 and 193 under the Securities Act of 1933. Most originators typically prepare a "Red Herring" prospectus or offering memorandum containing, among other things, detailed information about the pool of auto loans to be securitized. Prior to finalizing the prospectus or offering memorandum, the sponsor is required by Rule 193 to perform due diligence procedures to assure that the sponsor has reasonable assurance that the pool asset information in the prospectus or offering memorandum (most sponsors follow similar procedures for private or 144A offerings) is accurate in all material respects. It is often necessary for the pool of receivables to be selected before the Rule 193 procedures are performed. As a result of Rule 159 under the Securities Act, most sponsors assure that all information is contained in the Red Herring so that changes are not necessary after investors are committed to purchase the securities. Rule 193 and Rule 159 cause sponsors generally to assure that the Red Herring is final in virtually all respects other than information regarding the pricing of the securities or information dependent on pricing.

After printing the Red Herring, there may be a road show, either in person or an electronic road show. An in-person road show is particularly more likely for a new sponsor. A series of in-person road shows will often visit multiple cities, sometimes multiple countries, and usually takes a full week. Then the deal will be formally "launched" into the market and a few days later, the securities will be priced and sold to investors. Promptly after pricing, the final prospectus or offering memorandum is printed, with final pricing information and pricing-dependent information, and sent to investors with confirmations to confirm the sales of securities to those investors. The securitization closing typically takes place one week after pricing, after investors have already received the final prospectus or offering memorandum. The entire process, from pool selection through road shows, launch, pricing and closing can often take about four weeks.

To comply with Rules 193 and 159, we need the pool selection to take place prior to printing the Red Herring prospectus or offering memorandum, and the Red Herring to be essentially final at the time it is printed.

230 *Id.* at 57,985 (emphasis added).

The Commission has recognized this in Regulation AB by requiring that delinquent and non-performing assets be measured as of the "measurement date" (*i.e.*, the cutoff date) to determine whether the security is an "asset backed security" under Regulation AB.

The proposed QAL exemption requirement, however, would require sponsors to revisit the receivables in the pool, and to potentially eliminate some receivables after the final prospectus is already printed. For a transaction with extremely high credit quality, this should not be a requirement.

Second, it is simply impractical for any sponsor to confirm the status of any loan on any particular date. None of the SFIG auto sponsors have the capability to produce this information about an auto loan pool on the closing date of a securitization. The information regarding the assets being securitized that is presented in an offering document is as of the related cutoff date and the related credit enhancement is based off of this data, not any updated closing date information.

Third, if some auto loans expected to be QALs were removed at or after the closing of the securitization, the "qualifying asset ratio" might be adversely affected and the sponsor may discover only at closing that it failed to retain a sufficient amount of risk retention in the transaction. These determinations must take place at an earlier stage in the process to be manageable.

For the above reasons, SFIG auto sponsors propose that the requirement for loans included in a securitization to be contractually current be measured as of the cut-off date on which a pool of loans is allocated to such securitization, rather than on the closing date for such securitization.

However, , if the final rule requires that a determination be made as of the securitization closing date, SFIG auto issuer members propose that the terms of the exemption allow the sponsor to subsequently check after the closing date whether the loans included in the transaction were in fact current as of the securitization closing date, and repurchase any loans which were not current as of the securitization closing date.

Finally, SFIG members have been very confused by the term "contractually current" as used in § __18(a)(7).[231] It would be helpful for the language of the final rule to explicitly state that that QALs must be "no more than 30 days past due" rather than "contractually current" as of the applicable date. This is how virtually all auto deals are currently done. This would also be consistent with Regulation AB. Under Item 1101 of Regulation AB, an asset is not "delinquent" unless it is more than 30 or 31 days (or a single payment cycle) past due.

The SFIG equipment issuers wish to point out that, if the Joint Regulators agree to provide a qualifying equipment loan exemption, equipment loan issuers would have the same problems as auto issuers with the "contractually current" requirement.

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231 *Id.* at 58,042.

6. *Timing of Internal Control Certification*

SFIG auto and equipment issuer members agree with the objections to the internal control certification set forth in Section C of Part I of this Letter. However, if the delivery of an internal control certification remains in the final rule, SFIG auto and equipment issuer members would appreciate if the Joint Regulators would allow for the evaluation and delivery to be performed annually rather than within 60 days of the cutoff date to select the pool. It would be more efficient and far less burdensome (in terms of expense and time) if it could be done at the same time as the annual reporting required by Item 1122 of Regulation AB. Particularly for sponsors who offer multiple transactions each year, a requirement to perform this evaluation within 60 days of each cutoff date would require multiple evaluations each year. SFIG auto and equipment issuer members believe these multiple evaluations would be costly, without significant incremental benefit to investors.

7. *Requirement that Vehicle is "for Personal, Family or Household Use"*

Many of the SFIG auto issuers originate both personal and commercial loans through their retail channel. These issuers believe that commercial vs. personal use should not matter for purposes of the QAL exemption if commercial loans are originated through the same retail channel (*i.e.*, at the dealership) and the performance of those loans is the same. SFIG auto issuers have found that commercial loans that are originated through dealerships with substantially the same criteria as personal loans perform substantially the same as such personal loans and thus, this distinction should not be included in the QAL exemption.

It is impossible for any lender to know or monitor how the vehicle will be used, and it is impractical for the lender to be responsible for knowing or monitoring whether the vehicle is being used for "personal, family or household use." SFIG auto issuers would like to see this requirement eliminated.

Alternatively, if the Joint Regulators are unwilling to completely remove this requirement, we request that the requirement be changed to one under which the "obligor represents in the auto loan documents that the purchase of the vehicle is for personal, family or household use." Auto loan originators can control the provisions of their documents, but are unable to monitor the use of the vehicle after the auto loan is funded.

8. *Exclusion of Motorcycles*

SFIG issuer members that finance motorcycles believe that the exclusion of motorcycles is inappropriate. The Joint Regulators' conclusion seemed to be based on unsupported assumptions that consumers might be less likely to make their payments on motorcycle loans than auto loans because the motorcycle might be more likely to be used for recreational purposes. The performance of motorcycle loans is comparable to similar quality auto loans, indicating the priority obligors in fact place on their motorcycle loan payments, regardless of whether they use their motorcycle as a recreational vehicle or as their primary mode of transportation. We also note that the Re-Proposal would allow second homes and vacation homes to qualify as QRMs.

SFIG motorcycle loan issuers believe that the exemptions from the Risk Retention requirements should be based on the quality of the underwriting standards and the performance of the loans, not based on the particular asset that is financed. Like other "prime" loans, prime motorcycle loans are originated based primarily on the obligor's ability and likelihood to repay the loan. If the underwriting criteria for motorcycle loans is sufficiently high, such loans should qualify for a reduced risk retention requirement. Otherwise, the Joint Regulators are essentially saying that there are no underwriting standards, no matter how high those standards might be, that would qualify for a reduced risk retention requirement.

G. **The Joint Regulators Should Provide a Qualifying Equipment Loan (QEL) Exemption**

The SFIG membership appreciates that the Joint Regulators included an exemption for qualifying commercial loans. However, the exemption provided in the Original Proposal and Re-Proposal for qualified commercial loans is not useful to equipment (*e.g.*, agricultural equipment, construction and mining equipment, etc.) lenders, as the underwriting criteria needed to meet the exemption requirements do not appropriately reflect the underwriting standards used within their businesses. SFIG equipment finance industry members believe that equipment loans are inherently different from commercial loans, as broadly defined in the regulation, and believe that equipment loans should be specifically defined and granted a separate set of exemption requirements from the ones currently provided for in the proposal related to commercial loans.

Equipment ABS includes several different types of assets and underlying borrowers. Each lender generally follows similar processes for underwriting these types of loans, notably a focus on both the credit quality of the borrower and the value of the equipment. However, each lender will then tailor its criteria to the specific industry in which it lends. Thus, developing an overall guideline that would apply to each type of lender would be problematic. However, we have generated a set of criteria (in the spirit of criteria utilized for other asset types), while realizing that these guidelines may not be applicable to all lender types due to these industry differences.

While arguments could be made that, based on the excellent performance of equipment ABS and its lack of involvement in any of the problems that caused the financial crisis, no risk retention is needed for this asset-class, we understand the Joint Regulators' desire for specific, bright-line criteria and thus, we are proposing the following for consideration. SFIG equipment finance industry members would welcome the opportunity to meet with the Joint Regulators to help develop an exemption, and the related definitions and criteria, that would meet the Joint Regulators' requirements and also work for equipment ABS issuers.

Equipment ABS definition. While the ABS industry has developed a common understanding of what constitutes an equipment-backed ABS, there is currently no precise legal definition. Given the diversity of types of equipment that have historically fallen under the category of equipment ABS, we suggest utilizing one of the definitions previously agreed to by other regulatory bodies, such as the Federal Reserve Board[232] or under the TALF regulations[233].

Loans vs. Leases. There are many types of leases utilized by the equipment lending industry, some including residuals, level payments or balloon. In order to avoid the complexity of implementing criteria for each lease type, we are proposing that only loans be considered for QEL exemption.

Payment Schedules. As is common in certain equipment loans, the payment schedules of the loans (monthly, quarterly, etc.) are tailored to specific borrower types or sources of income in order to achieve the highest potential success of timely payment. It is very common for agriculture equipment loans to have annual payments for farmers that harvest their crops once a year, and this strategy has proven very successful. Thus, unlike residential mortgages for example, level monthly payments on equipment loans are not necessarily indicative of higher loan performance and so, monthly payments should not be a requirement for QELs. However, we do suggest that any QEL be fully amortized by the end of the loan term.

ABS Structures. Generally, equipment ABS structures have been very simple and understandable to investors. Equipment securitizations do not represent resecuritizations or complex CDO-type structures. Equipment lenders have generally retained a first-loss economic residual interest in the securitized assets and do not use an "originate-to-distribute" business model. We recommend that a reinvestment period not be permitted in a QEL ABS.

Underwriting Criteria. Equipment lenders generally have had a long history of developing underwriting criteria that focus on both the ability of the borrower to make timely payments as well as the value of the underlying equipment. Underwriting criteria for equipment loans have similarities to other asset types, such as autos (in terms of the essential need by borrowers for the asset), residential mortgages (in terms of equity in the underlying asset), and commercial loans (in terms of the financial ability of a borrower to make timely payments). Because the underwriting criteria for equipments are not identical to other asset types, this also supports the need for a separate exemption for equipment loans. The following is a summary of the relevant underwriting criteria:

1. **Type –** QEL must be in the form of a loan or installment sales contract (not a lease) and must fully amortize the principal of the loan prior to its maturity date.

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232 Federal Reserve Study at pg. 6. The Federal Reserve Study defines "Equipment Loans and Leases" as "loans and leases extended to facilitate the purchase or lease of business, industrial, and farm equipment, including 'large ticket' items such as bulldozers and backhoes and 'small ticket' items such as computers and copiers."

233 Term Asset Backed Securities Loan Facility, a Federal Reserve credit facility authorized under section 13(3) of the Federal Reserve Act. "Eligible equipment-related receivables will include loans and leases relating to business, industrial, and farm equipment. Such equipment includes, but is not limited to, agricultural, construction, or manufacturing equipment; trucks other than light trucks; smaller ticket items such as communications, office, and medical equipment, computers, copiers and security systems; and equipment types (other than aircraft) that have collateralized equipment ABS in the past. The credit exposures underlying an eligible equipment ABS may include a mixture of loans and leases on a mixture of types of equipment."

2. **Term** - Most equipment backing a loan in an ABS pool is designed to have a long useful life, some extending to 15 years or more. The loans, on the other hand, are generally much shorter and similar to an auto loan. This allows for equity in the equipment to build up faster than other asset types that match the useful life of the asset to the maturity of the loan. To maintain this common convention, we suggest that a QEL have an original term not exceeding 84 months.

3. **Equipment Value** - The value of the equipment is an important part of the underwriting criteria. In order to protect the value of the equipment, we suggest that a QEL contain the following requirements:

    a. a security interest in the equipment is obtained and the borrower is required (unless the lender or servicer does so) to pay taxes, charges, fees, and claims, where non-payment might give rise to an adverse lien on the related equipment;

    b. the borrower is required to obtain and maintain physical damage insurance on the equipment;

    c. the borrower is required (unless the lender or servicer does so) to maintain the physical condition of the equipment;

    d. the lender (or servicer) is permitted to inspect the equipment.

4. **Down Payment** - To protect against declines in the value of the equipment, we suggest that the borrower of a QEL provide a down payment (in the form of cash or trade-in allowance) of at least 10% of the purchase price of the equipment.

5. **Credit Reports, Verifications and Experience –** Because equipment borrowers are generally businesses, equipment lenders use a combination of sources to obtain the information needed to determine the financial strength of the borrower. Past payment performance on non-income producing, consumer-related debt (such as mortgages, credit cards or auto loans) may not be a strong indicator of the borrower's performance on an equipment loan because the equipment is frequently considered essential to the borrower's income. Past performance with the same lender is an important aspect of the evaluation because many borrowers are repeat borrowers for certain equipment types. Thus, while lenders may obtain a credit report or financial statements, there are many other sources of information that may supersede the need for these specific reports and consequently, credit reports or financial statements (and the verifications derived from them) should not be a requirement for QELs. As stated above, equipment lenders have developed over time their underwriting criteria and the specific expertise needed to prioritize what information is most important for specific borrower analysis. Accordingly, we recommend that QELs would only qualify for an exemption if the lender is sufficiently experienced that it has performed underwriting assessments of equipment loans for at least three years.

6. **No More Than 31 Days Past Due** - We recommend that a QEL be no more than 31 days past due on the *cut-off date*. Additionally, the SFIG equipment loan issuer

members add our support to the comments set forth above in the Qualifying Auto Loan section of this letter regarding the need to measure past due receivables as of the cut-off date, rather than closing date, due to the inability of issuers to make a past due determination on the loans as of the closing date.

H. The Definition of Seasoned Loans Should be Modified to Reflect the Relatively Short Terms of Auto and Equipment Loans.

In the Re-Proposal, the Joint Regulators stated that "the agencies believe that risk retention as a regulatory tool to promote sound underwriting is less relevant after loans have been performing for an extended period of time." Accordingly, the Re-Proposal does not require risk retention for a securitization transaction that is collateralized by only seasoned loans, subject to certain requirements. While SFIG auto issuer members appreciate this exemption, the definition of "seasoned loans" for auto loans is not practical. Unlike mortgage loans, auto loans are of a much shorter duration as discussed above. Most auto loans have maturities between 2 to 6 years, which results in a weighted average life for a pool of auto loans that falls somewhere within that range. A requirement that a "seasoned loan" be performing for two years may be equal to the full term or more than half the term of many auto loans. Therefore, our auto issuers propose that for auto loans, a "seasoned loan" be re-defined as a loan that has been outstanding and performing for the earlier of (1) two years, or (2) the period until the outstanding principal balance of the loan has been reduced to 33 percent of the original principal balance.

IX. STUDENT LOANS.

A. FFELP Loans Should Be Exempt From the Risk Retention Rules Like Other Assets Backed by Federal Guarantee Programs.

Many in the SFIG membership continue to believe that the final rule should include an exemption from risk retention for ABS collateralized or otherwise backed solely by FFELP loans (FFELP ABS) because FFELP loans are Federally guaranteed and no longer originated.[234] Under § __.19(b)(1) of the Re-Proposal, securitizations that are collateralized by "residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed (in whole or in part) as to the payment of principal and interest by the United States or an agency of the United States"[235] are exempt from the proposed rule's risk retention requirements. FFELP loans are guaranteed at 97-100% by the Federal government. Accordingly, many SFIG members believe that there is no reason to treat FFELP loans differently for risk retention purposes than these other assets that enjoy Federal guarantees.

Furthermore, a complete exemption of ABS collateralized or otherwise backed 100% by FFELP loans would in no way encourage lower underwriting standards given that FFELP-qualified student loans were required to be originated in full compliance with the Higher Education Act and the FFELP rules and regulations and, moreover, FFELP loans can no longer be originated. These SFIG members disagree with the Re-Proposal's assertion that risk retention for FFELP ABS could still provide a benefit since "[s]ponsors would therefore be encouraged to select assets for securitization with high quality underwriting standards."[236] The analysis of underwriting standards for FFELP loans is simply irrelevant. Financial institutions originating FFELP loans were not permitted to impose their own underwriting standards, and applicants were not "qualified" by virtue of specified creditworthiness criteria. Rather, the FFELP program was intended to provide access to all students in the U.S. attending eligible institutions. The Department of Education and the FFELP regulations specified all permissible criteria for origination. The predominant, and in most cases the only, relevant credit feature of the loans for purchasers of FFELP ABS is the Federal government guarantee. Indeed, since FFELP loans no longer can be originated, applicability of the risk retention rules or not cannot impact underwriting criteria for such loans.

The Re-Proposal also suggests that imposing risk retention requirements may help facilitate appropriate risk management practices for servicing FFELP Loans.[237] However, from many SFIG members' perspectives, the view that risk retention is needed to encourage proper servicing is highly questionable. Similar to FFELP origination standards, the Department of Education and the FFELP regulations specify rigid servicing standards, which, if not met, result in the partial or complete loss of the government guarantee. While the SFIG membership agrees that servicing is vitally important, most members believe that the substantial incentive provided

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234 Today, all new Federal government guaranteed student loans are originated directly by the Federal government through the Federal Direct Loan Program.

235 *Id.* at 58,043.

236 *Id.* at 57,971.

237 *Id.*

by the potential loss of the government guarantee for improper servicing is sufficient to align incentives with respect to FFELP loans.[238]

The Re-Proposal's improved servicing rationale for risk retention also misinterprets the traditional relationship between the securitization participants in FFELP transactions. Typically, if a servicer is not in compliance with the applicable contractual requirements, which includes adherence to the FFELP servicing standards, the residual investor (who retains the first loss risk in the FFELP loans) does not control the removal of such servicer. The indenture trustee acting at the direction of the controlling class or classes of investors has the power to replace the servicer. Thus, risk retention is neither needed nor appropriate for fostering proper servicing. Although FFELP loans are no longer originated, FFELP securitizations continue to be issued to finance or refinance those FFELP loans on the balance sheets of financial institutions and state and nonprofit entities that either were not able to finance such loans during the financial crisis or now need to refinance such loans to reduce financing costs. We believe that FFELP securitizations will continue to be an important component of the financial markets for the foreseeable future, given the significant volume of FFELP loans outstanding and their long terms

B. FFELP Loans Should Never Be Subject to Risk Retention Thresholds that Exceed the Actual Risk to Investors.

If the Joint Regulators do not find the above arguments compelling enough to warrant a complete exemption of FFELP loans, SFIG members generally agree that the 5% risk retention requirement should apply solely to the portion of each FFELP loan pool—up to 3%—that is *not* guaranteed. In other words, the 5% risk retention requirement should apply to, at most, 0.15% of each FFELP loan pool.[239]

Lastly, because FFELP ABS often include a mix of 100%, 97%, and 98% guaranteed loans, the appropriate risk retention rate should be weighted by the types of loans included in the pool, instead of simply imposing the highest level applicable to any single loan in the entire pool, as is done with the blended risk retention rates applied to blended pools of other consumer finance assets. Otherwise, the retained piece on FFELP pools could exceed 100% of the credit risk. For example, if a pool consisted of 99 loans with a 98% guarantee and one loan with a 97% guarantee, the "credit risk" to investors would be slightly over 2%. However, under the Re-Proposal, the required risk retention would be 3%. SFIG members do not generally believe that it is appropriate in any circumstance for a sponsor to be required to retain risk above the actual risk to purchasers in the transaction.

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238 A FFELP servicer must properly administer the loans or else compensate the owner of the loan for the loss of the guarantee. In addition, should such losses become systemic, the potential loss of its status as an "eligible servicer" of FFELP loans could endanger the servicer's entire business operations, a feature that on its own provides sufficient incentive to maintain the requisite servicing standards.

239 At such a level, the required risk retention has essentially become *de minimis* further supporting the argument that FFELP ABS should be removed entirely from the risk retention requirements, as it is for other federally guaranteed asset types.

X. RESECURITIZATIONS.

The SFIG membership appreciates the work of the Joint Regulators in considering the many comments related to the exemptions for certain resecuritization transactions in the Original Proposal. SFIG's members further appreciate the work of the Joint Regulators in expanding the exemption to take into account resecuritizations of certain RMBS that are structured to address prepayment risk. While this is certainly a step in the right direction, many of SFIG's members feel that further modifications are needed. Specifically, they seek to ensure that the Joint Regulators' concerns about the re-allocation of credit risk are addressed without stifling resecuritization as an important portfolio management tool. These members also seek further amendment of key terms and measures in order to foster the smooth operation of resecuritization transactions.

This section of the comment letter proposes the following four key modifications:

1. building on the exemption for the resecuritization of compliant or exempted ABS in order to allow for unrestricted tranching in a resecuritization transaction consisting of a single tranche of compliant or exempted ABS;

2. expanding the definition of "originator" to include ABS owners who initiate resecuritizations but who are not named as the sponsor of the deal;

3. allowing resecuritizers to hold risk by retaining 5% of the underlying resecuritized security; and

4. expanding the resecuritization exemption to include single security resecuritizations of legacy ABS, or QABS.

Adopting these measures would avoid negative consequences that may result from the implementation of the Re-Proposal, such as illiquidity and possible downward pressure on underlying ABS prices and making it more difficult for financial institutions to meet their capital and regulatory requirements.

A. Unrestricted Tranching in a Resecuritization of a Single Tranche Compliant or Exempted ABS Should Be Allowed.

The Joint Regulators recognized that certain resecuritizations are a particularly effective form of managing prepayment risk for RMBS.[240] RMBS tend to have longer maturities and a higher prepayment risk than other forms of ABS. Resecuritization permits structures that protect against prepayment risk and gives purchasers greater certainty that they will receive their expected cash flows over time. The Re-Proposal facilitates the use of resecuritization to manage prepayment risk subject to certain requirements. The transaction must be a resecuritization consisting of a pool of first-pay classes of ABS, which themselves must be collateralized by first-lien residential mortgages located within the US or its territories and which must be compliant with §15G of the Exchange Act (15G Compliant ABS). Under the Re-Proposal, any tranche of

[240] *See id.* at 57,973.

ABS issued in the resecuritization would be required to share *pro rata* with all other tranches in any realized principal losses. Therefore, the Re-Proposal would allow a pool of first-pay classes of ABS to be structured to reallocate prepayment risk but would specifically prohibit any structure that reallocates credit risk. For the reasons discussed below, many SFIG members believe that the resecuritization exception should be expanded to permit unrestricted credit and time tranching in any transaction that resecuritizes a single 15G Compliant ABS.

Resecuritization transactions are undertaken for a variety of different reasons. One common scenario involves a bank or other institution subject to capital or other regulatory rules that prohibit or otherwise make unattractive the holding of downgraded securities. In these circumstances, the downgraded security can often be repackaged so that a senior tranche issued in the resecuritization is assigned a rating consistent with the owner's regulatory or other needs and the subordinated tranche is sold to a dealer or third party. Through the process of resecuritization, the owner in this example is able to avoid selling all but a portion of its position in the underlying downgraded security. To achieve its purpose, this transaction requires the reallocation of credit risk.

Importantly, this proposal is limited to non-pooled resecuritizations consisting of a single tranche of exempt or compliant ABS. Many of SFIG's members believe that this expanded exemption furthers the balance that the Joint Regulators have sought to achieve between creating risk retention rules that ensure good underwriting and increased transparency and minimizing the disruption to the resecuritization market.

The restriction on credit tranching in a resecuritization of compliant or exempt ABS fails to further the policy outlined by the Joint Regulators. By definition, any tranche issued in a resecuritization of compliant or exempt ABS could have been issued in the original underlying offering. In all cases, the tranching of bonds issued in the original underlying compliant or exempt transaction could have been tranched and structured to accomplish precisely the same re-tranching as any resecuritization of a single tranche issued in that offering. Since any tranche created in the resecuritization could have been created in the original compliant or exempt securitization, we believe no important policy purpose is served by prohibiting credit tranching on a single, non-pooled tranche of compliant or exempt ABS.

We understand that the Joint Regulators view a sponsor's selection of the particular ABS that will constitute an ABS pool for resecuritization purposes to be tantamount to an "underwriting" decision. Our proposal addresses it by eliminating the ability of a sponsor to select multiple ABS for a resecuritization pool and requiring that a single tranche of ABS be resecuritized in a non-pooled transaction.

The Joint Regulators also have expressed concern that the process of pooling multiple ABS might be used to obscure the relatively poor credit quality of one or more particular ABS that comprise the resecuritized pool. Again, our proposal addresses the complexity and lack of transparency that could exist in a pooled ABS resecuritization by limiting the transaction to a single tranche of non-pooled compliant or exempt ABS. The inherent simplicity and transparency of our single security non-pooled proposal allows purchasers to focus on the performance of a single security without concern that the performance of one security might obscure the underperformance of another.

SFIG members also recognize the Joint Regulators' concerns relating to managed CDOs, and for that reason, we propose that no resecuritization of exempt or compliant ABS would be permitted to revolve, reinvest, or be subject to portfolio management. Unlike a CDO—which consists of a pool of multiple ABS interests, often actively managed—the collateral in this proposal is limited to a single 15G Compliant ABS. Furthermore, the narrowness of the proposed exemption would not permit the exemption's application to transactions with managed pools of collateral, thus ensuring that the resecuritization exception cannot be used to pool ABS of differing quality and collateral type as a kind of back-door CDO.

The Re-Proposal's prohibition on credit tranching significantly undermines the utility of the current narrow exemption and would unnecessarily disrupt the resecuritization market. Reallocation of credit risk is a key benefit of resecuritizations and an important motivating factor in the resecuritization marketplace. As noted in the example above, the tranching of credit risk on downgraded securities is a principal motivation behind the vast majority of recent resecuritization transactions. Resecuritizations can help financial institutions meet capital requirements and avoid artificially depressing ABS prices by forcing the sale of otherwise attractive securities. Resecuritization can also help owners of ABS to leverage senior pieces of their holdings, or transfer subordinate pieces. Reallocation of credit risk encourages market efficiency by permitting ABS owners to finance their portfolio and free up capital for other investments.

In sum, we believe our proposal strikes a conservative balance between the concerns of the Joint Regulators regarding underwriting practices, transparency of credit performance, and the risks of managed pools. Expanding the existing exemption to allow credit and other tranching of a single compliant or exempted ABS in a non-pooled resecuritization will enable ABS owners to continue to manage their portfolios efficiently, and will not expose resecuritization purchasers to any concentration of risk that could not have been structured as part of the original offering of the compliant or exempt single tranche of ABS. Additionally, the narrowness of the proposal maintains the Joint Regulators' restrictions with respect to CDOs and ensures that the aims of risk retention are met with a high degree of transparency.

B. <u>The Definition of "Originator" Should be Expanded to Include Both Owners of ABS and Others that Select Particular ABS for Resecuritization</u>.

In both the Original Proposal and the Re-Proposal, the Joint Regulators used a definition of "originator" that tracks that of § 15(G)(a)(4) of the Exchange Act, which states that an originator is: "a person who (A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset backed security; and (B) sells an asset directly or indirectly to a securitizer." The Original Proposal noted further that since this definition refers only to the entity that "creates" a loan or other receivable, only the original creditor would qualify as an originator. Subsequent purchasers or transferees would not be originators for the purposes of Section 15G. In a resecuritization transaction, as the Joint Regulators have observed, the selection of ABS for resecuritization is tantamount to an underwriting. It follows that there is no "originator" of the resecuritized ABS under the foregoing Exchange Act definition. SFIG members propose that the owner of the resecuritized ABS or the person that directs a third party to acquire and resecuritize a particular ABS on its behalf be deemed an "originator" of the resecuritized ABS so that said person can retain risk in compliance with Section 15G.

As noted, resecuritizations are often used as portfolio management tools. Typically, the owner of the underlying ABS contracts with a broker-dealer to facilitate a resecuritization. The owner of the ABS selects the underlying assets and acts as the originator, while the broker-dealer acts as a service provider. Generally, but not universally, the ABS owner—not the broker-dealer—would be regarded as the sponsor for risk-retention purposes.

Similarly, in some cases an investment fund may desire to purchase a resecuritized junior tranche of a given ABS interest. Without ever purchasing the underlying security, the fund can contract with a broker-dealer to acquire the desired ABS from a third party and then resecuritize it. The fund purchases the junior tranche and the broker-dealer places the senior tranche in the market on the fund's behalf. Again, a key feature of this transaction is that the buyer of the junior tranche, not the broker-dealer, selects the underlying assets that back the ABS issued in the resecuritization.

SFIG's members believe that it would be appropriate to expand the definition of the term "originator" to include both an owner that contributes an ABS to a resecuritization and a fund or other person that directs a third party to acquire and resecuritize a particular ABS on its behalf. In each case, the party who selects the collateral would be treated as the originator and would be required to retain credit risk on the collateral that it selects. Such an expansion would further the Joint Regulators' primary goals by: (1) giving the party who selects the underlying securities and benefits from the resecuritization transaction meaningful incentives to monitor and control the quality of the securitized assets; and (2) aligning the interests of that party with those of the purchasers.

Where an exemption from risk retention is not available, the party that selects the collateral would be obligated to satisfy the risk retention requirements, thereby aligning that party's interests with those of the purchasers of the other tranches of the resecuritization. By retaining risk, the owner-as-originator would have a strong incentive to control the quality of the assets in the resecuritization.

C. Resecuritizers Should Be Allowed To Hold Risk By Retaining 5% of the Underlying Resecuritized Security.

An expanded definition of originator as outlined in Section B of this Part X would require the owner of an ABS interest to retain risk in any resecuritization transaction. This could be accomplished through either an EVI, an EHRI, or, we would propose, by retaining 5% of the ABS interest that the owner/originator desires to resecuritize. For example, an ABS owner seeking to resecuritize a security with a face value of $100 would sell only $95 of its position into the resecuritization and would retain $5 of the original position.

While it would not necessarily be the desired mode of risk retention for all owners/originators, the retention of a 5% position in the underlying resecuritized security would be a straightforward way to measure an owner/originator's retained risk in a resecuritization.[241] Since the owner/originator would suffer, on a *pro rata* basis, any losses on the underlying

[241] Owner/originators who are required by law to divest downgraded assets would not be able to retain risk in this fashion.

security, this alternative risk retention measure would advance the goals of risk retention by aligning the owner/originator's and purchaser's incentives and economically would expose the owner/originator to similar risk as an EVI or the fortification interest option described in Section A of Part I.

D. <u>The Final Rule Needs an Exemption for Single Tranche Legacy ABS that Meet Specified Criteria</u>.

Following the Original Proposal, the Joint Regulators received comments suggesting the creation of an exemption from risk retention for ABS made before the effectiveness of the final rule. In the Re-Proposal, the Joint Regulators have chosen not to propose an exemption from risk retention for such legacy ABS.

Some SFIG Members SFIG's membership believe that requiring risk retention on all resecuritizations of legacy ABS is overly broad and would limit the ability of market participants to efficiently resecuritize certain higher quality ABS.

These SFIG Members respectively therefore propose that resecuritizations of legacy ABS that meet certain criteria (Qualified ABS) should be exempt from the risk retention requirements. These Qualified ABS would share the following characteristics:

a. first pay class;

b. issued before 2008;

c. supported by non-delinquent performing underlying collateral having a balance of at least 105% of the entire resecuritized ABS and any *pari passu* classes as of the distribution date preceding the closing date for the resecuritization transaction;

d. has not been written down by any realized losses; and

e. has not been downgraded in the previous 12 months.

Additionally, many SFIG members understand the concerns of the Joint Regulators with respect to CDOs, and this exemption would only apply to resecuritizations of single classes of Qualified ABS, and not to pools of underlying collateral that are Qualified ABS. Many SFIG members see no reason why resecuritizations of high quality ABS such as the Qualified ABS described above should not be exempt from risk retention requirements in a resecuritization transaction.

E. <u>Conclusion</u>.

While the SFIG membership appreciates the Joint Regulators' consideration of comments on the Original Proposal, the Re-Proposal has the potential to severely disrupt the resecuritization market. By not allowing for credit tranching, by maintaining a narrow definition of originator, and by excluding the types of ABS included in our proposed definition of Qualified ABS, the Re-Proposal may exert downward pressure on the value of existing ABS. Such downward pressure would not be related to the risk profile of the ABS, but rather would be the result of restrictions that limit the liquidity of ABS and prevent owners from effectively managing their investments.

The Re-Proposal's restrictions on resecuritizations also interact with other financial regulations, with potentially serious negative effects on financial institutions. Current financial regulations require that when certain institutions hold an ABS that is subsequently downgraded, those institutions must sell the downgraded ABS. Financial institutions currently use resecuritizations to avoid selling downgraded ABS at firesale prices. The Re-Proposal in its current form, would severely limit the ability of financial institutions to resecuritize their assets, and would consequently limit their ability to capture a greater portion of the value of a downgraded ABS. Again, this may have the effect of exerting downward pressure on ABS unrelated to their risk profile.

SFIG's members believe that the adoption of the proposals described above would satisfy the purposes of risk retention without impeding the valuable role that resecuritizations currently play in the economy. Further, by adopting the limitations and restrictions described above, the exceptions for resecuritizations could not be used to exempt CDOs or other similar synthetic products from the credit risk retention rules.

XI. <u>MUNICIPAL BOND REPACKAGING/TENDER OPTION BONDS</u>.

Following the release of the Original Proposal, a number of participants in the MBR market, including both sponsors and investors, commented on the proposed risk retention requirements and requested that MBR transactions be exempted from the Joint Regulators' risk retention requirements. The suggested reasons for an exemption included, among others, the following:

(a) MBR transactions are fundamentally different than transactions following an originate-to-distribute model that can give rise to the "moral hazard problem" discussed in the commentary accompanying the Re-Proposal.[242] In general, the party that selects the underlying asset(s) and brings such asset(s) to the MBR transaction is using the structure as a financing tool, directly benefits from the positive performance of such asset(s) and, most importantly, retains virtually all of the risk of such asset(s) through the nature of its residual or subordinate interest, regardless of the dollar size of that interest. This arrangement results in an alignment of interests with the other investors in the transaction, thus rendering the proposed risk retention requirements unnecessary.

(b) Applying risk retention rules to MBR transactions would restrict, and potentially eliminate, a key demand component for municipal securities and consequently increase borrowing costs for the issuers of municipal securities. The Joint Regulators have acknowledged the importance of municipal financing by exempting securities issued by municipal entities; they should likewise exempt securitizations backed by municipal securities.

The SFIG membership appreciates that the Joint Regulators acknowledged these and other reasons for an exemption in the commentary accompanying the Re-Proposal.[243] We also note that the Joint Regulators "believe that the risk retention mechanisms already in place for [MBR] securitizations already serve to address the moral hazard problem discussed [in the release]" and even suggest an exemption is included in the Re-Proposal in the form of "two options that would reflect current market practice."[244]

Based on the foregoing, the SFIG membership respectfully requests that the original requests for a true exemption be reconsidered and that a general exemption for MBR transactions be included in § __.19 of the risk retention rules. MBR transactions are, fundamentally, financing transactions, involve comparatively simple and highly rated underlying assets and have comparatively simple structures with no significant credit tranching or transfer of risk. Any marginal benefit that may be gained from applying risk retention requirements to a market that has "risk retention mechanisms already in place"[245] is outweighed by the risk that

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242 *Id.* at 58,005.

243 *Id.* at 57964-65.

244 *Id.* at 58,018 (listing the options for MBR transactions under "Other Exemptions").

245 *Id.*

unnecessarily restrictive risk retention options would adversely impact, and potentially eliminate, a market that carries significant market liquidity and public policy benefits.

If the Joint Regulators determine that a general exemption should not be made available to the MBR market and instead determine that transaction-specific or structure-specific risk retention options are appropriate, the SFIG membership strongly urges the Joint Regulators to craft such options in the least restrictive manner possible, accommodating well established and well functioning practices in the MBR market[246] that are by nature protective of investors, as such practices were developed and continue to evolve with significant investor involvement. To do otherwise would put this important market at risk.[247]

SFIG members would like to highlight that the nature of MBR structures makes it difficult, if not impossible, to apply the risk retention features that the Re-Proposal applies to other assets and structures. As further described below, the difficulty in crafting a risk retention option that "fits" the characteristics of established MBR transactions is further evidence that MBR transactions simply are not the type of securitization that Section 15G was intended to address. In response to the Joint Regulators' request for comment, we propose a number of clarifications and modifications to the risk retention options proposed for MBR transactions that would limit disruption to this important market.

A. The Party Required to Retain an Interest in the Transaction Should Be Clarified to Include Certain Third Party Investors.

In order to accommodate current market practice, the SFIG membership urges the Joint Regulators to clarify that the party required to retain an interest in an MBR transaction may be a party other than the "sponsor" of such transaction. The sponsor of a typical MBR transaction (*i.e.*, the financial institution that structures and facilitates the transaction) is not necessarily the primary beneficiary of the transaction structure. In most cases, the sponsor's financial gain is limited to the receipt of certain fees, including fees received as placement agent, remarketing agent, or liquidity provider. Rather, the entity that owns the underlying asset(s) prior to the transaction or selects the underlying asset(s) for purchase and deposit in the transaction is the entity that holds the residual or subordinate interest in the transaction, that benefits from the financing provided by the MBR structure, and that retains virtually all of the risk of such asset(s) through the nature of its residual or subordinate interest, regardless of the dollar size of that interest. In some cases, that entity may be the financial institution sponsoring the transaction. However, in cases where a third party investor selects the assets and holds the residual or subordinate interest, requiring the sponsor of the transaction to retain an interest in the securitization would create a significant burden on such institution without a corresponding benefit and would likely cause many of such sponsors to depart the MBR market.

Specifically, SFIG's members request that the Joint Regulators clarify that the risk retention requirements may be satisfied if the required retained interest is held by the sponsor or

[246] One consequence of the fact that the MBR market is well established and well functioning is that the profit margins on transactions are thin.

[247] To put a finer point on this, the risk retention rules included in the Re-Proposal likely would shut down significant segments of the MBR market, and the tender option bonds market in particular.

a "qualified residual holder," which would be defined as a third party investor that selects the underlying asset(s) for the transaction ***and*** obtains the primary financing benefit of the MBR structure. Further, they request that the risk retention rules be clarified so that multiple qualified residual holders may, in the aggregate, hold the required retained interest in a single MBR transaction so long as such investors are all managed by a common regulated entity. From a marketability perspective, there is generally a minimum size for MBR transactions. In the current MBR market, it is often the case that multiple funds that share the same fund manager will invest in separate portions of the residual or subordinate interest issued in an MBR transaction. Each portion of the residual or subordinate interest is often related to one of the municipal securities held in the issuing entity. This arrangement allows funds within the same fund family to pool their resources to invest in an MBR transaction that would be unlikely to exist if each fund were required to invest alone.

B. Any Risk Retention Options Should Accommodate a Broader Range of MBR Transactions.

While the Joint Regulators proposed to accommodate the existing MBR market, the definitions of "qualified tender option bond entity" and "tender option bond," when taken together, would exclude a significant number of transactions and significant classes of investors that are generally considered part of that market. For example:

(a) The requirement that the issuing entity be collateralized solely by municipal securities that generate tax-exempt interest would exclude certain MBR transactions, including transactions backed by taxable municipal securities or transactions backed by custodial receipts evidencing beneficial ownership of municipal securities.[248]

(b) The requirement that the issuing entity qualify under IRS Revenue Procedure 2003-84 would similarly exclude MBR transactions backed by any assets other than tax-exempt municipal securities.

(c) The requirement that a tender option bond include a tender option for purchase at any time upon no more than 30 days' notice[249] would exclude a number of MBR transactions.[250]

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248 Further, the specific requirement that the holders of the securities issued by a "qualified tender option bond entity" be "eligible to receive" tax-exempt income would create compliance issues for sponsors and issuers in the MBR market. Re-Proposal, § ___.10(a)(4), 78 Fed. Reg. at 58,034. While an MBR transaction can be structured so that the tax exemption on the underlying assets "passes through" to investors, it is unclear how sponsors or issuers can determine and warrant the eligibility of those investors to receive tax-exempt interest.

249 We assume that the proposed notice requirement related to tender options is based on the demand feature requirements found in Rule 2a-7 of the Investment Company Act. We note, however, that amendments to Rule 2a-7 have been proposed and are currently under consideration. Included in those proposed amendments is the elimination of the requirement that a demand feature be exercisable at any time on no more than 30 calendar days' notice.

250 MBR transactions where the tender option bond is issued in a "term mode" for a certain period of time, in some cases exceeding 30 days, are common.

(d) The requirement that a tender option bond have all necessary features to qualify for purchase under Rule 2a-7 of the Investment Company Act would exclude a number of investors and MBR transactions and would create a compliance issue for sponsors and issuers.[251]

Tender option bonds transactions financing tax-exempt municipal securities are the most common form of MBR transaction, as described by the Joint Regulators in the commentary on the Re-Proposal[252]However, other forms of MBR transactions exist that offer the same market liquidity and policy benefits, have similar mechanisms to address the moral hazard problem highlighted by the Joint Regulators and do not introduce significantly different risks to investors. Therefore, the SFIG membership requests that the term "qualified tender option bond entity" be replaced with the term "qualified municipal repackaging entity," which would be defined as an issuing entity meeting the following conditions:

(a) The issuing entity solely owns, or is collateralized solely by, one or more[253] municipal securities or securities evidencing a beneficial ownership interest or other similar interest in municipal securities.[254]

(b) The issuing entity issues two classes of securities: (i) one class entitled to receive a specified portion of the interest on the underlying assets, which generally is a floating rate of interest but may be a fixed rate of interest for a specified term; and (ii) one class[255] meeting the definition of "qualified municipal residual interest" (defined below).

(c) To the extent the class described under clause (b)(i) includes the right to tender the related securities to the issuing entity for purchase and/or is subject to tender and purchase upon the occurrence of specified tender events, a regulated liquidity provider provides 100% guarantee or liquidity coverage on all securities of such class prior to the occurrence of a trust termination event (defined below in Section C of this Part).

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251 While money market funds are common investors in the MBR market, they are by no means the only investors. Therefore, risk retention options requiring MBR transactions to exclusively involve money market fund-eligible securities would both exclude other investors from the MBR market and exclude MBR transactions that are not structured to be money market fund-eligible. Further, while certain MBR transactions are structured to be money market fund-eligible, the money market funds themselves, rather than the sponsors and issuers, make the eligibility determination. Neither sponsors nor issuers can make a final determination on eligibility, and they are not the parties required to do so under the current regulatory scheme.

252 Re-Proposal, 78 Fed. Reg. at 57,964.

253 As discussed above, it is common in the MBR market for transactions to involve more than one individual municipal security, often in order to result in a transaction that is large enough to be marketable to investors in the floater interests.

254 We intend for securities issued by trusts, custodial arrangements or similar entities or structures to be included as appropriate underlying assets for MBR transactions where such securities are backed primarily by municipal securities, as such transactions are common in the MBR market.

255 As discussed above, in the current MBR market, the residual interest in an MBR transaction is often divided into subseries to accommodate investment by multiple funds under management by a common regulated entity.

C. Any Risk Retention Options Should More Accurately Capture the Structures and Transaction Mechanics Utilized in MBR Transactions.

The SFIG membership believes that risk retention options under the final rule should more accurately capture the structures and transaction mechanics utilized in MBR transactions, and to this end, makes several proposals for modifications to the Re-Proposal.

First, we request that the Joint Regulators revise the primary risk retention option (*i.e.*, the option proposed under § __.10(c) of the Re-Proposal) to address its limited applicability and certain technical incompatibilities between this option and typical MBR structures.

As proposed, the primary risk retention option would allow a sponsor to satisfy the risk retention requirements by retaining an interest that, at issuance, meets the requirements of an EHRI but that, following a tender option termination event, meets the criteria for an EVI.[256] The proposed primary risk retention option's focus on the occurrence of a tender option termination event would make the option unavailable to any MBR transaction that does not include a put feature in the terms of the "floater"[257] interest and therefore does not include a "tender option termination event" as a triggering event for the unwind of the transaction.

In addition, the requirement that the retained interest satisfy the criteria for an EHRI or an EVI at different points in a transaction's lifespan is technically problematic. Even in a typical tender option bonds transaction (*i.e.*, the most common form of MBR transaction), the residual interest would not satisfy these requirements. Prior to a tender option termination event, a residual interest is not technically a first-loss piece in the structure with the most subordinated claim to payments of both principal and interest. Rather, the residual interest and the floater interest are, together, partnership interests evidencing the ownership of the issuing entity's assets. Similarly, following a tender option termination event, a residual interest does not technically meet either prong of the definition of EVI, because it does not qualify as a single vertical security, and the holder of the residual interest does not hold an interest in each class of ABS interests issued by the issuing entity.[258]

Rather than incorporating terms used in the standard risk retention option and focusing on a tax-driven concept that would make the option unavailable to a number of MBR transactions, the SFIG membership requests that (1) a new term – "qualified municipal residual interest" – be introduced to capture the characteristics of the residual or subordinate interest in typical MBR transactions, and (2) the primary risk retention option for MBR transactions allow the risk retention requirements with respect to a qualified municipal repackaging entity to be satisfied if

256 *Id.* § __.10(c), 78 Fed. Reg. at 58,035.

257 As used herein, "floater" interest refers to the interest issued in an MBR transaction that is not the residual or subordinate interest. In a typical tender option bonds transaction, the "floater" interest is the floating rate, puttable security.

258 *Id.* § __.2, 78 Fed. Reg. at 58,026. The difficulty in crafting a risk retention option that "fits" the characteristics of established MBR transactions, as discussed in this and the following paragraphs, is further evidence that MBR transactions simply are not the type of securitization that Section 15G of the Exchange Act was intended to address.

the sponsor or one or more qualified residual holders retains a "qualified municipal residual interest."[259]

"Qualified municipal residual interest" would be defined as an ABS interest in a qualified municipal repackaging entity equal to at least (1) 5% of the face value of the assets of the qualified municipal repackaging entity at closing, or (2) solely with respect to assets for which no face value is available, 5% of the fair market value of the assets of such qualified municipal repackaging entity at closing,[260] which interest is either (a) an interest that initially only receives residual cash flow on the issuing entity's assets following payments on the floater interest but that, upon the occurrence of a "trust termination event," receives cash flows on a *pari passu* basis with the floater interest, or (b) a legally subordinate interest. To accommodate a wider range of MBR transactions, "trust termination event" would be defined to include "tender option termination events" and other similar events that, pursuant to the transaction documents, lead to the unwinding of the issuing entity and the liquidation and/or distribution of its assets.

<u>Second</u>, we appreciate the inclusion of the secondary risk retention option for sponsors of qualified tender option bond entities, which would allow a sponsor to retain municipal securities outside of the issuing entity.[261] We would view the availability of this option to qualified municipal repackaging entities as being useful in certain circumstances. However, we request clarification that the secondary option may be satisfied by the sponsor of an MBR transaction or a qualified residual holder.

<u>Third</u>, the SFIG membership requests that an additional risk retention option be included to address the fact that certain MBR transactions include additional structural features that further align the interests of residual holders and other investors. While typical MBR transactions are currently structured in a way that results in a strong alignment of interests among the investors, including the parties that select the underlying assets and brings such assets to the transaction (as discussed above and as addressed in industry comments on the Original Proposal), there are certain MBR transactions that go even further to align such interests. In certain transactions, the residual holder or one of its affiliates provides liquidity coverage on the floater interest and/or credit enhancement on the underlying municipal securities to cover principal and interest. As this arrangement effectively places all risk on the residual holder, the SFIG members believe that it is appropriate that no minimum amount of risk retention be required with respect to a transaction involving a qualified municipal repackaging entity if the holder of the residual or subordinate interest provides, either directly or through an affiliate, any

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259 As discussed above, in order to accommodate current market practice, the Joint Regulators should clarify that (i) the risk retention requirements may be satisfied if the required retained interest is held by the sponsor or a qualified residual holder, and (ii) multiple qualified residual holders should be permitted to hold, in the aggregate, the required retained interest in a single MBR transaction.

260 We note that the risk retention option included in § __.10(d) provides for the satisfaction of the risk retention requirements through holding municipal securities with a face amount equal to 5% of the face amount of the municipal securities deposited in the issuer. Due to the relatively simple nature of municipal securities and their strong historical performance, we agree that sizing the required retained interest by face value is an appropriate approach and believe that such an approach eliminates an unnecessarily complicated fair value analysis. However, in order to accommodate certain underlying assets with respect to which no face value is available, providing for measurement based on fair value in such cases would be appropriate.

261 *Id.* § __.10(d), 78 Fed. Reg. at 58,035.

of (1) 100% liquidity coverage on the floater interests, (2) a binding reimbursement obligation to the provider of such 100% liquidity coverage on the floater interests, or (3) 100% credit enhancement on the underlying municipal securities.

D. **The Final Rule Should Include Exceptions to the Prohibitions on Transfer and Hedging for Certain Common Transactions.**

The SFIG membership requests that the Joint Regulators clarify that certain common transactions entered into in connection with MBR transactions are outside the scope of the hedging prohibitions included in the risk retention requirements, namely: (1) risk reducing and other transactions with regard to the underlying municipal security, such as securities lending transactions and repurchase transactions, that are entered into by the sponsor prior to the establishment of the MBR structure, and (2) transactions between the sponsor or its affiliates and an unrelated third party with respect to an MBR structure where the purpose of such transaction is to provide financing to such third party for such municipal securities and the sponsor establishes the MBR structure for the purpose of obtaining such financing. The SFIG membership believes that such transactions are independent from the MBR transaction and therefore, "are not materially related to the credit risk of either the retained ABS interests or the securitized assets" as contemplated by the prohibition on certain hedging transactions in § __.12(b)(2) of the Re-Proposal. In addition, we request that the Joint Regulators clarify that a transfer in whole of the residual or subordinate interest by the holder of such interest is not within the scope of the transfer prohibitions included in the risk retention requirements so long as the transfer is either to an affiliate of such transferor holder or to another investor that is managed by the same regulated entity as is the transferor holder.

E. **The Disclosure Requirements Applicable to MBR Transactions Should Be Clarified.**

In addition to considering the concepts outlined above—which, when taken together, would provide for more inclusive options for existing MBR transactions without diminishing the effectiveness of the risk retention rule-making effort or conflicting with investors' objectives—we request that the Joint Regulators clarify the disclosure requirements related to risk retention for MBR transactions. In addition to other items, the requirements set forth under § __.10(d) of the Re-Proposal would require the disclosure of the form, fair value and nature of the retained interest in accordance with the general disclosure obligations set forth under § __.4(d). It is not clear, however, which of the general disclosure items are intended to apply or how certain disclosure items would be applied to an MBR transaction.[262] For example:

While the proposed primary risk retention option for qualified tender option bond entities (*i.e.*, the option proposed under § __.10(c) of the Re-Proposal) includes elements of an EHRI, it is unclear how certain disclosure items under § __.4(d)(1) would apply, such as the disclosure of the accuracy of a sponsor's historical cash flow projections.[263]

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[262] The difficulty in crafting disclosure requirements that "fit" the characteristics of established MBR transactions, as discussed in this paragraph, is further evidence that MBR transactions simply are not the type of securitization that Section 15G was intended to address.

[263] In fact, it is our expectation that the cash flow projection and principal repayment projection requirements, in general, would not apply to MBR transactions due to the structure of the residual interests and the lack of

Similarly, it is unclear if and how the disclosure requirements relating to an EVI would apply. The disclosure items under § __.4(d)(2) relate to the two forms of vertical interest (*i.e.*, a single vertical interest and an interest in each class of ABS interests), but, as discussed above, neither form is applicable to typical MBR transactions.

It is unclear how certain disclosure items relating to fair value would apply where bonds are held outside of the issuing entity to satisfy the risk retention requirement, as the amount of such bonds is measured by face value.[264]

Rather than incorporating the general disclosure requirements from § __.4(d), we request that the disclosure requirements applicable to the sponsor of a qualified municipal repackaging entity be limited to:

(a) the name and form of organization of the qualified municipal repackaging entity;

(b) a description of the form and material terms of the retained interest;

(c) whether the qualified municipal residual interest is held by the sponsor or a qualified residual holder; and

(d) a description of the face value (or fair value, if applicable) of the qualified municipal residual interest or the municipal securities separately retained, as applicable.

F. Any Risk Retention Requirements Applicable to MBR Transactions Should Only Be Effective on a Prospective Basis.

The SFIG membership requests that the effective date of any risk retention requirements applicable to MBR transactions be clarified so that only MBR transactions with initial closing dates after the effective date of the Joint Regulators' final rules are subject to the risk retention requirements. As discussed above, the Joint Regulators have acknowledged that the risk retention mechanisms utilized in the current MBR market "serve to address the moral hazard problem," so any requirement to make technical modifications to MBR transactions that closed prior to the effectiveness of the final rules would be unnecessarily burdensome.

(cont'd)
scheduled principal payments in typical MBR transactions. While there is no provision in the Re-Proposal that expressly applies the provisions of § __.4(b)(2) to transactions involving qualified tender option bond entities, the disclosure requirements applicable to EHRIs would require the disclosure of information related to the projections. We, therefore, request clarity on this point. We note that using the proposed term "qualified municipal residual interest" instead of partially basing the MBR risk retention option on the term "EHRIs," with respect to which the projection requirements are applicable, would provide clarity.

264 Further, as discussed above, we propose a face value measurement for the primary risk retention option, where applicable.

XII. CORPORATE DEBT REPACKAGING.

Following the release of the Original Proposal, a number of sponsors requested that corporate bond repackagings be exempted from the risk retention requirements. The reasons for an exemption include, among others, the following:

1. Corporate bond repackagings involve assets purchased in the secondary market and do not involve "originate to distribute" activities, meaning that there is no need for risk retention to apply to these transactions.

2. Corporate bond repackagings are not the type of securitization that Section 15G of the Exchange Act was intended to address, because these transactions are simple pass through structures which happen to utilize a trust and are therefore inadvertently caught up within the scope of Section 15G.

3. The bonds in corporate repackagings can be sold directly to investors in the repackaging without any risk retention requirement.

4. The corporate bond repackaging market is quite small relative to other markets and will be substantially eliminated if subjected to risk retention because sponsors will simply sell the underlying asset without any risk retention requirement. This result would be particularly harmful for institutional investors seeking to repackage corporate bonds that such investors own.

The SFIG membership appreciates that the Joint Regulators responded to the comments made requesting an exemption from risk retention for "corporate bond repackagings." However the SFIG membership is concerned that the Joint Regulators do not fully understand the simplicity of corporate bond repackagings or appreciate that the credit exposure in corporate bond repackagings can be sold to investors without restriction. Finally, sponsors of corporate bond repackagings are quite concerned that, due to the small size of the corporate bond repackaging market and the lack of a sizable constituency to explain the impact of the proposed risk retention rules on that market, the Joint Regulators simply have not had sufficient reason to fully consider whether the risk retention rules should apply to corporate bond repackagings. In fact, the Joint Regulators stated no reason for denying the requested exemption.

Corporate repackagings are not designed to transform the credit profile of the underlying security; rather, the purpose is to tailor the payment or trading characteristics of an existing security to better align with investors' preference. Many corporate repackagings are sold to institutional investors at the request of the institutional investor. Investors often request a customized set of cash flows that cannot be obtained by buying the underlying corporate bond. For example, an investor may want to own a bond, but may want the bond to be denominated in dollars, yet the bond is issued in yen. A dealer will deposit the bond into a trust and simply swap the bond from yen to dollars. Most corporate bond repackagings have several common characteristics: (1) a trust owns a single bond purchased in the secondary market and, if the repackaging is in a public offering, the bond is issued or guaranteed by a company which is rated investment grade by at least one rating agency and is subject to the periodic reporting requirements of the Exchange Act; (2) an issuing trust issues one or more classes of certificates that collectively represent a pass-through of amounts received on the underlying bonds or other assets of the trust; (3) there is no credit tranching among the classes of certificates issued by the issuing trust, so that losses are shared proportionally amongst the investors; and (4) because there is no credit tranching, if a rating is sought on the certificates, the rating is a pass-through rating equal to the lowest rating of the underlying bond or other assets of the trust. Given that corporate repackagings pass-through the corporate credit, and that the bonds in the trust can be sold directly to the investors in the trust, no regulatory or investor protection purpose is served by requiring the sponsor to retain a portion of the risk.

We would also like to respond to the Joint Regulators' statement that "risk retention at the securitization level for corporate debt repackagings aligns the sponsor's interests in selecting the bonds in the pool with investors in the securitization, who are often retail investors."[265] Five misunderstandings are apparent in this statement. First, the vast majority of corporate bond repackagings involve a single bond, making the Joint Regulators' reference to a pool is misleading. The reason why we mention this point is because we can understand that the Joint Regulators may have a heightened concern over a pool of credits as opposed to a single credit. Second, there is no particular method for selecting the bonds for a corporate bond repackaging. Sponsors simply purchase the bonds in the secondary market, *i.e.*, the only "selecting" is whether bonds are available for sale. Third, corporate bond repackagings are often sold to a single investor which requested that the bond be repackaged. Fourth, the bonds that are in corporate bond repackagings can be sold directly to the investors without any risk retention requirement, thus, applying a risk retention rule will do nothing to align the interests of sponsors and investors. Fifth, because corporate bond repackagings are structured with assets purchased in the secondary market and no borrower is involved, risk retention will not create an alignment between borrowers and investors.[266]

For all of these reasons, the SFIG membership urges the Joint Regulators to reconsider the original requests for an exemption for corporate bond repackagings and to adopt a general exemption for such transactions in § __.19 of the risk retention rules.

If the Joint Regulators determine that a general exemption should not be made available to corporate bond repackagings and instead determine that transaction-specific or structure-specific risk retention options are appropriate, we believe that such an exemption should apply to any transaction that: (1) repackages securities that could be sold to investors in the transaction directly without risk retention; and (2) does not involve credit tranching.

Further, if risk retention must apply to corporate debt repackagings, then either of the following approaches should be an additional means of satisfying the risk retention requirement: retaining 5% of the underlying securities in the repackaging or retaining 5% of any class of securities issued in the repackaging which class is *pari passu* with the securities being issued to investors in the transaction.

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265 *Id.* at 57,975.

266 The Joint Regulators may respond that adding a risk retention requirement would provide additional benefit to investors; however, such a position expands the risk retention rules well beyond their purpose. Broker-dealers in securities can sell registered corporate bonds to investors without risk retention, and corporate bond repackagings are simply the sale of registered corporate bonds to investors in small denominations.

XIII. CONCLUSION

The securitization industry plays a crucial role in moving capital throughout the economy. It ensures that investors have access to the segments of the economy in which they wish to invest and that consumers and industry at all levels have access to the liquidity that they need. A well regulated securitization industry supports a healthy economy and reduces risks overall. Many SFIG members believe that if the Joint Regulators adopt the suggestions contained herein, the credit risk retention rules can achieve their goals without undermining the efficiency and effectiveness of the securitization market.

*   *   *   *   *

We are grateful for the chance to provide these comments on the Re-Proposal. If there are any questions arising from our comments or any other aspect of this topic, we welcome the opportunity to provide assistance in any way helpful. Please feel free to contact the undersigned at Richard.Johns@SFIndustry.org, (571) 296-6017, at any time.

Respectfully Submitted,

Richard Johns
Executive Director

APPENDIX A

Index of Defined Terms

APPENDIX B

Typographical Corrections

The Changes proposed in this Appendix B reflect the SFIG membership's suggested corrections to several typographical errors noted in the Re-Proposal. This does not reflect an exhaustive list of all changes to the proposed rule suggested by this Letter.

1. The definition of "Eligible ABCP Conduits" in § __.6 should be changed to read as follows (deleting "Asset backed securities collateralized solely by" in (2)(i)(A) because it is repeats (2)(i)):

"*Eligible ABCP conduit* means an ABCP conduit, *provided that:* (1) The ABCP conduit is bankruptcy remote or otherwise isolated for insolvency purposes from the sponsor of the ABCP conduit and from any intermediate SPV; (2) The asset backed securities acquired by the ABCP conduit are: (i) Collateralized solely by the following: (A) assets originated by an originator-seller or one or more majority-owned OS affiliates of the originator seller, and by servicing assets"

2. § __.6(b)(1) should be modified to read as follows (removing the reference to § __.5 which seems to be a vestigial reference to the "horizontal risk retention" section that has since been combined with the "vertical risk retention" section as § __.4):

"The intermediate SPV's originator-seller retains an economic interest in the credit risk of the assets collateralizing the ABS interest acquired by the eligible ABCP conduit in accordance with paragraph (b)(2) of this section, in the same form, amount, and manner as would be required under § __.4"

APPENDIX C

Additional Definitions for Inclusion in the Final Rule[267]

We would propose that the following definitions be added to the final rule:

"Eligible participation interest" means, with respect to any securitization transaction, an interest in an underlying asset or pool of underlying assets that:

(a) is a fixed undivided percentage interest;

(b) constitutes either (i) an owner's interest, where the issuing entity holds a participant's interest, or (ii) a participant's interest, where the issuing entity holds the owner's interest;

(c) in respect of all rights to cash flow from the underlying assets, is *pari passu* with the interest held by the issuing entity; and

(d) does not provide the holder of the participant's interest with recourse against the owner due to the lack of creditworthiness of any obligor on an underlying asset.

"Owner's interest" means, with respect to a participation interest arrangement in one or more underlying assets, the interest of the owner of the underlying asset or pool of underlying assets who has granted a participation interest in each such underlying assets to another party.

"Participant's interest" means, with respect to a participation interest arrangement in one or more underlying assets, the interest of a participant that has acquired a participation interest in each such underlying asset directly or indirectly from the owner of the underlying assets.

267 As noted above, the additional changes addressed in this Appendix do not reflect an exhaustive list of the changes to the final rule proposed by this Letter.

APPENDIX D

Proposed Textual Edits to Re-Proposal With Respect to Revolving Master Trusts[268]

§ .5 Revolving issuing entities.

(a) Definitions. For purposes of this §__.5, the following definitions apply:

Eligible horizontal interest means any eligible horizontal residual interest that meets the requirements of §__.4, or an eligible series level horizontal interest.

Eligible series-level horizontal interest means one or more ABS interests issued by a revolving issuing entity, whether certificated or uncertificated, in a single or multiple classes, subclasses, or tranches, meeting, individually or in the aggregate, the following requirements of this paragraph:

(1) For any series of the revolving issuing entity that distinguishes between the series' share of the interest and fee collections and the series' share of the principal collections from the securitized assets collateralizing the investors' ABS interests, which may according to the terms of the securitization transaction documents, include not only the series' ratable share of such collections but also excess collections available from other series, then:

(i) The horizontal interest's claim to any part of the series' share of the interest and fee collections on the common pool of securitized assets for any period is subordinated to the payment of accrued interest due on the related payment date to more senior investors' ABS interests in the series, and, in the case of a horizontal interest that is subordinated to another series of investors' ABS interests, accrued interest due on the related payment date to such senior series of investors' ABS interests; provided that references in this clause (i) to "interest due" shall not include any portion of interest payable to more senior investors' ABS interests on a subordinated basis because such interest exceeds bona fide[269] limitations specified in the securitization transaction documents; and

(ii) The horizontal interest's claim, if any, to any part of the series' share of the principal collections on the common pool of the securitized assets for any period is subordinated to all principal payments due on the related payment date and all principal deposits required to be made on the related payment date to, or for the benefit of, other investors' ABS interests[270] in the series that are in accumulation or amortization periods

[268] As noted above, the additional changes addressed in this Appendix do not reflect an exhaustive list of the changes to the final rule proposed by this Letter.

[269] The references to "bona fide" here and in clause 2(i) of the definition of "eligible series-level horizontal interest" are intended to prevent any such limitation implemented to circumvent the risk retention requirements.

[270] For the avoidance of doubt, the reference to other investors' ABS interests here and in the corresponding provision of clause 2(ii) shall not include any investors' ABS interests that are fungible (in terms of class, subclass or tranche designation) with the most senior ABS interests included in such horizontal interest.

on such payment date and, in the case of a series that is subordinated to another series of investors' ABS interests, all principal payments due and all principal deposits required to be made on such payment date to, or for the benefit of, the related investors' ABS interests of such senior series that are in accumulation or amortization periods on such payment date.

(2) For any series of the revolving issuing entity for which clause (1) does not apply, then:

(i) The horizontal interest's claim to any part of the series' share of the collections on the common pool of securitized assets for any period is subordinated to the payment of accrued interest due on the related payment date to more senior investors' ABS interests in the series, and, in the case of a horizontal interest that is subordinated to another series of investors' ABS interests, all accrued interest due on the payment date to such senior series of investors' ABS interests; provided that references in this clause (a) to "interest due" shall not include any portion of interest payable to more senior investors' ABS interests on a subordinated basis because such interest exceeds bona fide limitations specified in the securitization transaction documents; and

(ii) The horizontal interest's claim, if any, to payment of principal or to the deposit of funds for the future payment of principal by the issuing entity from the series' share of the collections on the common pool of securitized assets on any payment date is subordinated to the payment of principal due on such payment date and all principal deposits required to be made on such payment date to, or for the benefit of, all other ABS interests in such series that are in accumulation periods or amortization periods on such payment date and, in the case of a series that is subordinated to another series of investors' ABS interests, all principal payments due and all principal deposits required to be made on such payment date to, or for the benefit of, the investors' ABS interests of such senior series that are in accumulation periods or amortization periods on such payment date.

(3) If such horizontal interest includes a residual interest in series-level interest and fee collections remaining after the payment of all accrued interest due on all investors' ABS interests for such series on any payment date, such residual interest's claim to any part of the series' interest and fee collections is further reduced by the series' share of defaults on the principal amounts of the securitized assets for the related period, to the extent that collections on such principal amounts would have been payable to more senior ABS interests in the series on such payment date.

<u>Investors' ABS interests</u> means all ABS interests issued by a revolving issuing entity, but excluding the seller's interest and any residual interest in series-level excess spread retained by the sponsor or any majority-owned affiliate of the sponsor as described in clause (3) of the definition of eligible series-level horizontal interest.

(cont'd)

For example, if the horizontal interest includes retained Class D notes and Class C notes, such reference shall not include any Class C notes that are not retained by the sponsor or majority-owned affiliate.

Revolving issuing entity means an issuing entity that issues (or proposes to issue) on multiple issuance dates one or more series, classes, subclasses, or tranches of asset backed securities which are collateralized by one or more common pools of securitized assets that will change in composition over time.

Seller's interest means an ABS interest or ABS interests:

(1) Collateralized by a common pool of the securitized assets and servicing assets owned or held by the issuing entity that also collateralize one or more investors' ABS interests excluding, for the avoidance of doubt, assets that have been allocated as collateral for less than all of the ABS interests secured by such common pool);

(2) That, with respect to each series of investors' ABS interests that will receive an allocation of collections and losses with respect to the common pool of the securitized assets referenced in clause (1) of this definition, is *pari passu*[271] with or subordinated to such investors' ABS interests in terms of the allocation of all collections and losses on such common pool of securitized assets; and

(3) That adjusts for fluctuations in the outstanding principal balance of the securitized assets in the common pool.

(b) General requirement. A sponsor satisfies the risk retention requirements of §__.3 of this part with respect to a securitization transaction for which the issuing entity is a revolving issuing entity if the sponsor retains a seller's interest of not less than 5 percent of the unpaid principal balance of all outstanding investors' ABS interests issued by the issuing entity that are entitled to an allocation of collections and losses with respect to the common pool of the securitized assets collateralizing such seller's interest. For purposes of such calculation, a sponsor may exclude from the outstanding investors' ABS interests any eligible horizontal interest retained by the Sponsor or majority-owned affiliates.[272]

(c) Measuring and retaining the seller's interest. The retention interest required pursuant to paragraph (b) of this section:

(1) Must meet the 5 percent test at the closing of each issuance of ABS interests by the issuing entity (based on the *pro forma* calculation of the seller's interest on the issuance date described in clause (1)(i) of paragraph (g) of this section), and at every seller's interest measurement date specified under the securitization transaction documents for purposes of determining whether a collateral shortfall would trigger an early amortization period or early accumulation period under the related securitization

[271] If the request to include subordinated seller's interests is not implemented in the final rule, the reference to *pari passu* in this clause (2) should be revised to say "*pari passu* to such investors' ABS interests in terms of the allocation of all collections and losses prior to the commencement of an accumulation period or amortization period."

[272] SFIG members believe that it would be consistent with the goals of the risk retention rules to exclude investors' ABS interests retained by the Sponsor and majority-owned affiliates to avoid what is in essence a form of double-counting (*e.g.*, requiring the sponsor to also retain an amount equal to 5% of the securities already retained by the Sponsor and its majority-owned affiliates).

transaction documents, but no less than monthly, until no ABS interest in the issuing entity is held by any person not affiliated with the sponsor; provided that a sponsor will be deemed to have satisfied the risk retention requirements of paragraph (b) for any seller's interest measurement date if any shortfall in the required seller's interest is cured by no later the last day of any applicable cure period (as defined in the securitization transaction documents).

(2) May be retained by one or more majority-owned affiliates of the sponsor, including one or more depositors of the revolving issuing entity.

(d) Multi-level trusts; multiple common pools.

(1) If one revolving issuing entity issues one or more collateral certificates or similar instruments entitling the holder thereof to an allocation of collections and losses with respect to all or a portion of the securitized assets held by the revolving issuing entity (all of which certificates and instruments are referred to as collateral certificates in this paragraph (d)) that is held by another revolving issuing entity, which in turn issues ABS interests for which the collateral certificate(s) is all or a portion of the securitized assets, a sponsor may satisfy the requirements of paragraphs (b) and (c) of this section by retaining the seller's interest for the assets represented by the collateral certificate(s) through either revolving issuing entity, so long as both revolving issuing entities are maintained at the direction of the same sponsor or its majority-owned affiliates.

(2) If the sponsor retains the seller's interest associated with a collateral certificate at the level of the revolving issuing entity that issued the collateral certificate, the proportion of the seller's interest required by paragraph (b) of this section that shall be retained at that level shall equal no less than the proportion that the securitized assets represented by the collateral certificate bears to the total securitized assets securing the related ABS interests held by the revolving issuing entity that issues the ABS interests, as of each measurement date required by paragraph (c).

(3) If a sponsor satisfies the requirements of paragraphs (b) and (c) of this section by retaining a seller's interest associated with a collateral certificate at the level of the revolving issuing entity that issued the collateral certificate, the sponsor may reduce the seller's interest associated with such collateral certificate required on each measurement date if the sponsor or a majority-owned affiliate of the sponsor retains an eligible horizontal interest as contemplated by paragraph (f) of this section issued by the revolving issuing entity that issued the collateral certificate; provided that for purposes of the definition of "eligible series level horizontal interest," the investors' ABS interests secured by the collateral certificate shall be deemed to be senior ABS interests of the same series or a senior series of ABS interests, as applicable, with respect to such eligible horizontal interest.

(4) If an investors' ABS interest will receive an allocation of collections and losses from two or more common pools of securitized assets, a sponsor may satisfy the requirements of paragraphs (b) and (c) of this section by retaining a combination of seller's interests in all such common pools of securitized assets and each such seller's

interest shall equal no less than the proportion that the securitized assets represented by each such common pool of securitized assets bears to the total securitized assets of all such common pools, as of each measurement date required by paragraph (c).

(e) Offset for pool-level excess funding account. The 5 percent seller's interest required on each measurement date by paragraph (c) of this section may be reduced on a dollar-for-dollar basis by the balance, as of such date, of an excess funding account or other similar account in the form of a segregated account that:

(1) Is funded in the event of a failure to meet the minimum seller's interest requirements or other minimum collateral requirements under the securitization transaction documents by collections on the related common pool of securitized assets otherwise payable to the holder of the seller's interest; and

(2) In the event of an early amortization or early accumulation applies amounts held in the account to make payments to, or deposits for the benefit of, holders of investors' ABS interests in the same manner as collections or principal collections, as applicable, on securitized assets.

(f) Combined retention at trust and series level. The 5 percent seller's interest required on each measurement date by paragraph (c) of this section may be reduced (as described in the following sentence) to a percentage lower than 5 percent to the extent that the sponsor or majority-owned affiliate of the sponsor retains one or more ABS interests that are secured by the common pool of securitized assets that collateralizes such seller's interest, in the form of an eligible horizontal interest. The permissible reduction in the 5 percent seller's interest attributable to eligible horizontal interests retained by the sponsor or a majority-owned affiliate of the sponsor shall be equal to the percentage equivalent of (i) the sum of the fair values of all ABS interests that comprise such eligible horizontal interests, divided by (ii) the outstanding principal balance of all outstanding investors' ABS interests issued by the issuing entity that are entitled to an allocation of collections and losses on the common pool of collateral that collateralizes such seller's interest. The sponsor may elect to assign a fair value of zero to any ABS interest for purposes of calculating the amount described in clause (i) of the preceding sentence. For purposes of this paragraph (f) and paragraph (g) of this section, the fair value of any ABS interest issued by a revolving issuing entity that does not issue interest-only or premium bonds and that has an outstanding principal balance shall be deemed to be the outstanding principal balance of such ABS interest.

(g) Disclosure and record maintenance. (1) Disclosure. A sponsor relying on this section shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset backed securities in the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, the following disclosure in written form under the caption "Credit Risk Retention":

(i) The value (expressed as a percentage of the unpaid principal balance of all of the investors' ABS interests issued by the issuing entity that are entitled to an allocation of collections and losses with respect to the common pool of the securitized assets collateralizing such seller's interest and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of each seller's interest that the sponsor will retain (or did retain) as of a date not earlier than the most recent measurement date specified under the securitization transaction documents preceding the date of such disclosure (and adjusted on a *pro forma* basis for the issuance of ABS interests on or prior to the closing of the securitization transaction, any reduction in the principal amount of outstanding ABS interests, if applicable, on or prior to the closing date, and any addition or removal of assets (other than through the creation of additional assets in previously designated revolving accounts or the liquidation of previously designated assets) that will take place on or prior to the closing date of the securitization transaction, using the applicable cut-off date balance for such addition or removal as determined in accordance with the securitization transaction documents or a more recent date), and the outstanding principal balance (or fair value if required in accordance with paragraph (f) of this section) of any eligible horizontal interest relied upon by the sponsor to reduce the 5% seller's interest requirement and the calculation of the percentage reduction described in paragraph (f) of this section;

(ii) A description of the material terms of the seller's interest and of any eligible horizontal risk retention described in paragraph (f) of this section; and

(iii) If the sponsor will retain (or did retain) any horizontal risk retention described in paragraph (f) of this section that is not valued based on its outstanding principal balance, the same information as is required to be disclosed by sponsors retaining eligible horizontal interests pursuant to § __.4(d)(1)(iii) and (iv).

(2) Record maintenance. A sponsor must retain the disclosures required in paragraph (g)(1) of this section in written form in its records and must provide the disclosure upon request to the Commission and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

(h) Early amortization of all outstanding series. A sponsor that relies on this §__.5 to satisfy the risk retention requirements of §__.3 of this part, does not violate the requirements of this part if its seller's interest falls below the level required by §__. 5 after an early amortization event or similar event triggers early amortization or early accumulation, as specified in the securitization transaction documents, of all series of ABS interests issued by the trust to persons not affiliated with the sponsor, if:

(1) The sponsor was in full compliance with the requirements of this section on all measurement dates specified in paragraph (c) of this section prior to the event that triggered early amortization or early accumulation;

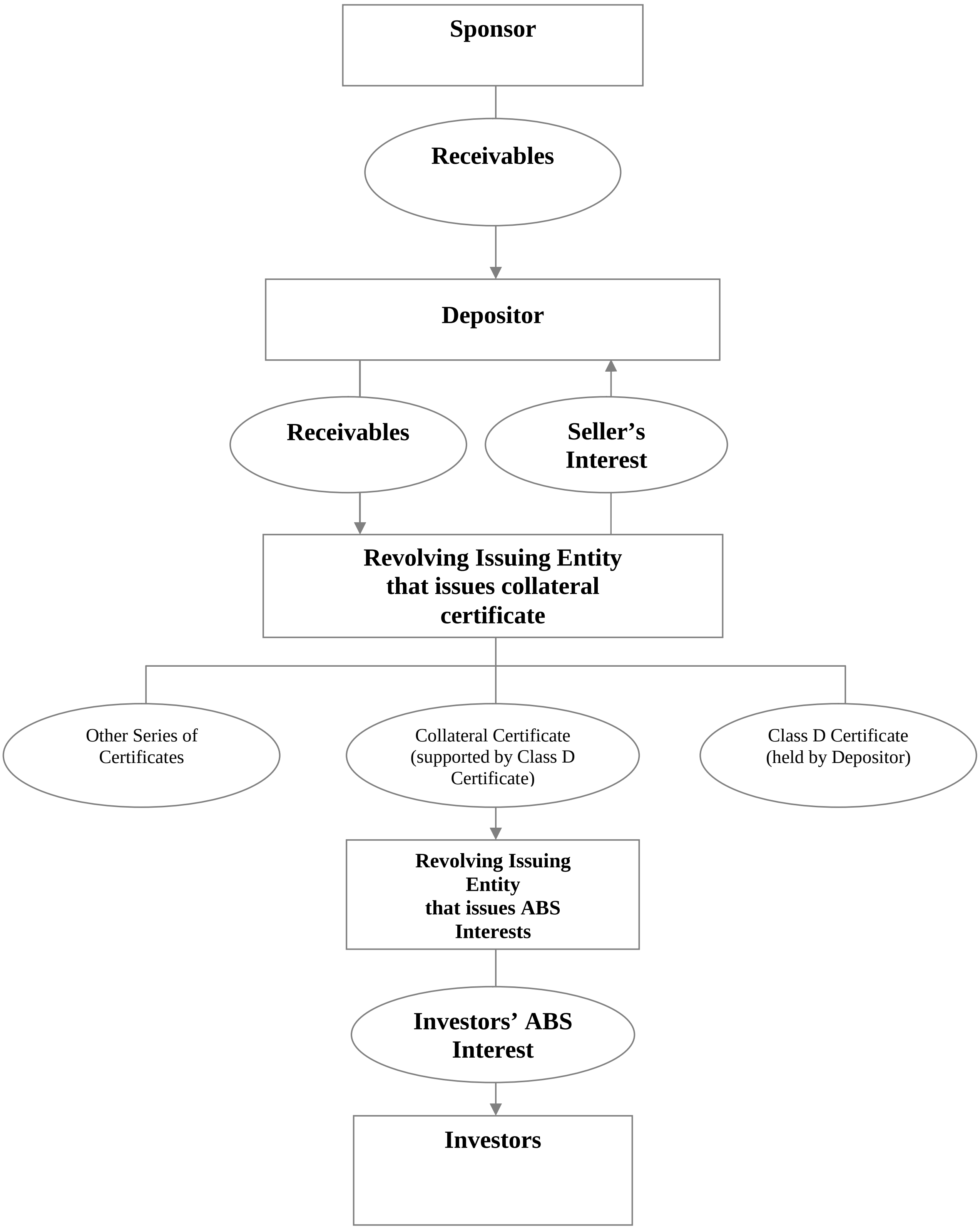
(2) The terms of the seller's interest continue to make it *pari passu* or subordinated to each series of investors' ABS interests issued by the issuing entity with respect to the allocation of all losses with respect to the securitized assets;

(3) The terms of any eligible horizontal interest relied upon by the sponsor pursuant to paragraph (f) to offset the minimum seller's interest amount continue to be subordinated as described in the definition of eligible horizontal interest; and

(4) The revolving issuing entity issues no additional ABS interests after early amortization or early accumulation is initiated to any person not affiliated with the sponsor, either during the amortization period or at any time thereafter.

(i) Grandfathering. For purposes of determining the permissible reduction in the 5 percent seller's interest attributable to eligible horizontal interests retained by the sponsor or a majority-owned affiliate of the sponsor, the sponsor may, in its discretion, exclude from both clauses (i) and (ii) of the percentage calculation described in the second sentence of paragraph (f) of this section, any ABS interests issued by the issuing entity prior to the effective date of the final rule. However, if the amount described in clause (i) of such percentage calculation includes any eligible horizontal interest that is subordinated to an investors' ABS interest issued prior to the effective date of the final rule, then clause (ii) of such percentage calculation shall include the outstanding principal balance of all outstanding investors' ABS interests issued by the issuing entity, including any ABS interests issued prior to the effective date of the final rule.

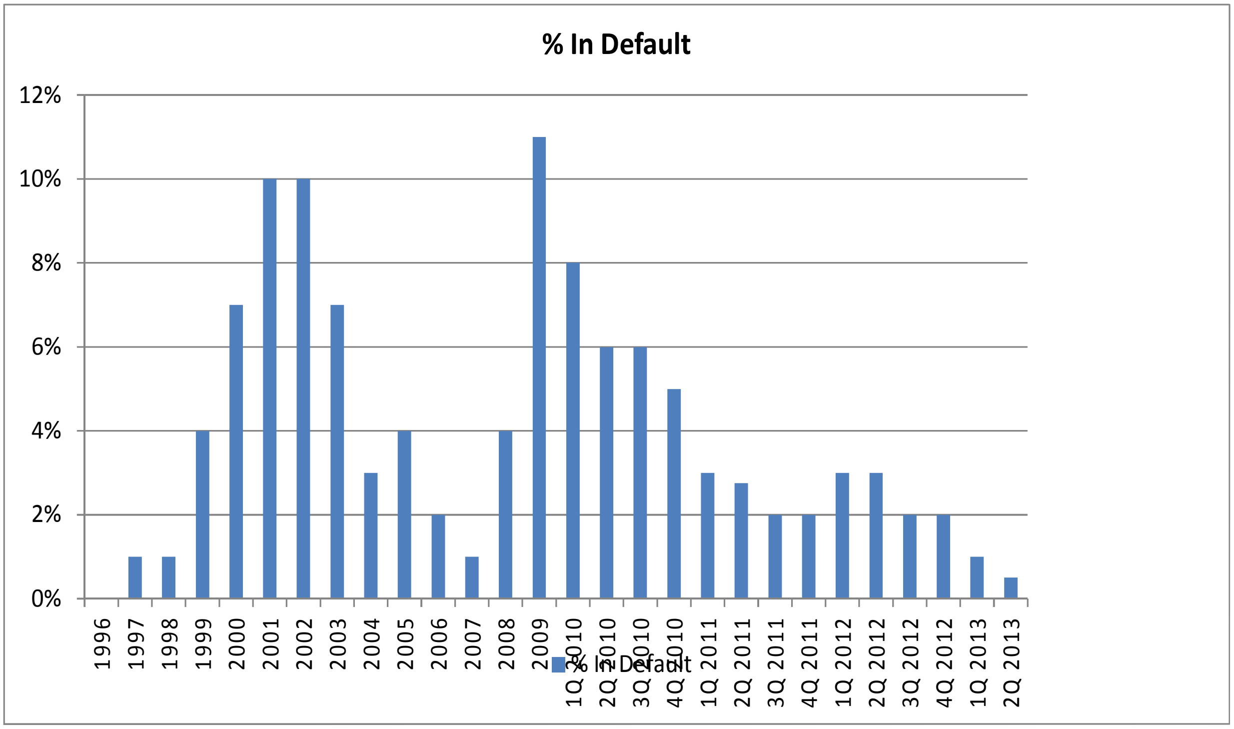
APPENDIX E


Sponsor
Receivables
Depositor
Receivables
Seller's Interest
Revolving Issuing Entity that issues collateral certificate
Other Series of Certificates
Collateral Certificate (supported by Class D Certificate)
Class D Certificate (held by Depositor)
Revolving Issuing Entity that issues ABS Interests
Investors' ABS Interest
Investors

APPENDIX F

CLO Notes

Note 1: Percent of Outstanding Leveraged Loans in Default or Bankruptcy
As of June, 2013 less than 1% of all leveraged loans outstanding were in default or bankruptcy.



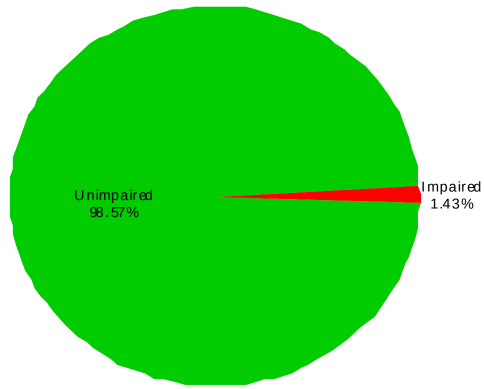
Source: Extracts from S&P Capital IQ June, 2013, p. 197. Includes all loans including those not included in the LSTA/LPC mark-to-market service; Vast majority are institutional tranches.
Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

Note 2: CLO Collateral Has a Low Default Rate
As of May 2013, for pre-crisis CLOs ("CLO 1.0"), the current collateral default rate was approximately 4%, and for post-crisis CLOs issued starting in 2010 ("CLO 2.0"), it was less than 0.25%. Source: Moody's CLO Interest, May 1, 2013.

Note 3: CLO Debt Securities have suffered few Losses

Performance: CLO note impairments have been all but non-existent

Cumulative **impairment rate from Jan 1996 to May 2012**



- Over the course of 17 years, the cumulative impairment rate of CLOs has been de minimus – less than 1.5% in that entire time span
- Losses will be lower than impairments, because impairments can include market value EOD, distressed exchanges, etc., in addition to realized losses

Source: Moody's Investors Service

LSTA

11

Losses on US Cash Flow CLO Tranches are Infrequent

Infrequent losses on US broadly syndicated arbitrage cash flow CLO tranches are proof of the strong performance of underlying loan assets and the effectiveness of over-collateralization (OC) diversion features. Very few of the US cash flow CLOs we rate have realized principal losses on their rated debt to date. Between 1 January 1996 and 16 May 2012, we rated 4,118 tranches in 719 broadly syndicated US arbitrage cash flow CLOs. Exhibit 1 shows that losses have been rare and that no CLO tranches with initial ratings higher than A2 (sf) have suffered losses.

EXHIBIT 1

Losses in US Broadly Syndicated Arbitrage Cash Flow CLOs

1 January 1996 – 16 May 2012

Impairment Type	# of CLOs	# of Impaired Tranches	# of Impaired Investment-Grade Tranches	# of Impaired Non-investment-Grade Tranches	Highest Initial Rating of Impaired Tranche
Realized principal losses at maturity	14	32	18	14	Baa2 (sf)
Distressed exchange	4	7	3	4	A2 (sf)
EoD because of a market value feature	1*	1*	0	1	Ba2 (sf)
Other tranches likely to suffer principal losses	12	19	4	15	A2 (sf)
Total	31	59	25	34	A2 (sf)

* Although two CLOs are in an Event of Default (EoD) because of a market value feature in the OC test, only one tranche, which we rate C (sf), has a high probability of suffering a principal loss at maturity.

Sources: Moody's Investors Service, trustee notices and reports; all data are as of 16 May 2012.

707805229.17 13434419

All of the CLOs that suffered principal losses at maturity were early vintage deals that closed before 2002, and most had large exposures to poorly performing high-yield bonds in the stressful credit environment between 1999 and 2002. Other losses have largely been the result of idiosyncratic structural features or special events, rather than a reflection of the underlying collateral's credit performance.

Principal losses at maturity in US CLOs have been rare

Of the 4,118 tranches in the 719 US broadly syndicated arbitrage cash flow CLOs we have rated since the beginning of 1996, only 32 tranches in 14 CLOs suffered principal losses at maturity. All 14 closed between 1997 and 2001; the highest initial rating of any of the impaired tranches was Baa2 (sf). Most had invested heavily in high-yield bonds whose value deteriorated significantly in the stressful credit environment between 1999 and 2002.

These CLOs allowed a maximum portfolio exposure to fixed-rate assets ranging from 15% to 32%; one allowed a maximum of 75%. In addition, a number of these deals further required that the portfolio exposure to fixed-rate assets meet a minimum threshold of 10% or higher.
In contrast, post-2001 vintage CLOs tend to have tighter investment constraints, typically stipulating that the maximum exposure to fixed-rate assets not exceed 5% to 10% of the total portfolio.

Because of their investment constraints, most of the 14 CLOs had sizeable exposures to high-yield bonds by the 2000-2002 downturn; as a result, they suffered because of the deteriorating credit quality of the bond collateral. Although the leveraged loan collateral in these CLOs was also not immune to downgrades or defaults, high-yield bonds accounted for most of the defaults; lower ultimate recoveries for bonds versus loans were also a key reason for losses on the junior notes.

Three of the 14 CLOs restructured a large number of the underlying assets to mature after the maturity date of the CLO notes. These assets remained outstanding when the CLOs reached their stated maturities, preventing the full principal repayment of mezzanine and junior notes at maturity."
Source: Moody's CLO Interest July 25, 2012, pp 4-6. Italics added. This article focused on broadly syndicated US arbitrage cash flow CLOs, did not consider interest deferred on deferrable tranches by itself as an impairment and used the exposure to fixed-rate assets in the CLO documents as a proxy to measure the exposure to high-yield bonds.

Note 4: CLOs performed well during the downturn.
"CLOs are virtually unique among pre-crisis structured products, in that their soundness was demonstrated during and after the 2008 financial crisis. The overwhelming majority of pre-crisis CLO tranches have returned to their original credit ratings, and no AAA or AA rated tranche has yet suffered a credit loss. With the model proven, investors across the risk spectrum have returned to the product, facilitating a 203% CAGR in new CLO issuance over the past eight quarters. With this growth has come a reasonably well-defined standard structure, often called CLO 2.0, that in many ways is even safer than the pre-crisis CLOs that successfully navigated the downturn. With investors of all types seeking alternatives to duration exposure, the floating-rate nature of most CLO securities (and the collateral that supports them) is well suited to today's investment environment."
Source: Barclays Credit Research, "U.S. Credit Focus," June 28, 2013, p. 1

Note 5: CLO Structural Features Provide Significant Protection to CLO Securityholders
No CLOs were closed between mid-2008 and March 2010. CLO 1.0 in the charts below refers to CLOs that closed prior to 2009 and CLO 2.0 refers to CLOs that closed starting in 2010.

Indicative Capital Structure of Pre-Crisis (1.0) and Post-Crisis (2.0) CLOs

Class of Notes	CLO 1.0 % of Notional	CLO 1.0 OC Ratio at Issuance	CLO 1.0 Rating (S&P/ Moodys)	CLO 2.0 % of Notional	CLO 2.0 OC Ratio at Issuance	CLO 2.0 Rating (S&P/ Moodys)
A	72%	129%	AAA/Aaa	61%	140%	AAA/Aaa
B	7%	121%	AA/Aa2	11.5%	128%	AA/Aa2
C	5%	116%	A/A2	7.5%	120%	A/A2
D	5%	111%	BBB/Baa2	5%	115%	BBB/Baa2
E	3%	108%	BB/Ba2	5%	110%	BB/Ba2
Equity	8%	NAP	NR/NR	10%	NAP	NR/NR

Note: For illustrative purposes only.
Source: Barclays Credit Research, "U.S. Credit Focus," June 28, 2013, p. 2.

Typical CLO 2.0 Collateral Portfolio Concentration Limits

Collateral Type	% of Total Collateral
First lien Senior Loans	At least 90% of total portfolio
Mezzanine/Unsecured Loans or Bonds	No more than 10% of total portfolio
CCC Rated Obligations	No more than 7.5% of total portfolio
Participations	No more than 20% of total portfolio
Structured Finance Securities	None allowed
Synthetic Securities	None allowed
Fixed Rate Obligations	No more than 7.5% of total portfolio
Any Single Obligor	Nor more than 2% of total portfolio
Any Single Industry	No more than 10% of total portfolio
Covenant-Lite Loans	No more than 50% of total portfolio
DIP Loans	No more than 7.5% of total portfolio

Source: Barclays Credit Research, "U.S. Credit Focus", June 28, 2013, p. 3.

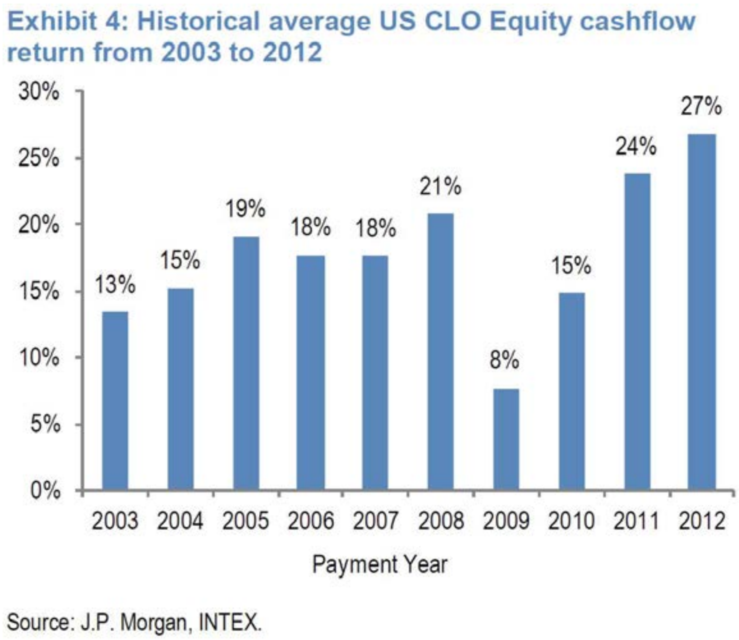
Pre- and Post-Crisis CLO Collateral Quality Test Limits

Collateral Quality Test	**CLO 1.0 (Pre-2008)**	**CLO 2.0 (2010 to Present)**
Minimum Weighted Average Spread (WAS)	2.5% – 3.5%	4% - 4.5%
Minimum Weighted Average Recovery Rate (WARR)	45% – 50%	43% - 45%
Maximum Weighted Average Life (WAL)	10 years	8 years
Minimum Diversity Score (DS)	55 - 75	45 - 60

Source: Barclays Credit Research, "U.S. Credit Focus," June 28, 2013, p. 4.

Note 6: CLOs Provide Attractive Returns to Equity Investors

"Price volatility was extreme in the cycle, but on a buy-and-hold basis US CLO equity cashflow returns averaged 19% from 2005 to 2012"



Source: JPMorgan US Fixed Income Strategy, US Fixed Income Markets Weekly, March 22, 2013, pp.1-2.

Note 7: CLO 2.0 Average Equity at Closing

CLO Average Equity	
2013	10.8%
2012	10.8%
2011	11.5%

Source: Credit Suisse, CLO New Issuance Tracker, June 6, 2013 (Outliers above 25% removed from data set)

Note 8: CLO Equity and Overcollateralization Increase over Time

Failure to satisfy a CLO overcollateralization ("OC") ratio or CLO interest coverage ("IC") ratio prevents cash from being distributed to the equity when the performance of the CLO portfolio is deteriorating below tested levels. An OC ratio is the percentage obtained by dividing an adjusted outstanding principal balance of the CLO assets (haircut for deteriorating assets) by the outstanding balance of the CLO debt. The numerator excludes defaulted assets after three years (prior to that time defaulted assets are included at a haircut based on a recovery rate percentage value) and that portion of obligations rated below a specified level (typically CCC+/Caa1 or below) in excess of the permitted concentration limit for such obligations. The numerator may also exclude or haircut obligations that are deferring interest (other than permitted PIK obligations that currently pay cash interest at a specified minimum percentage), obligations purchased at a significant discount, obligations that mature after the stated maturity of the CLO debt securities and other types of assets that have deteriorated from the parameters on which the transaction is structured and modeled. The denominator which is the outstanding principal balance of the CLO debt securities is increased by deferred interest thereon, if any. Currently the equity cushion in CLOs created by the OC tests is increasing.

- In a study by Morgan Stanley, encompassing a surveillance universe of 425 USD denominated CLOs issued during 2000 through 2011:

  - Median senior OC cushions increased to 14.48% from 14.37% during the prior month.

  - Median junior OC cushions for US CLOs increased to 5.08% from 4.93% during the prior month.

  - This increase in OC cushions occurred even though the study noted that more than 80% of 2005- 2007 vintage US CLOs have received cumulative equity cash distributions more than their equity tranches' original balance (par value). *[See the chart below.]*

  - Of the 410 US CLO transactions in the Morgan Stanley sample universe, only 15 are currently failing their junior OC tests.

Source: Morgan Stanley Research CLO Market Tracker, September 6, 2013, pp. 9-13. Italics added.

- A recent Moody's study found that

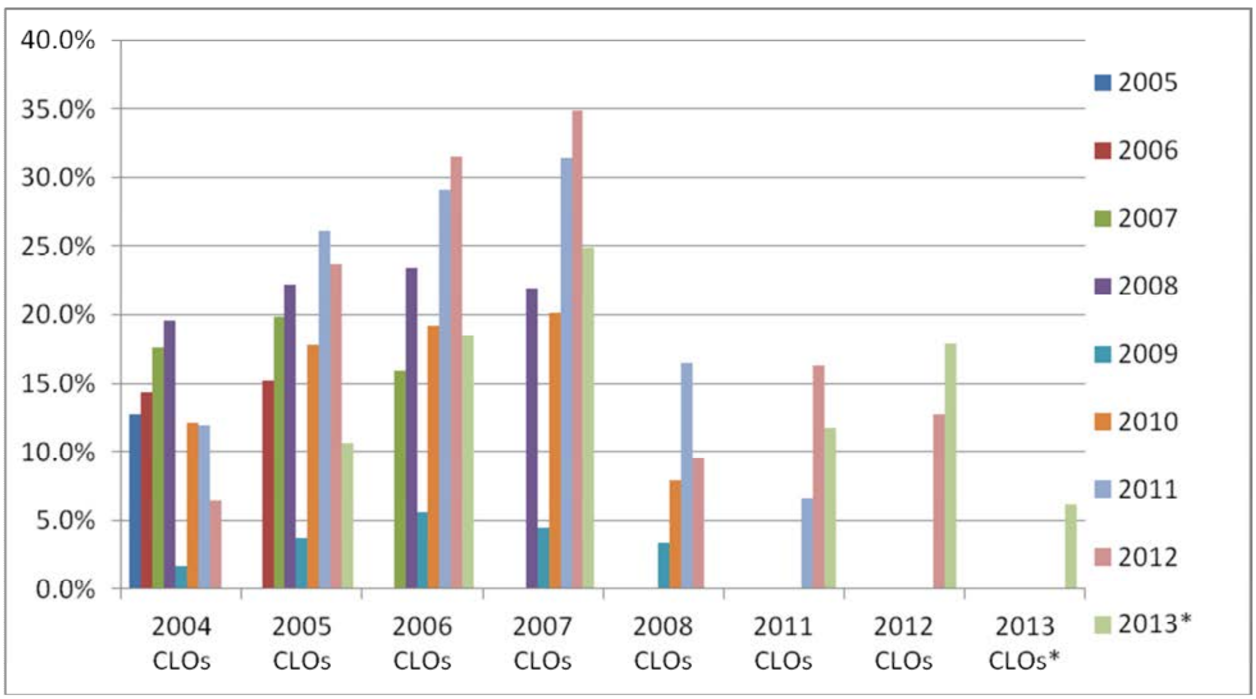
    - Senior OC levels for CLOs in their reinvestment period have steadily increased from a low of 118% in May of 2009 to approximately 123% in January 2013.

    - Senior OC levels for CLOs in their amortization period have also increased from a low of 118% in May of 2009 to 135% in January of 2013.

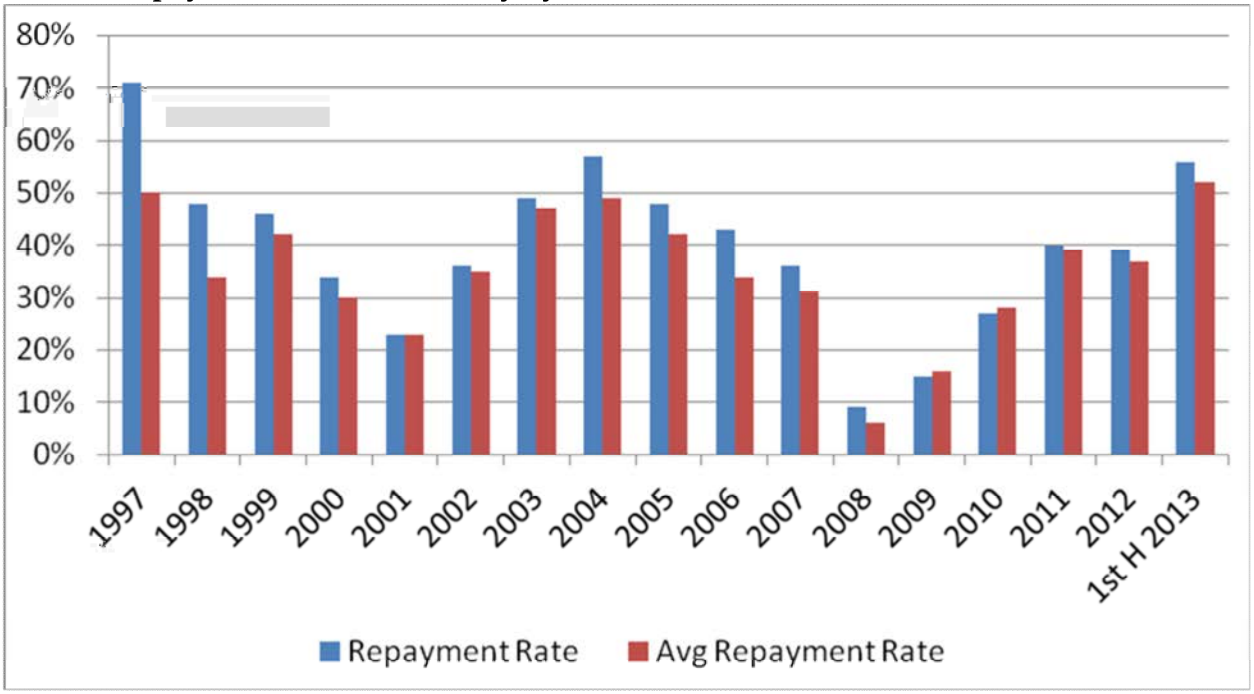
    - Senior OC levels for all CLOs have increased from a low of 118% in May of 2009 to 127% in January of 2013.

  Source: Moody's CLO Interest, May 1, 2013, page 21. Based on a sample of 189 reinvesting CLOs and 328 amortizing CLOs for a total of 517 CLOs.

Percent of Equity Par Amount Distributed to Equity by CLO Vintage by Year



Note 9: Repayment Rates on Broadly Syndicated Loans



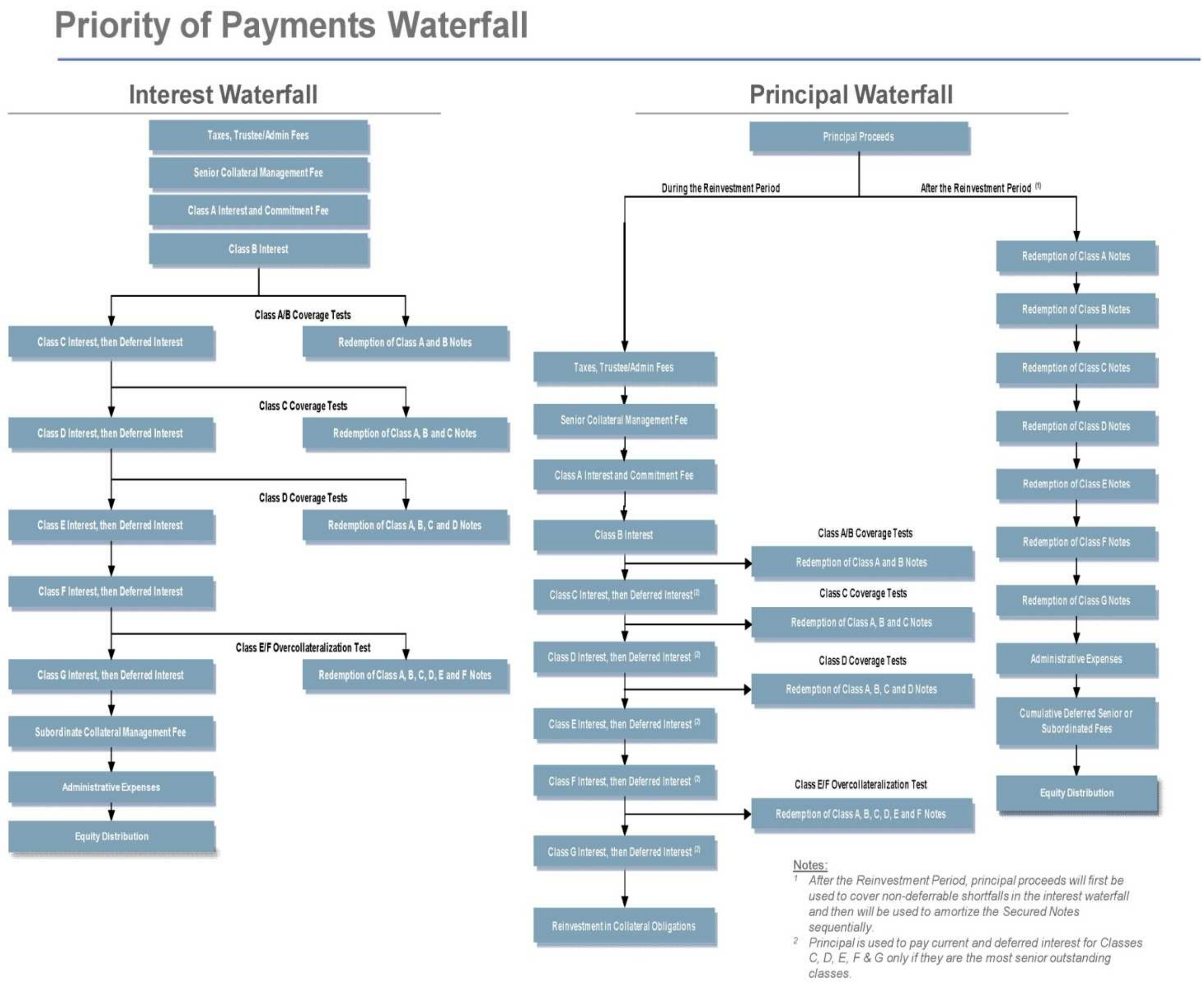
Source: S&P Capital IQ, June 2013, page 162

Note 10: CLO Market Provides Needed Capital To Business

YEAR	ASIAN BANKS	CANADA BANK	EURO BANK	FINANCE CO.	INSURANCE COS.	CLOS & FUNDS	SECURITIES FIRMS	US BANKS
1994	17.2%	5.3%	18.6%	4.9%	6.3%	17.2%	1.1	29.5%
1995	14.1	4.7	19.1	5.1	6.2	16.4	1.4	22.1
1996	11.0	5.9	17.4	3.1	8.0	22.1	2.9	29.7
1997	11.1	3.5	15.8	4.1	6.7	25.6	3.8	29.3
1998	7.1	7.3	21.0	4.5	4.8	25.8	1.8	27.8
1999	3.7	4.6	14.7	6.5	5.2	36.5	0.5	28.3
2000	4.3	5.0	10.1	4.3	1.3	47.9	1.6	25.4
2001	1.5	2.6	8.4	9.2	4.6	47.8	2.2	23.6
2002	1.7	2.2	9.1	7.6	4.0	55.9	2.0	17.5
2003	1.1	1.6	6.5	9.2	4.6	62.0	0.6	14.4
2004	3.8	1.5	11.4	6.4	3.5	60.1	1.4	12.0
2005	3.1	1.2	8.5	7.0	2.1	64.8	1.1	12.3
2006	2.3	0.9	7.5	5.9	2.1	71.8	2.0	7.5
2007	2.2	1.2	5.8	3.8	1.8	77.4	2.3	5.5
2008	2.3	2.3	9.0	6.9	1.4	63.8	3.5	10.8
2009	0.6	3.4	7.2	4.6	3.8	61.3	4.7	14.3
2010	1.6	1.6	4.6	4.6	4.4	73.1	1.9	8.3
2011	2.1	1.9	5.1	4.2	4.6	72.4	1.3	8.5
2012	1.3	0.9	3.2	2.3	4.1	80.7	1.2	6.3
1ST H 2013	1.1	1.0	3.7	2.2	4.0	78.9	1.7	7.4

Source: S&P Capital IQ , June 2013, page 132- "Primary Market for Highly Leveraged Loans by Investor Type

Note 11: Indicative CLO Priority of Payments



Note 12: Lead Arrangers

US Leveraged Loans Lead Left Rankings					
as of October 25, 2013					
Rank	**Lead Left**	**Value $bn**	**No.**	**% share**	
1	JPMorgan	180.4	330	19.5	19.5
2	Bank of America Merrill Lynch	177.1	390	19.2	38.7
3	Credit Suisse	94.7	118	10.2	48.9
4	Wells Fargo Securities	71.7	204	7.8	56.7
5	Citi	65.4	82	7.1	63.8
6	Deutsche Bank	62.9	75	6.8	70.6
7	Barclays	40.9	54	4.4	75.0
8	Goldman Sachs & Co	36.9	42	4.0	79.0
9	Morgan Stanley	30.5	38	3.3	82.3
10	GE Capital Markets Inc	19.0	89	2.1	84.4
	Subtotal	**779.5**	**1,422**	**84.4**	
	Total	**923.7**	**2,020**	**100**	

Source: Dealogic

APPENDIX G

ABCP Spreadsheet

ABCP Risk Retention Option Disclosure Proposal				
Section and Description of Proposed Disclosure	Currently Report	Could Report if Required	Issues with Reporting	Comments
§_.6(d) Periodic Disclosures to Investors				
(1) Liquidity				
-Name of regulated liquidity provider	X			
-Form of organization of regulated liquidity provider		X		
-Description of form of liquidity coverage		X		
-Amount of liquidity coverage	X			
-Nature of liquidity coverage	X			
-Notice of failure to fund	X			
(2) Deal Specific				
(A) Asset Class	X			
(B) SIC Code		X		
(C) Description of the form of risk retention		X		
(C) Fair value			X	Reporting of fair values of underlying ABS would be extremely difficult if not impossible.
(C) Nature of interest		X		
§_.6(e) Additional Disclosures to Regulators				
-Name of organization of each originator/seller or majority owned OS affiliate that will retain		X		
-Form of organization of each originator/seller or majority owned OS affiliate that will retain		X		
§_.6(f)(2)(ii)(A) Notification of holders of ABCP in Case of Non-Compliance				**§_.6(f)(2)(ii)(A) notification obligations must be subject to a sponsor's actual knowledge standard**
(1) If originator-seller fails to retain risk				
- Name of each originator/seller that fails to retain risk			X	Identification of originators/sellers that breach risk retention would pose confidentiality/privacy issues
- Form of organization of each originator/seller		X		
- Amount of related asset backed securities held by conduit		X		
(2) If originator-seller or majority-owned OS affiliate hedges risk retention (violation)				
- Name of each originator/seller or majority owned OS affiliate that hedged its risk retention			X	Identification of originators/sellers that breach risk retention would pose confidentiality/privacy issues
- Form of organization of each originator/seller or majority owned OS affiliate that hedged its risk retention		X		
- Amount of related asset backed securities held by conduit		X		
(3) Any remedial actions taken by the ABCP Conduit sponsor or other party		X		

APPENDIX H[273]

Proposed Markup to Section __.6 of the Re-Proposal

SUBPART B—CREDIT RISK RETENTION

(a) Definitions. For purposes of this section, the following additional definitions apply:

5 percent credit enhancement means credit enhancement provided to an ABCP conduit sized to cover at least 5% of the amount invested by such ABCP conduit under all customer transactions without regard to the credit risk or other performance of such customer transactions.

100 percent non-asset tested liquidity coverage means ~~an amount~~liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) provided with respect to all the ABCP issued by an ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, such ABCP conduit in order to provide for the timely repayment of maturing ABCP issued by such ABCP conduit, sized to cover at least equal to the outstanding balance of all ABCP issued by ~~the~~such ABCP conduit ~~plus any accrued and unpaid interest~~ without regard to the credit risk or other performance of the ~~ABS interests held by the~~customer transactions entered into by such ABCP conduit and without regard to any credit enhancement.

100 percent asset tested liquidity coverage means liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) provided with respect to all the ABCP issued by an ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, such ABCP conduit in order to provide for the timely repayment of maturing ABCP issued by such ABCP conduit, sized to cover at least the outstanding balance of all ABCP issued by such ABCP conduit, as such amount may be reduced by non-performing assets included in the ABCP conduit's customer transactions.

ABCP means asset backed commercial paper that has a maturity at the time of issuance not exceeding ~~nine months~~397 days, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

ABCP conduit means an issuing entity with respect to ABCP.

Bank sponsor means, with respect to any customer transaction entered into by an ABCP conduit, the regulated liquidity provider that underwrites and approves such customer transaction.

Customer transaction means a loan, note or other security investment, purchase or other form of financing transaction entered into by an ABCP conduit for the benefit of an originator-seller, the repayment of which relies on cash flows from loans, repurchase agreements or other financial assets or security or other interests therein, in each case that meets each of the following criteria:

[273] As noted above, the additional changes addressed in this Appendix do not reflect an exhaustive list of the changes to the final rule proposed by this Letter.

(i) Such transaction is underwritten by the related bank sponsor using the same procedures that such bank sponsor uses for similar transactions that are originated by the bank sponsor for its own account; and

(ii) Such transaction is originated by the ABCP conduit directly or by a financial institution that satisfies the requirements of a regulated liquidity provider or another ABCP conduit; and

(iii) If any such transaction (other than a pre-existing transaction) involves the issuance or transfer of an asset backed security, the sponsor of the securitization transaction that created such asset backed security certifies to the bank sponsor that it satisfies the risk retention requirements of this part (whether through complying with the base risk retention requirement of § ___.3 or by falling within any of the exemptions provided in this part), and agrees to provide re-certifications to the bank sponsor periodically in accordance with the documents governing the customer transaction pursuant to which the ABCP conduit acquired such asset backed security; and

(iv) If any such transaction (other than a pre-existing transaction) does not involve the issuance or transfer of an asset backed security, (a) the originator-seller warrants to the bank sponsor that it will retain on an ongoing basis (subject to the hedging and other restrictions in § ___.12 of this part), a material net economic interest in the underlying financial assets, which shall not be less than 5% of the nominal value of such underlying financial assets, (b) the ABCP conduit is not required to provide funding under such customer transaction at any time in excess of 95% of the nominal value of the underlying financial assets that meet the eligibility criteria for such funding (which criteria shall, in any event, exclude defaulted financial assets), and (c) the bank sponsor underwrites the customer transaction to the equivalent of at least investment grade (as defined in 12 CFR 324.2);

together with related rights, including collateral therefor and servicing assets, provided that customer transactions shall not include synthetic securitizations.

Eligible ABCP conduit means an ABCP conduit, provided that:

(1) The ABCP conduit is bankruptcy remote ~~or~~and otherwise isolated for insolvency purposes from the related bank sponsor~~ of the ABCP conduit and from any~~, any originator-seller or intermediate SPV party to any customer transaction with such ABCP conduit;

(2) The ~~asset-backed securities acquired by the ABCP conduit are:~~ABCP conduit's investments are limited to customer transactions and short term cash equivalent investments;

~~(i) Collateralized solely by the following:~~

~~(A) Asset-backed securities collateralized solely by assets originated by an originator-seller or one or more majority-owned OS affiliates of the originator-seller, and by servicing assets;~~

~~(B) Special units of beneficial interest or similar interests in a trust or special purpose vehicle that retains legal title to leased property underlying leases~~

~~that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases originated by an originator-seller or majority-owned OS affiliate, and by servicing assets; or~~

~~(C) Interests in a revolving master trust collateralized solely by assets originated by an originator-seller or majority-owned OS affiliate and by servicing assets; and~~

~~(ii) Not collateralized by asset backed securities (other than those described in paragraphs (i)(A), (i)(B) and (i)(C) of this definition), otherwise purchased or acquired by the intermediate SPV, the intermediate SPV's originator-seller, or a majority-owned OS affiliate of the originator seller; and~~

~~(iii) Acquired by the ABCP conduit in an initial issuance by or on behalf of an intermediate SPV (A) directly from the intermediate SPV, (B) from an underwriter of the securities issued by the intermediate SPV, or (C) from another person who acquired the securities directly from the intermediate SPV;~~

~~(3) The ABCP conduit is collateralized solely by asset backed securities acquired from intermediate SPVs as described in paragraph (2) of this definition and servicing assets; and~~

(3) ~~(4) A regulated liquidity provider has entered into a legally binding commitment to provide 100 percent liquidity coverage (in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or other similar arrangement) to all the ABCP issued by the ABCP conduit by lending to, purchasing ABCP issued by, or purchasing assets from, the ABCP conduit in the event that funds are required to repay maturing ABCP issued by the ABCP conduit. With respect to the 100 percent liquidity coverage, in the event that the ABCP conduit is unable for any reason to repay maturing ABCP issued by the issuing entity, the liquidity provider shall be obligated to pay an amount equal to any shortfall, and the total amount that may be due pursuant to the 100 percent liquidity coverage shall be equal to 100 percent of the amount of the ABCP outstanding at any time plus accrued and unpaid interest (amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit and liquidity support that only funds performing receivables or performing ABS interests does not meet the requirements of this section).~~(i) One or more regulated liquidity providers have entered into one or more legally binding commitments to provide 100 percent non-asset tested liquidity coverage in the aggregate, or (ii) (a) one or more regulated liquidity providers have entered into one or more legally binding commitments to provide 100 percent asset tested liquidity coverage in the aggregate, and (b) the bank sponsor has entered into a legally binding commitment to provide at least 5 percent credit enhancement (which, for the avoidance of doubt, may be provided as part of any 100 percent non-asset tested liquidity coverage); and

(4) The ABCP conduit does not issue any securities (other than its nominal equity and a single class of ABCP, all payable at the same level of credit priority) to persons other than regulated liquidity providers through the provision of 5 percent credit enhancement, 100 percent non-asset tested liquidity coverage, and/or 100 percent asset tested liquidity coverage.

Intermediate SPV means a special purpose vehicle that:

~~(1) Is a direct or indirect wholly-owned affiliate of the originator-seller;~~

(1) ~~(2)~~ Is bankruptcy remote or otherwise isolated for insolvency purposes from the eligible ABCP conduit, the originator-seller, and any majority~~-~~ owned OS affiliate that, directly or indirectly, sells or transfers assets to such intermediate SPV;

(2) ~~(3)~~ Acquires assets ~~that are originated by~~from the originator-seller or its majority~~-owned OS affiliate from the originator-seller or majority-~~ owned OS affiliate, or acquires asset backed securities issued by, or makes loans to or other investments in, another intermediate SPV or the original seller that are collateralized solely by such assets; and

(3) ~~(4) Issues asset backed securities collateralized solely by such assets, as applicable.~~Enters into a customer transaction.

Majority-owned OS affiliate means an entity that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, an originator-seller participating in ~~an eligible ABCP conduit.~~a customer transaction. For purposes of this definition, majority control means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling ~~financial~~financing interest in the entity, as determined under GAAP.

Originator-seller means an entity that originates (or acquires using the same underwriting criteria it would use for similar assets it originated) assets and sells or transfers (including by way of pledge to secure a loan) those assets directly, or through a majority-owned OS affiliate, to an intermediate SPV or to an ABCP conduit.

Pre-existing transaction means a customer transaction that is entered into by an ABCP conduit prior to the effective date hereof; provided that the funding commitment of such ABCP conduit or any regulated liquidity provider thereto has not been increased or renewed after the effective date hereof.

Regulated liquidity provider means:

(1) A depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813));

(2) A bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof;

(3) A savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or

(4) A foreign bank whose home country supervisor (as defined in § 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21)) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

(b) In general. An ABCP conduit and each related bank sponsor each satisfies the risk retention requirement of §__.3 of this part with respect to the issuance of ABCP by an eligible ABCP conduit ~~in a securitization transaction if, for each ABS interest the ABCP conduit acquires from an intermediate SPV:~~if the applicable bank sponsor:

~~(1) The intermediate SPV's originator-seller retains an economic interest in the credit risk of the assets collateralizing the ABS interest acquired by the eligible ABCP conduit in accordance with paragraph (b)(2) of this section, in the same form, amount, and manner as would be required under~~ § ~~__.4 or~~ § ~~__.5; and~~

~~(2) The ABCP conduit sponsor:~~

(i) Approves each ~~originator-seller and any majority-owned OS affiliate permitted to sell or transfer assets, directly or indirectly, to an intermediate SPV from which an~~related customer transaction entered into by such eligible ABCP conduit ~~acquires ABS interests~~;

(ii) Approves each related originator-seller and, if applicable, each intermediate SPV ~~from~~with which an eligible ABCP conduit is permitted to ~~acquire ABS interests~~enter into customer transactions;

(iii) Establishes criteria governing the ~~ABS interests~~customer transactions, and the assets underlying the ~~ABS interests, acquired by the~~customer transactions, entered into by such eligible ABCP conduit~~;~~

~~(iv) Administers the ABCP conduit by monitoring the ABS interests acquired by the ABCP conduit and the assets supporting those ABS interests, arranging for debt placement, compiling monthly reports, and ensuring compliance with the ABCP conduit documents and with the ABCP conduit's credit and investment policy~~; and

(iv) ~~(v)~~ Maintains and adheres to policies and procedures for ensuring that the conditions in this paragraph (b) have been met.

(c) ~~Originator-seller~~Other bank sponsor compliance with risk retention. The use of the risk retention option provided in this section by an ABCP conduit or its related bank sponsor does not relieve the originator-seller that sponsors ABS interests acquired by an eligible ABCP conduit from such originator-seller's obligation, if any, to comply with its own risk retention obligations under this part.

(d) Periodic disclosures to investors. An ABCP conduit sponsor relying upon this section shall provide, or cause to be provided, to each purchaser of ABCP, before or contemporaneously with the first sale of ABCP to such purchaser and at least monthly thereafter, to each holder of commercial paper issued by the ABCP ~~Conduit~~conduit, in writing, each of the following items of information:

(1) The name ~~and form of organization~~ of the regulated liquidity provider that provides liquidity coverage to the eligible ABCP conduit, including ~~a description of~~ the ~~form,~~ amount~~,~~ and nature of such liquidity coverage, and notice of any failure to fund.

(2) With respect to each ~~ABS interest held by~~customer transaction then included in the ABCP conduit~~:(A)The~~'s assets, the asset class ~~or brief description~~ of the underlying receivables~~;~~

~~(B) The standard industrial category code (SIC Code) for the originator-seller or majority-owned OS affiliate that will retain (or has retained) pursuant to this section an interest in the securitization transaction; and~~

~~(C) A description of the form, fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as a dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)), as applicable, and nature of such interest in accordance with the disclosure obligations in § ___.4(d) of this part~~.

(e) Disclosures to regulators regarding originator-sellers and majority-owned OS affiliates. ~~An ABCP conduit~~A bank sponsor relying upon this section shall provide, or cause to be provided, upon request, to the Commission and its appropriate Federal banking agency, if any, in writing, all of the information required to be provided to investors in paragraph (d) of this section, and the name and form of organization of each originator-seller or majority~~-~~ owned OS affiliate that will retain (or has retained) pursuant to this section an interest in the ~~securitization~~customer transaction.

(f) Duty to comply.

~~(1) The ABCP conduit retaining sponsor shall be responsible for compliance with this section.(2) An ABCP conduit retaining~~ Each bank sponsor relying on this section:

(~~i) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor compliance by each~~1) May rely on certifications, representations and warranties made by any sponsor of a securitization transaction, any applicable originator-seller ~~and~~or any majority-owned OS affiliate~~ which sells assets~~, in each case, to ~~the~~an eligible ABCP conduit~~ with the~~, certifying that such person is in compliance with its risk retention requirements ~~of paragraph (b)(1) of~~under this ~~section~~part; and

(~~ii~~2) In the event that ~~the ABCP conduit~~such bank sponsor ~~determines~~becomes aware or has actual knowledge that an originator-seller or majority-owned OS affiliate no longer complies with the requirements of paragraph (b)(1) of this section, shall:

(~~A~~i) Promptly notify~~ the holders of the ABCP,~~ the Commission and its appropriate Federal banking agency, if any, in writing of:

~~(1)~~ (A) The name and form of organization of any originator-seller that fails to retain risk in accordance with ~~paragraph (b)(2)(i) of~~ this section and the amount of asset backed securities issued by an intermediate SPV of such originator-seller and held by the ABCP conduit or, as applicable, the principal amount invested by such ABCP conduit pursuant to any other customer transaction;

~~(2)~~ (B) The name and form of organization of any originator-seller or majority-owned OS affiliate that hedges, directly or indirectly through an intermediate SPV, its risk retention in violation~~ of paragraph (b)(1)~~ of this section and the amount of asset backed securities issued by an intermediate SPV of such originator-seller or majority-owned OS affiliate and held by the ABCP conduit or, as applicable, the principal amount invested by such ABCP conduit pursuant to any other customer transaction; and

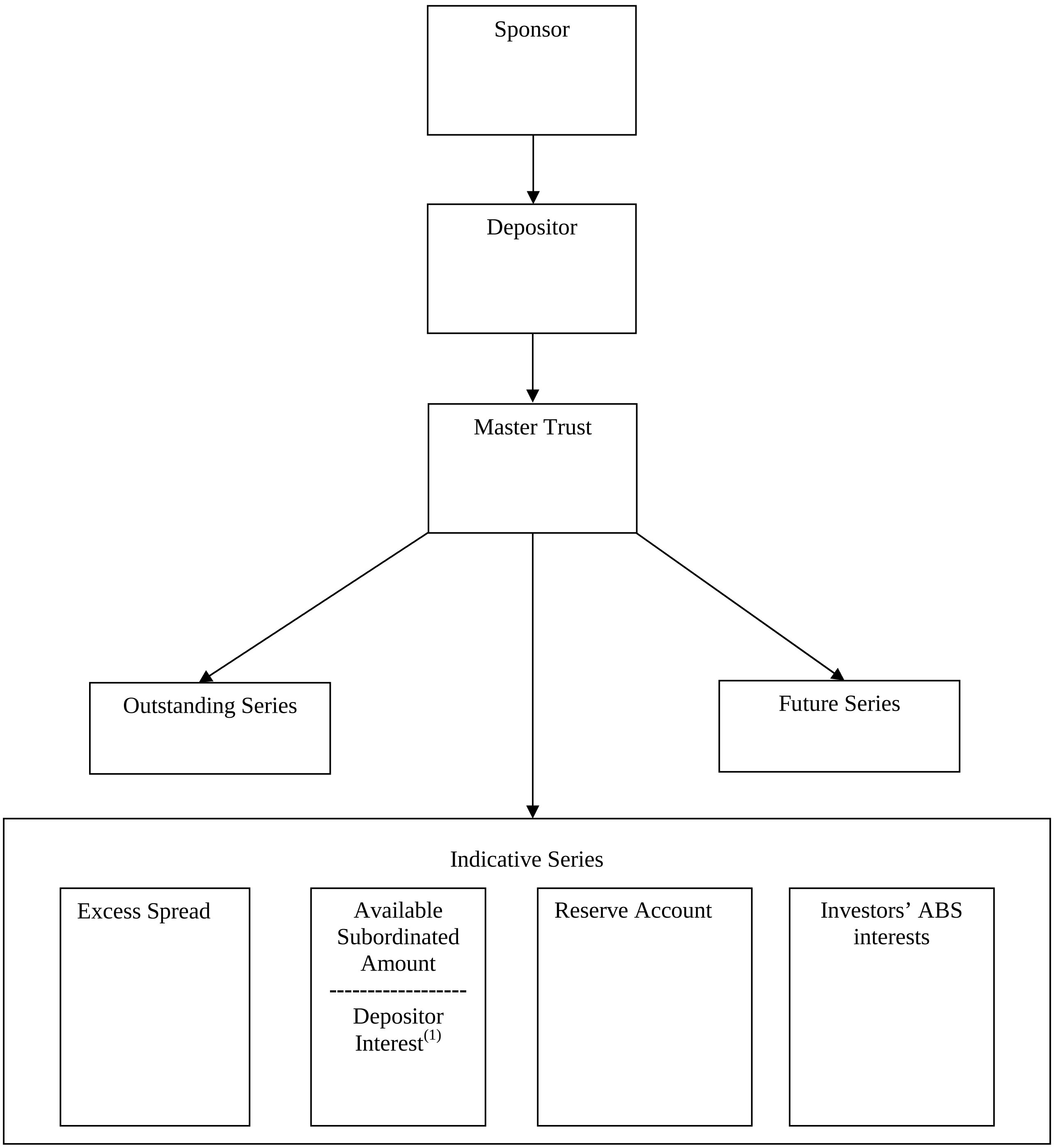
~~(3)~~ (C) Any remedial actions taken by the ~~ABCP conduit~~related bank sponsor or other party with respect to such asset backed securities or other customer transaction; and

(~~B~~ii) Take other appropriate steps pursuant to the requirements of paragraphs (b)(2)(iv) and (b)(2)(v) of this section which may include, as appropriate, curing any breach of the requirements in this section, or removing from the eligible ABCP conduit any asset backed security or other customer transaction that does not comply with the requirements in this section.

Appendix I

EXAMPLE OF TYPICAL FLOORPLAN SECURITIZATION STRUCTURE

The following diagram provides a simplified overview of the structure for a typical floorplan master trust securitization and the enhancement available for an indicative series issued by a floorplan master trust.



(1) The depositor interest represents the interest in the trust assets not allocated to any series. A portion of the depositor interest equal to the available subordinated amount is subordinated to the investors' ABS interests.