ORAL ARGUMENT NOT YET SCHEDULED

No. 17-5004

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

THE LOAN SYNDICATIONS AND TRADING ASSOCIATION,

Appellant,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION;
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,

Appellees.

On Appeal from the United States District Court for the District of Columbia in Case No. 16 Civ. 652 (Hon. Reggie B. Walton)

OPENING BRIEF OF APPELLANT

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April 19, 2017

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

The following information is provided pursuant to D.C. Circuit Rule 28(a)(1):

(A) Parties and Amici

Appellant

The Loan Syndications and Trading Association

Amicus Curiae Supporting Appellant Below

Chamber of Commerce of the United States of America

Appellees

United States Securities and Exchange Commission

Board of Governors of the Federal Reserve System

Amicus Curiae Supporting Appellees Below

Better Markets, Inc.

(B) Ruling Under Review

This appeal challenges the memorandum and order granting summary judgment to Appellees and denying summary judgment to Appellant, entered by the Hon. Reggie B. Walton on December 22, 2016 and reported as *Loan Syndications & Trading Association v. SEC*, — F. Supp. 3d —, 2016 WL 7408834. *See* JA2341-88.

(C) Related Cases

In consolidated cases Nos. 14-1240 and 14-1304, Appellant petitioned for review of the final rules adopted by Appellees that are the subject of the instant appeal. After this Court held that it lacked jurisdiction to directly review the final rules, it transferred the petitions to the United States District Court for the District of Columbia. *See Loan Syndications & Trading Ass'n v. SEC*, 818 F.3d 716 (D.C. Cir. 2016). Appellant now seeks review of the district court's order granting Appellees' motion for summary judgment and denying Appellant's. Counsel is aware of no related cases currently pending in this or any other court.

RULE 26.1 DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure and Local Rule 26.1, the Loan Syndications and Trading Association respectfully submits this Corporate Disclosure Statement and states as follows:

The Loan Syndications and Trading Association ("LSTA") is a not-for-profit trade association representing members participating in the syndicated corporate loan market. The LSTA has no parent corporation, and no publicly held company has 10% or greater ownership in the LSTA.

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GLOSSARY

ABS	Asset-Backed Security
APA	Administrative Procedure Act
Commission	United States Securities and Exchange Commission
CDO	Collateralized Debt Obligation
CLO	Collateralized Loan Obligation
LSTA	The Loan Syndications and Trading Association
SEC	United States Securities and Exchange Commission

INTRODUCTION

In 2010, Congress enacted the "credit risk retention" provision of the Dodd-Frank Act. That provision sought to limit how financial entities, especially banks that originate loans, use securitizations to transfer the risks of those loans from themselves to investors. In a typical securitization, pools of loans serve as the basis for issuing classes of securities to investors who are entitled to payments from income generated by the pooled loans. As a result, those investors – rather than the party that originated the loans – bear the risk of resulting losses. The Act directed financial regulators to ensure that certain parties involved in structuring securitizations retain some of that associated credit risk rather than transferring all of it away.

This case concerns the application of the resulting regulation to managers of a particular type of securitization, called open market collateralized loan obligations, or "CLOs." CLOs are securitizations backed by large loans generally originated by leading banks and provided to large companies with relatively high levels of debt. CLOs are an important source of financing for those companies and performed exceptionally well during the financial crisis, especially relative to other types of securitizations. Managers of CLO assets, like other fund managers, work on behalf of investors and are rewarded principally based on their investment

performance and fund oversight. Managers of CLO assets are not themselves in the business of originating loans or taking ownership positions in loans.

This case presents two issues: whether the Act applies at all to these managers and, if so, whether the requirement imposed on them is the product of reasoned decisionmaking. As to the first, the central issue of statutory construction is whether the manager "sells" or "transfers" loans to the CLO. Because the manager never owns or controls loans that it could transfer or sell to the CLO, and because it instead acts on behalf of the CLO to facilitate the CLO's purchase of the loans, the Act does not apply to the managers. They act for the purchasers or transferees of the loans, not as sellers or transferors.

As to the second issue, the agencies initially determined that a 5 percent level of credit risk retention was adequate, and that levels above that would harm borrowers, consumers, and market efficiency. Yet the agencies then adopted a rule that, in nearly all its applications, imposes a higher level of credit risk and thereby causes precisely the harms that the agencies identified. The agencies reached this result by disregarding the key statutory factor of credit risk, ignoring inconsistencies in their approach, failing to assess the rule's implications, failing to respond to comments, and rejecting alternatives that would better meet the agencies' own objectives. The rule is a classic instance of arbitrary decisionmaking.

STATUTES AND REGULATIONS

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1890-96 (2010), codified in relevant part at 15 U.S.C. § 78*o*-11, and the relevant portions of the *Credit Risk Retention* rules jointly promulgated thereunder, codified at 17 C.F.R. pt. 246 and 12 C.F.R. pt. 244, are reproduced in the Addendum.

STATEMENT OF ISSUES

1. Whether the agencies properly interpreted the term "securitizer," defined to include "issuer[s]" and persons who "sell[] or transfer[] assets … to the issuer," 15 U.S.C. § 78*o*-11(a)(3), to extend to persons that facilitate the issuer's purchase of assets but who themselves own no loans to transfer or for which they can "retain" credit risk.

2. Whether the agencies acted arbitrarily by requiring securitizers in nearly every application of the rule to hold far more than the amount of risk the agencies deemed sufficient under Section 941, when the agencies elsewhere determined that excess risk retention would increase borrowing costs, limit the availability of credit, and otherwise harm the public interest.

STATEMENT OF FACTS

I. Industry Background.

A. Financing Large U.S. Businesses: Leveraged Loans and CLOs.

Large and medium-sized U.S. businesses depend on financing to conduct and improve their operations, innovate, and hire employees. Some businesses can secure capital by issuing shares or by issuing tradable, investment grade bonds. Many significant and innovative businesses, however, depend for financing on high-yield bonds or, more commonly, on commercial loans from groups of commercial banks or from individual banks and other financial institutions. These "leveraged loans" are commonly provided to companies that have relatively significant debt burdens or otherwise do not qualify for investment grade credit ratings. JA934-35.

Businesses, including many of the nation's most significant and widely recognized ones, rely on more than $1.2 trillion of outstanding leveraged loans. JA1433; JA943-53 (indicative companies include Rite Aid, Toys"R"Us, and Delta Air Lines). A handful of the nation's largest commercial banks serve as "lead arrangers" that coordinate the lending process for most syndicated loans. Through that process, other banks and non-bank institutions undertake extensive due diligence before negotiating and financing the loans. JA1093-94. Portions of the resulting leveraged loans may be held by these loan originators or traded on a

robust, transparent secondary market. Banks, insurance companies, mutual funds, hedge funds, non-bank financing companies, and the issuers of the collateralized loan obligations ("CLOs") at issue in this case purchase portions of leveraged loans and thus ultimately provide the financing for them. *Id.*; JA763-64; JA2098-122.

B. The Structure and Operation of CLOs.

CLOs are investment funds designed to invest primarily in leveraged loans. Of the $1.2 trillion in outstanding leveraged lending in 2011, CLOs provided approximately $285 billion. CLOs represent an increasingly important source of financing. JA1437.

CLOs are structured as securitizations. In a securitization, a legal entity purchases and pools income-generating assets; creates classes – or "tranches" – of securities with different priorities of claim to the assets' stream of income; and issues those securities to investors. In this way, the risk of borrower non-payment inherent in the loans – the credit risk – is shifted away from the securities that have higher priority to the loan payments and concentrated in the securities that have lower, subordinated priorities. The ultimate borrowers can thus secure financing from investors averse to credit risk and seeking investment grade securities, as well as from investors willing to accept greater credit risk in return for the greater potential reward associated with subordinated securities. The result has been the

remarkably expanded availability of credit to borrowing companies that otherwise would have been excluded from the markets, lower financing costs, and more varied products available to investors. JA2103-04; JA2156-57.

The CLOs at issue in this case are "open market CLOs." Open market CLOs are organized principally by and for large, sophisticated investors to provide a vehicle for investment in leveraged loans. CLOs generally acquire those loans through purchases in the secondary market. Managers of open market CLOs select but never own the loans, either before or after the CLO's formation. JA1159; JA1098; JA1103-04. Much like the managers of mutual funds, managers of CLO assets are generally registered investment advisers, with fiduciary duties to investors, and their business is based on securing fees from successfully managing investors' funds. In contrast, "balance-sheet CLOs," which are not at issue in this case, are designed by the originators or owners of leveraged loans, which sell or transfer their loans to securitization vehicles that in turn issue securities to investors. JA1130-31; JA762-63; JA2007. Those vehicles are not actively managed. JA1179-80.

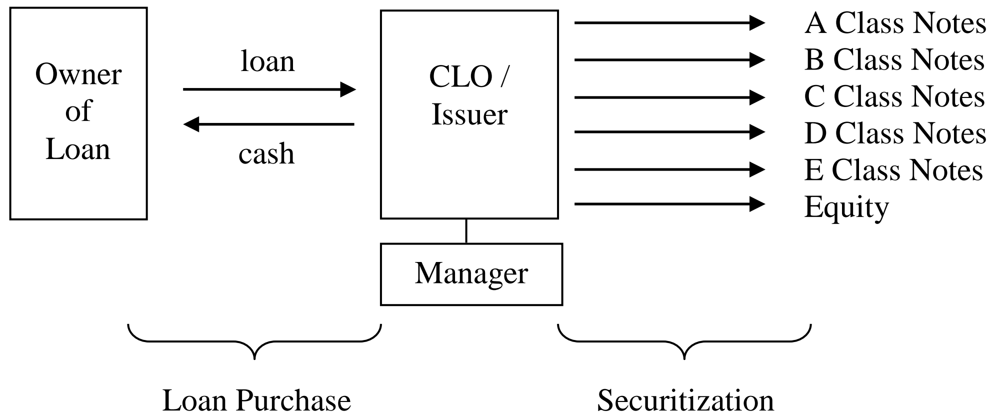
Open market CLOs are developed in stages. Initially, investors negotiate with the manager to define the investment parameters that bind the CLO (and thus the manager) and to establish the CLO's structural features that protect investors. Then, the manager facilitates the CLO's purchase of portions of leveraged loans

and the CLO's issuance of tranches of notes to investors. Thereafter, the manager manages the CLO's loan portfolio. JA1704-05.

The CLO's acquisition of assets. The CLO is a separate legal entity. It has board members and, pursuant to a power of attorney and agreements noted above, a manager that acts as an agent to select and facilitate the CLO's purchase of loans. JA2009; JA764-65.

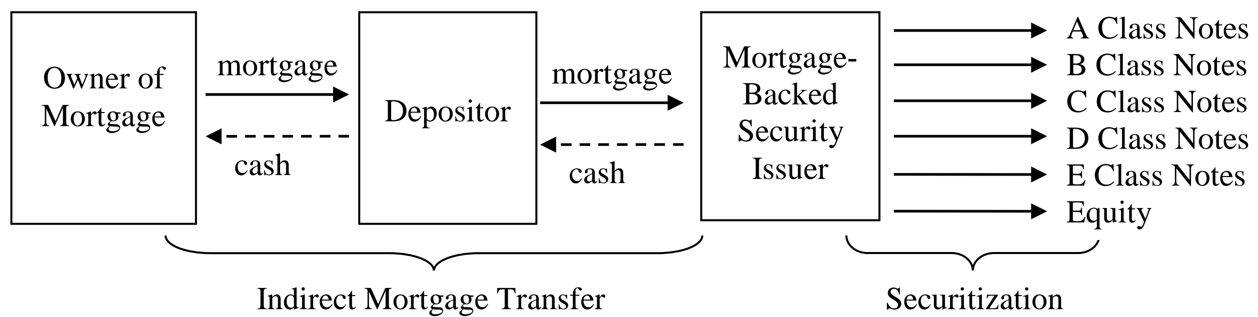
The CLO purchases portions of loans from syndicate banks or in the secondary market (hence the term "open market CLO"). A typical CLO portfolio comprises portions of roughly 150 loans, often totaling $500 million or more. Those loans generate payments of interest and repayments of principal that are distributed in priority to the CLO investors. Investors depend on the CLO manager's judgments about loan quality, which will determine the CLO's performance and, eventually, the amount of compensation due to the manager. Unlike for many other securitizations, the manager never owns or possesses loans that are sold or transferred to the CLO issuer. JA980; JA1095-96. The following structure typifies how CLOs acquire assets:

Direct Sales / Transfers to CLOs



In contrast, other types of securitizations often use an indirect transfer structure. JA1160-61. For example, securitizations based on real property assets (*e.g.*, mortgages) use an intermediary, or "depositor," that stands in the chain of title between the entity selling loans and the issuer:

Indirect Sales / Transfers for Real Estate Securitizations



Issuing CLO securities. The CLO issues debt and equity securities to investors. The notes with first priority to receiving payments from the asset pool typically have the highest investment grade rating (AAA) and usually comprise more than 60 percent of the total value of all issued securities. Tranches of

securities with progressively subordinate claims on the payments have correspondingly greater credit risk (and higher rates of potential payments). The most subordinated class of notes or preferred shares (the equity) has no defined entitlement to any particular payment; instead, equity holders receive any residual payments once the more senior noteholders have received all payments due to them.

The following CLO structure is typical:

Class of Notes	% of Overall Value	Rating	
A	61 – 72	AAA	
B	7 – 11.5	AA	
C	5 – 7.5	A	
D	5	BBB	investment grade
E	3 – 5	BB	non-investment grade
Equity	8 – 10	not rated	

See JA2091; JA1789-99; JA2107. Through securitization, the credit risk of the CLO assets is directed away from the holders of investment grade notes and concentrated almost entirely in the most subordinate, equity securities. JA2037.

Managing CLO assets. After the open market CLO purchases loans and issues securities, the CLO manager actively manages the CLO's assets following an initial "ramp up" stage – much as the manager of a mutual fund might. The relatively small number of loans in a typical CLO's portfolio allows the manager to monitor the performance of each loan and to respond to changes in performance or market conditions by buying and selling loans, within the parameters set by

investors. The CLO is thereby able to recognize gains on performing assets and limit losses on under-performing ones, and may during a certain period reinvest proceeds from principal repayments in new loans, protecting the CLO's long-term health. JA876, JA1705-10.

C. CLO Performance and Distinguishing Characteristics.

Open market CLOs performed exceptionally well during the financial crisis, especially compared to other types of securitizations. Losses were concentrated in securitizations backed by residential and commercial mortgages, as well as in "collateralized debt obligations" (CDOs), which pooled various loans or derivatives and notes from other securitizations. Whereas "435 … CDOs experienced an event of default" during the financial crisis, "no Managed CLO triggered an event of default." JA874-75; JA526-27. A post-crisis analysis by Moody's concluded that only 32 of 4,118 CLO tranches (0.8%) suffered any losses at maturity, and even those losses were far from substantial and were concentrated in the most subordinated tranches; investors in investment grade CLO notes suffered almost no losses. JA1096; JA1152-53; JA874-75; JA1789-99.

Open market CLOs performed so well during the financial crisis due to a variety of characteristics that protect investors and reduce risk. JA1703-10. One is the fact that these CLOs purchase loans on the open market rather than originate loans. Most securitizations are organized by loan originators (or owners), who

face a potential conflict of interest with investors when they secure fees for originating loans but then use securitizations to transfer the risks associated with the loans to investors. In contrast, open market CLOs are designed by investors and asset managers to enable investment in portfolios of leveraged loans. The managers do not own or originate a portfolio of loans, do not receive fees related to originations, and earn their fees based largely on how the CLO's assets perform. JA1133-35; JA770-72.

Several characteristics of managers of CLO assets also contributed to CLOs' good performance. Those managers are regulated as investment advisers under the Investment Advisers Act of 1940, have fiduciary duties to the CLO, and are compensated in large measure based on the performance of the managed assets. Specifically, they receive their primary periodic payment only after all debt noteholders receive payments due to them, and a significant portion of their compensation is deferred and paid only if CLO equity noteholders have received a previously agreed, total return on their investment. JA1095-96. This compensation reflects the most concentrated credit risk: if the CLO's assets perform well, the managers are well compensated; if not, they bear the consequences. Investors sometimes require managers to further align their interest with investors' by investing a modest amount in the CLO's equity. JA1180.

Furthermore, CLO investors are limited to institutions and very high net worth individuals, who often set the investment parameters that bind the manager, may have approval rights over certain loan purchases, and have rights to remove the manager. JA2007-08. The manager provides investors with detailed information regarding the performance of the individual loans owned by the CLO. Investors also enter agreements that limit the CLO's assets principally to the type of large-company, "leveraged loans" described above that have a priority claim on the borrower's assets, providing significant value even for the small percentage of loans that go into default. JA2008-09. Investors in notes with higher protections are further protected by performance-based triggers that divert payments to them if the market value of CLO assets falls below certain thresholds. JA1705-06.

II. Statutory Background.

In drafting the Dodd-Frank Act, Congress identified two features of poorly structured securitizations that contributed to the financial crisis and the collapse of securitization markets. S. Rep. No. 111-176, at 128 (2010). One was the "complexity and opacity" of certain securitizations, such as CDOs, which prevented investors from assessing relevant risks. *Id.* at 128-29. The other problem was that many securitizations were produced "under the 'originate to distribute' model." *Id.* at 128. As noted, lenders would often originate loans with

the expectation that the credit risk would be transferred through securitizations they created.

Congress designed Section 941 of Dodd-Frank to address these problems. Congress's solution was to have certain parties involved in securitizations "retain a material portion of the credit risk of any asset" underlying a securitization. *Id*. at 129. It reasoned that "[w]hen securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interests with those of investors in asset-backed securities." *Id*. The objective was not to limit securitizations, but rather to "restore investor confidence," to "permit securitization markets to resume their important role as sources of credit for households and business," and "to encourage recovery of securitization markets." *Id.* at 128, 130-31.

Section 941 accomplished this objective in three steps. *First*, it amended Section 15G(a)(3) of the Securities Exchange Act to define "securitizers" subject to credit risk retention requirements. An entity is a "securitizer" if it is "an issuer of an asset-backed security" *or* if 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." 15 U.S.C. § 78*o*-11(a)(3).

Second, the statute defined securitizers' risk retention obligation in terms of "credit risk" and required four agencies – the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, the Federal

Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the "agencies") – jointly to establish a retention requirement of "not less than 5 percent of the credit risk for any asset" that supports a securitization. *Id.* § 78*o*-11(c)(1)(B); *see id.* § 78*o*-11(b)(1). Credit risk is the risk that the borrower will not fulfill its obligations and is distinct from the interest rate, legal, operational, currency, and other risks affecting the securities' value. *See* JA315; JA1167.

Third, Congress directed the agencies to adjust the 5 percent baseline requirement, either upward or downward, to account for differences among securitizations. It rejected "a 'one size fits all' approach to risk retention" as potentially "adversely affect[ing] certain securitization markets." S. Rep. No. 111-176, at 130. Thus, Congress empowered the agencies to "issue exemptions, exceptions, or adjustments to the rules" when doing so would "help ensure high quality underwriting standards" and "improve the access of consumers and businesses to credit on reasonable terms," protect investors, or meet other objectives. 15 U.S.C. § 78*o*-11(e)(1)-(2); *see id.* § 78*o*-11(c)(1)(G)(i) (agencies "shall" provide appropriate exemptions).

III. Agency Proceedings.

To implement the risk retention requirement, the agencies jointly issued a notice of proposed rulemaking in 2011, JA179, followed by a revised notice in

2013, JA1206, and ultimately a final Credit Risk Retention Rule (the "Rule") the next year, JA2170.[1]

The agencies interpreted the statutory definition of "securitizer" by declining to give *any* independent meaning to one of the two prongs of the statutory definition, subsection (a)(3)(A) (defining securitizers to include "issuers"), on the ground that their construction of the other prong, subsection (a)(3)(B), was adequately broad. JA2177-78. That second prong defines a securitizer as "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." 15 U.S.C. § 78*o*-11(a)(3)(B). The agencies referred to the person defined in the second prong as a "sponsor" of the securitization and interpreted the definition to include persons that "organize and initiate" a securitization and that facilitate the *purchase* of securities by the issuing entity. *See* JA2222-24. This purchasing activity, they concluded, amounted to "transferring assets … indirectly … to the issuer." JA2223. On this basis, the agencies determined that a manager of an open market CLO, which facilitates loan purchases for the CLO, falls within

[1] The joint orders also addressed matters not directly at issue in this case, including the determination that no risk retention would be required for securitizers of certain especially risky residential mortgages, despite their prominent role in the financial crisis. *See* JA2254-62; JA2161-65 (SEC Commissioner Gallagher, dissenting); JA2323.

the definition of "securitizer," even though it does not own or possess any assets that can be sold or transferred to the CLO or for which it can "retain" credit risk.

With regard to Congress's direction to establish appropriate levels of "credit risk" for securitizers to retain, the agencies determined that 5 percent would be sufficient to achieve the statute's objectives. JA2180. The agencies decided, however, to define the retention requirements not in terms of assets' credit risk, but rather in terms of their "fair value," *i.e.*, economic or market value. JA2181-83. Securitizers could choose to retain a "vertical" interest comprising 5 percent of each tranche of issued security; a "horizontal" interest comprising only the most subordinate securities, but equal to 5 percent of the economic value of all assets supporting the securitization; or any combination of vertical and horizontal interests amounting to 5 percent of that economic value. *Id*. In initially proposing this scheme, the agencies acknowledged that a horizontal interest of subordinated securities would embody considerably more risk than a vertical interest of equivalent economic value, and they sought comment on whether they should reduce this disparity. JA1219; JA1291. But the agencies then addressed this issue no further.

Commenters, however, argued that the agencies should reduce the required horizontal interest to align it with the 5 percent risk retention level the agencies found sufficient. The LSTA, for example, presented expert analysis indicating

that, for a typical CLO, nearly all the credit risk of the assets was embodied in the most subordinate, equity tranche (amounting to 8-10 percent of the value of the assets), so the manager's purchase of 5 percent of equity securities – or less than 0.5 percent of the economic or "fair" value of the overall assets – would reflect nearly 5 percent of the credit risk. JA1167-72. (That expert also demonstrated that the majority of the CLO manager's compensation, which is subordinated, also bears the equivalent of nearly 5 percent of the assets' credit risk. *Id.*) Commenters proposed that managers of open market CLOs that adopted a series of "best practices" designed to protect investors should be deemed to have satisfied the retention requirement if they also purchased 5 percent of the CLO's equity. JA2125-46. For similar reasons, one commenter argued that an open market CLO manager that held CLO equity worth one percent of the economic value of the assets, reflecting approximately 10 percent of the assets' credit risk, should be deemed to satisfy the risk retention requirements. JA1717. Thus, for a CLO with $500 million of assets, a manager would have to commit only $5 million rather than $25 million as required by the agencies' rule.

The agencies, however, declined to adopt any of the proposed alternatives or otherwise base their horizontal retention requirement on credit risk rather than economic value. JA2226. They also rejected commenters' arguments that

managers of CLO assets were not "securitizers" subject to the risk retention requirements. JA2223.

Two of the five SEC Commissioners dissented from the decision to adopt the Rule. *See* JA2161; JA2166.

IV. Judicial Proceedings.

In November 2014, LSTA petitioned for review of the Rule in the D.C. Circuit. This Court held that it lacked jurisdiction to directly review the Rule and transferred the case to the district court. *See Loan Syndications & Trading Ass'n v. SEC*, 818 F.3d 716, 721, 724 (D.C. Cir. 2016). On December 22, 2016, the district court granted summary judgment in the agencies' favor. It upheld the agencies' conclusion that the definition of "securitizer" under 15 U.S.C. § 78*o*-11(a)(3) extended to managers of CLO assets. JA2354-68. The court also rejected LSTA's claims that the Rule, and especially its imposition of variable levels of credit risk above the 5 percent baseline deemed adequate by the agencies themselves, was arbitrary and capricious. JA2368-80. LSTA filed a notice of appeal on January 5, 2017. JA2390.

JURISDICTIONAL STATEMENT

The district court had subject matter jurisdiction over this action under 28 U.S.C. § 1331 because LSTA alleges that the Rule is arbitrary, capricious, and contrary to federal law. JA2336-40. This Court has jurisdiction under 28 U.S.C.

§ 1291 to review the district court's final order granting Appellees' motion for summary judgment and denying Appellant's. *See* JA2389.

With respect to standing, LSTA is a trade association representing members directly addressed by the Rule promulgated by Appellees. JA2172; JA2177; 17 C.F.R. § 246.21. LSTA's members include lead arrangers of loans and managers of the assets of open market CLOs, which are directly regulated by the challenged rules addressing retention of credit risk. *E.g.*, JA714; JA762; JA1924-44; JA1440; JA1809-94; JA1460-67; JA1334-42; LSTA, *Membership List*, http://www.lsta.org/about/membership/directory (last visited Apr. 14, 2017).

SUMMARY OF ARGUMENT

This case presents two issues: whether Section 941 applies at all to the managers of CLO assets and, if so, whether the requirement imposed on them is the product of reasoned decisionmaking.

I. Section 941 extends the risk retention requirements only to "issuers" of securitization notes and to parties that "organize[] and initiate[]" securitizations by "selling" or "transferring" assets *to* issuers. The parties agree that the managers of CLO assets are not "issuers" for this purpose, but the agencies concluded that the Rule applies to the managers because they "transfer" the loans to the CLO. It is undisputed, however, that a manager never owns or possesses the loans before the CLO acquires them, acts entirely on behalf of the CLO as its agent and investment

manager, and facilitates the CLO's purchase of the loans. That is, the manager is a purchaser or *transferee* of the loan, not a seller or *transferor*. The plain terms of the statute apply only to transferors and thus provide the agencies with no authority to require the managers to retain credit risk. And this accords with Congress's intent: the managers do not originate the loans or otherwise possess any credit risk that they transfer to investors, and they have no incentive or ability to create risky assets and then offload that risk. Indeed, they have no credit risk to "retain."

II. Even if the Act applies to these managers, the agencies arbitrarily imposed an excessive and inconsistent level of risk retention. The agencies determined that retention of 5 percent of the credit risk associated with a securitization's pooled assets was sufficient to align investor and securitizer interests. They also determined that imposing additional risk or requiring additional capital outlays would be inefficient and harm borrowers, consumers, and securitizers in various ways. Yet the agencies produced a rule that in nearly all its applications has securitizers retain more than 5 percent of credit risk – for many managers of CLO assets, nearly *nine times* that level. To retain such excessive risk, securitizers must commit nine times the capital that would be necessary to retain 5 percent of credit risk.

The agencies produced this result because they defined the retention requirement not in terms of the statutory factor of a percentage of credit risk, but in

terms of a percentage of fair (*i.e.*, market) value. In so doing, the agencies ignored the fact that fair value and credit risk are distinct and unrelated concepts; two sets of assets can have equivalent fair values – *e.g.,* a million dollars' worth of Treasury bonds and a million dollars' worth of junk bonds – but vastly different probabilities of default, *i.e.*, credit risk. By ignoring this distinction, and by applying a fair value-based requirement to the most highly subordinated, risky securitization notes, the agencies required far more credit risk retention than they had determined was actually necessary, and far more than that associated with applications of the Rule involving mainly the safest securitization notes. For managers of CLO assets and others who are required by investors or financial necessity to hold the riskier interests, the agencies' mistaken focus on fair value meant that all the harms that the agencies associated with excessive credit risk retention would, in fact, occur. The agencies never explained why they did not tailor their rule to focus on the statutory factor of credit risk or reduce the amount of required risk to the 5 percent benchmark that they determined to be appropriate. They ignored comments urging this focus and rejected alternatives that would have satisfied the very objectives and levels of risk retention that the agencies had deemed best. In all these respects, the rule is arbitrary and capricious.

STANDARD OF REVIEW

The Court reviews challenges to the lawfulness of agency action *de novo*, giving no deference to the judgment of the district court. *Athens Cmty. Hosp., Inc. v. Shalala*, 21 F.3d 1176, 1178 (D.C. Cir. 1994). The Court "shall … hold unlawful and set aside agency action … found to be … arbitrary, capricious, an abuse of discretion, … otherwise not in accordance with law[,] … [or] in excess of statutory jurisdiction, authority, or limitations." 5 U.S.C. § 706(2)(A)-(C).

ARGUMENT

I. THE TERM "SECURITIZER" UNDER SECTION 941 DOES NOT EXTEND TO MANAGERS OF CLO ASSETS BECAUSE A MANAGER DOES NOT SELL OR TRANSFER ASSETS TO THE CLO.

Under Section 941, the agencies may impose credit risk retention obligations only upon a "securitizer" who "through the issuance of an asset-backed security, transfers, sells, or conveys [credit risk] to a third party." 15 U.S.C. § 78*o*-11(b)(1). The statute defines a "securitizer" as:

> (A) an issuer of an asset-back 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 ….

Id. § 78*o*-11(a)(3). Because the agencies do not claim that managers of CLO assets fall within subsection (A) of this definition (and indeed read subsection (A) out of the statute, *see infra* at 29-30), the only question is whether subsection (B)

extends to those managers who, as agents of the CLO issuers, facilitate the issuers' *purchase* of assets. Because the manager does not control the assets prior to any sale or transfer, and is the transferee of the assets rather than the transferor, the text, context, and structure of the statute make plain that subsection (B) does not apply to these managers and leaves no ambiguity that would support the agencies' exercise of power. *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).

1. To fall within subsection (B), the manager of the CLO's assets must sell or transfer assets to "an issuer," which in this case is indisputably the CLO entity on behalf of which the manager acts. The agencies rightly have never contended that the manager of the CLO's assets sells assets to the CLO, but they do argue that the manager "transfers" assets to it.

The plain meaning of "transfer" as used in subsection (B) forecloses that interpretation. In a legal context, to "transfer" an asset is to divest control or possession over the asset. *See, e.g.*, *Black's Law Dictionary* 1727 (10th ed. 2014) ("[t]o sell or give" or "to pass or hand over from one to another, esp. to change over the possession or control of"); *Merriam-Webster's Collegiate Dictionary* 1328 (11th ed. 2003) ("conveyance of right, title, or interest in real or personal property from one person to another"); *The New Oxford American Dictionary* 1797 (2001) ("[M]ake over the possession of (property, a right, or a responsibility) to

someone else."); *The American Heritage Dictionary* 1832 (4th ed. 2000) ("*Law* To make over the possession or legal title of; convey"); *Random House Webster's College Dictionary* 1366 (2d ed. 1997) ("Law. to make over the possession or control of: to transfer a title to land."). Thus, to be a transferor, one must have control or possession of the asset before the transaction occurs. A CLO manager fails this test: It obtains control over a CLO's assets only *after* the transfer occurs, once the CLO takes ownership and possession.

"[T]he specific context in which [the term] is used, and the broader context of the statute as a whole," reinforce this conclusion. *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341 (1997). Subsection (B) plainly describes a two-sided *financial* transaction, involving the sale or transfer of a financial *asset*. The term "transfer," in turn, must be understood in the legal and transactional sense of divestment of control or ownership appropriate for that transactional context.

Subsection (B) also plainly identifies which side of such financial transactions a securitizer is on. A securitizer under subsection (B) is an entity engaged in "selling or transferring assets" to an "issuer." A securitizer is thus a party on the transaction's selling side – a counterparty to the issuer and its agents on the receiving side. This creates an obvious problem for the agencies' effort to fit managers of CLO assets within subsection (B) because such managers act on the wrong side of these transactions. Acting on behalf of a CLO (*i.e.*, the issuer)

and subject to the contractually-imposed limits on its discretion, a manager selects loans to be purchased on the open market and facilitates the CLO's purchase of those loans through a power of attorney. *See supra* at 6-7. The CLO manager is an agent of the transferee, not a transferor.

The fact that the statute's central requirement is for securitizers to "retain" credit risk, 15 U.S.C. § 78*o*-11(c)(1)(B), underscores why it does not apply to CLO managers. The concept of risk *retention* assumes ongoing exposure to credit risk, before and after the issuance of notes to third parties. However, the manager – like all other fund managers – does not have any interest in the assets prior to note issuance that would expose it to credit risk. The Rule would require a CLO manager to obtain credit risk, not retain it – further confirmation that, under the plain meaning of Section 941, the manager of the CLO's assets is not a securitizer.

In addition, the term "transferring" appears in subsection (B) alongside the word "selling," and repeatedly appears elsewhere in Section 941 in association with the terms "sell" and "convey." *See, e.g.*, 15 U.S.C. § 78*o*-11(b)(1) (applying risk retention requirements to any securitizer that "transfers, sells, or conveys [credit risk] to a third party"); *see also id.* § 78*o*-11(b)(2), (c)(1)(B)(i) & (ii), (c)(1)(C)(iii). These associations confirm that "transfer" must be understood in its legal, transactional sense because "a word is known by the company it keeps." *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961). The "commonsense

canon of *noscitur a sociis* … counsels that a word is given more precise content by the neighboring words with which it is associated." *Freeman v. Quicken Loans, Inc.*, 132 S. Ct. 2034, 2042 (2012). Here, the fact that selling and conveying involve divesting control or possession support construing "transferring" to involve this element as well. *See Jarecki*, 367 U.S. at 307 (explaining that context can indicate that a word "with various shades of meaning" has a "precise and narrow application" in a particular statute).

The agencies try to turn this point on its head by arguing that "[t]o read 'transfer' narrowly to require ownership or possession would make the preceding word 'sell' superfluous because the act of selling necessarily involves the legal transfer of the asset." JA2223. But the canon against surplusage does not help the agencies because their construction of "transfer" is broader, *see infra* at 27, and so would equally encompass the term "sell." *See United States v. Ali*, 718 F.3d 929, 938 (D.C. Cir. 2013) ("[T]he canon against surplusage merely favors that interpretation which *avoids* surplusage, not the construction substituting one instance of superfluous language for another."). Nor is it true that a legal construction of "transfer" makes the term synonymous with "sell": "Sell" more naturally applies to an arm's length disposition for consideration, while "transfer" more naturally extends to a shift of assets between affiliated entities. Indeed, in a securitization, one entity holding the asset (*e.g.*, a depositor) may transfer the asset

to the issuer, while another entity receives the economic value of that transfer. Any remaining overlap between the terms "sell" and "transfer" simply reflects Congress's common practice of employing redundancy "so as to remove any doubt and make doubly sure" the statute applies as intended. *Loving v. IRS*, 742 F.3d 1013, 1019 (D.C. Cir. 2014).

Finally, construing "securitizer" not to reach managers of CLO assets is consistent with the congressional objectives behind Section 941. Those managers primarily arrange purchases of loans in the secondary market and are not part of the "originate to distribute" problem that Section 941 sought to address. *See* S. Rep. No. 111-176, at 128. They are instead like other types of fund managers, which are hired and compensated based on their ability to select high-performing assets and which, critically, are not regulated at all under the statute.

2. The agencies ignore the legal and transactional context of the statute in arguing that subsection (B) extends to managers of CLO assets. They claim that "transfer" is "commonly defined as 'to cause to pass from one to another,'" which the manager supposedly does by "select[ing] the assets for the collateral pool and direct[ing] the issuing entity to purchase such assets." JA2223. This reliance on a colloquial rather than legal meaning of "transfer," however, ignores the fact that the term's meaning is a question of *statutory* construction. The term appears in a law, and "the law uses familiar legal expressions in their familiar legal sense," not

"their everyday sense." *Bradley v. United States*, 410 U.S. 605, 609 (1973) (alteration omitted); *see also* A. Scalia & B. Garner, *Reading Law: The Interpretation of Legal Texts* 73 (2012) ("[W]hen the law is the subject, ordinary legal meaning is to be expected, which often differs from common meaning.").

As proof of that point, the agencies' suggested definition of "transfer" makes no sense in the context of the statute. A purchaser who selects and arranges delivery of an item – a book, a car, or even a security – may conceivably "cause [the item] to pass" to itself, but no one would say the purchaser "transfers" those items to itself. In contrast, the legal, transactional sense of "transfer" fits naturally in subsection (B), as one would expect given that subsection (B) is part of a law and describes a commercial transaction.

For similar reasons, the statutory term "indirectly" does not transform the meaning of "transfer" or otherwise assist the agencies. A purchaser may in some sense be a but-for cause of an asset's transfer, directly or indirectly, but that does not mean the purchaser is doing the transferring or becomes the transferor. This is especially so because the statute makes perfectly clear what it means to transfer assets "indirectly": The assets need not pass directly from transferor to transferee, but may instead pass *indirectly* through intermediaries, "including through an affiliate" of the transferor. 15 U.S.C. § 78*o*-11(a)(3)(B). Or, a seller may direct another party to make the transfer, as happens in many securitizations, in which the

depositor functions in just this intermediary or third-party way. *See supra* at 8. Subsection (B) prevents securitizers from circumventing the statute by using intermediaries and reflects the reality that securitizations very often involve intermediate transfers, particularly when real property is involved – a reality the agencies themselves acknowledged. *See* JA2177-78 & n.41.

3. In addition to being unnatural and non-contextual, the agencies' broad reading of "transfer" points to two further flaws in their approach. *First*, such a reading is open-ended in a manner Congress could not have intended. The agencies' construction would extend to any participant in initiating or organizing a securitization who has a role in "caus[ing]" assets to pass to the issuer. Every banker, lawyer, loan trader, corporate official, or advisor who assisted in or served as a cause of the shift of assets to the issuer would fall within the definition. Indeed, the agencies' construction effectively reads out of subsection (B) all the words beginning with "by selling or transferring …." If the agencies' view of "transfer" were accepted, potentially every party who "organizes or initiates" a securitization transaction would have "caused" the "transfer" of assets to the issuer.

Second, the agencies themselves created any need to give "transfer" such an unnaturally broad construction because they gave subsection (A), the first prong of the definition of "securitizer" that encompasses "issuers," no independent effect at

all. Construing subsection (B) to describe what pre-existing regulations called a "sponsor," JA2177, the agencies stated that a sponsor "identif[ies] the party subject to the risk retention requirements for *every* securitization transaction," JA2178 (emphasis added). This statement concedes that the agencies treated one of the two prongs of a defined term as surplusage, even though agencies could instead have fulfilled their "duty to give effect … to every clause and word of a statute" simply by interpreting "issuer" to mean "issuing entity."[2] *Duncan v. Walker*, 533 U.S. 167, 174 (2001); *see Freeman*, 132 S. Ct. at 2043 (explaining that courts should "favor[] that interpretation which *avoids* surplusage").

This error matters here because the agencies assert that they construed "transfer" to extend to CLO managers lest there be no party to a CLO securitization subject to risk retention obligations. *See* JA2223-24; *see also* Agencies' Summary Judgment Br. 30-31. But to the extent that omission causes a

[2] Making matters worse, the agencies *did* interpret "issuer" to mean "issuing entity" for the term's appearance in subsection (B) – but only there. *See* JA188 n.41. Thus, in addition to violating the rule against surplusage, the agencies' approach departed, without explanation, "from the normal rule of statutory construction that words repeated in different parts of the same statute generally have the same meaning." *Law v. Siegel*, 134 S. Ct. 1188, 1195 (2014); *see also* *IBP, Inc. v. Alvarez*, 546 U.S. 21, 33-34 (2005) (explaining that there is "no plausible argument" that a phrase means one thing in one subsection and another thing in an adjoining subsection, "not only because of the normal rule … that identical words used in different parts of the same statute are generally presumed to have the same meaning," but also because the latter subsection contained "an explicit reference to the use of the identical term" in the former subsection).

problem, it is entirely one of the agencies' own making. Had the agencies construed "issuer" as "issuing entity" in the first prong of the definition, as they did in the second, no statutory gap would exist; any gap arises only from the agencies' own decision to ignore subsection (A). As LSTA noted, the CLO itself – a distinct legal entity that holds the relevant assets and issues securities backed by them – is the "issuer" of an asset-backed security, *see, e.g.*, 15 U.S.C. §§ 78c(a)(8) & 77b(a)(4), and thus could fall within subsection (A) of the definition of "securitizer," *see id.* § 78*o*-11(a)(3)(A); JA1098 n.21. The agencies should not be permitted to use a misconstruction that nullifies subsection (A) to justify a separate misconstruction of subsection (B) that stretches its meaning beyond what its text can plausibly bear.

4. The district court's conclusion that the meaning of "transfer" is ambiguous and that the agencies' construction is reasonable is wrong for all the reasons discussed above. In addition, the district court made two significant mistakes of its own. *First*, the court relied heavily on its observation that "Congress intended to broadly delegate the task of regulation in this complex market to the expert agencies." JA2356. A broad delegation, however, does not permit agencies to disregard plain text. *See Chevron*, 467 U.S. at 842-43. If the meaning of "transfer" is clear – and, as LSTA has shown, it is – the scope of delegation is irrelevant.

Second, to support the agencies' construction of "transfer," the district court noted the similarity between the definition of "securitizer" in Section 941 and the definition of "sponsor" in SEC Regulation AB, 17 C.F.R. § 229.1101(*l*), and inferred that Congress "chose to incorporate the agencies' broad definition of 'sponsor' into the statutory definition of 'securitizer.'" JA2357. Even if that is correct, however, it offers no support for applying the statute to managers of CLO assets because the pre-existing definition of "sponsor" did not apply to them either. Indeed, Regulation AB does not apply to CLOs at all because it covers only asset-backed securities "with a general absence of active pool management," 79 Fed. Reg. 57184, 57296 (Sept. 24, 2014); *see also* 17 C.F.R. § 229.1101(c)(2)(ii) (providing that for an asset-backed security to fall under Regulation AB, "[t]he activities of the issuing entity for the asset-backed securities" must be "limited to passively owning or holding the pool of assets"), and CLOs, as the agencies acknowledge, are actively managed, *see* JA2219; *supra* at 9-10.

Accordingly, the district court's reasoning should be rejected, and this Court should hold that Section 941's plain terms do not encompass the managers of CLO assets.

II. THE RULE'S IMPOSITION OF NON-UNIFORM AND EXCESSIVE CREDIT RISK RETENTION WAS THE PRODUCT OF ARBITRARY AND CAPRICIOUS DECISIONMAKING.

Even if the Court concludes that managers of CLO assets are securitizers, it should vacate the rule as arbitrary and capricious in several respects.

A. The Agencies Relied Upon an Improper Factor and Failed to Apply the Requisite Statutory Factor.

Congress directed the agencies to regulate the level of "credit risk" to be retained by securitizers. 15 U.S.C. § 78*o*-11(c)(1)(B)(i). However, the agencies based the Rule's requirements on the quite different factor of "fair value" and did not even assess the amount of "credit risk" the Rule required. By doing so, the agencies violated basic principles of reasoned decisionmaking and misapplied the statutory term "credit risk." *See also Judulang v. Holder*, 565 U.S. 42, 52 n.7 (2011) (noting that an arbitrary and capricious agency action is also unreasonable under *Chevron*). "[A]gency action is lawful only if it rests on a consideration of the relevant factors," *Michigan v. EPA*, 135 S. Ct. 2699, 2706 (2015), and is unlawful "if the agency has relied on factors which Congress has not intended it to consider," *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Inc. Co.*, 463 U.S. 29, 43 (1983). "A statutorily mandated factor, by definition, is an important aspect of any issue before an administrative agency …." *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004). Because the Rule's requirements are not based on the statutory factor of credit risk, and instead largely

stem from consideration and application of a non-statutory factor of fair value, the Rule must be set aside.

Credit risk and fair value are quite different concepts. Fair value is simply the economic or market value of a particular asset. Credit risk, in contrast, is the anticipated loss resulting from borrowers' non-payment of a pool of loans – an understanding the Rule itself reflects in the definition of "credit risk," JA2310, and one routinely acknowledged elsewhere by the agencies in a range of banking and financial regulations, *see, e.g.*, Fed. Reserve Bd., *Credit Risk Rating at Large U.S. Banks,* 84 Federal Reserve Bulletin 897, 914 (Nov. 1998), http://bit.ly/2oAMIxR.

Credit risk and fair value differ in significant practical ways that lie at the heart of this dispute. Two sets of assets can have equivalent fair value but vastly different levels of credit risk. For example, one million dollars' worth of AAA-rated securities, such as U.S. Treasury bonds, and one million dollars' worth of BB-rated "junk" bonds both have fair value of one million dollars. The Treasury bonds, however, have virtually no risk of non-payment and thus no credit risk (indeed, the interest rate on those bonds is commonly called the "risk free" rate). The BB-rated bonds, by contrast, have material risk of borrower non-payment, reflected in the far higher interests payments that investors demand to compensate for that additional credit risk.

In the context of risk retention by securitizers, this practical difference is immense. Because credit risk is concentrated in the securitization's most subordinated notes, a "horizontal" interest (composed only of the riskiest subordinated notes) that has the same fair value as a "vertical" interest (composed principally of the safest securities) embodies vastly more credit risk. Put another way, a very small horizontal interest and a much larger vertical interest, measured by fair value, can hold equivalent credit risk. *See infra* at 40-42.

As noted, Congress required the agencies to base risk retention on the appropriate level of credit risk. *See* 15 U.S.C. § 78*o*-11(b)(1) (directing the agencies to determine "the portion of the credit risk" securitizers must retain). Congress focused on credit risk for a simple reason: its goal was to "provide securitizers an incentive to monitor and ensure the quality of the securitized assets" and to avoid losses, JA2173-74; JA2180, and asset quality and potential loss are measured through credit risk, not fair value. *See also* S. Rep. No. 111-176, at 37 (requiring retention of a percentage of credit risk was intended to have securitizers focus on the quality and potential losses of loans underlying the securitization).

Yet, despite the statutory command, the agencies based the crucial component of the Rule, the horizontal interest, on "a fair value framework." JA2185; *see* JA2176 ("[t]he amount of eligible horizontal residual interest is equal to the fair value of [that] interest divided by the fair value of all ABS interests

issued in the securitization"); JA2311.[3] This departs entirely from a focus on potential losses or credit risk. Indeed, the agencies' focus on fair value led them to not even assess the amount of credit risk that a securitizer would bear using the horizontal interest and to reject alternatives that would have focused on credit risk on the ground that the retention was too small as measured by *fair value*. *See infra* at 43, 50-52.

The agencies argued to the district court that their reliance on fair value was appropriate only because "the horizontal option exposes the sponsor to the same amount of credit losses as the vertical under a total-loss scenario." Agencies' Summary Judgment Br. 47. This rationale appears nowhere in the agencies' orders, however, and the district correctly concluded that it is impermissibly post-hoc. JA2379; *see SEC v. Chenery Corp.*, 318 U.S. 80, 87 (1943). Moreover, the explanation makes no sense in terms of how market participants or regulators understand credit risk. "Credit risk," by its plain terms, contemplates a risk – a possibility of loss, not a certainty of total loss. *See, e.g.*, Comptroller of the Currency, *Rating Credit Risk: Comptroller's Handbook*, app. C at 51 (Apr. 2001) ("Many companies in the financial services industry use the following three terms

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[3] The Rule contemplates that the securitizer can hold any combination of vertical and horizontal interests (including exclusively one or the other), JA2311, so every application of the Rule other than a purely vertical holding is predicated on fair value. Even the purely vertical holding was initially designed to be measured based on total value. *See* JA191; JA1306.

when defining credit risk: probability of default (PD), loss given default (LGD), and expected loss (EL)…. [T]he concepts are inherent to the regulatory ratings.”). Indeed, the Rule’s own definition of “credit risk” employs the traditional, probabilistic sense of risk used by the market, and its reference to “[t]he effect that significant changes in the underlying credit quality of the asset … may have on the market value” applies only in the event of a partial, not total, loss. JA2310. A securitizer holding a vertical interest could, in any event, suffer a “total loss” only in the entirely unrealistic scenario of (a) every single borrower completely defaulting, (b) none of them having any assets subject to credit recovery in bankruptcy, and (c) the issuing entity holding no cash, treasuries, or other assets. Understandably, the agencies could point to no other instance where they employ a “total loss” understanding of credit risk or to any support for that view in the record.

The district court, for its part, found the agencies’ use of fair value to be reasonable based principally on statements in the order explaining why fair value is superior to par value, face value, and other measures of total value, not credit risk. JA2372 (citing JA1289, JA2185). None of these cited portions of the order addressed the relation between credit risk and fair value, how much credit risk was required by the horizontal component, why it was appropriate to depart from the 5 percent credit risk baseline, or why the credit risk associated with the horizontal

interest should not be brought closer to the 5 percent baseline. Thus, the district court, like the agencies, failed to consider the central problem with fair value.

The court also erred in justifying the use of fair value on efficiency and administrability grounds. JA2373. *First*, the agencies did not argue that fair value is a proxy for credit risk, so that argument cannot save the Rule now. *See Chenery*, 318 U.S. at 87. *Second*, in any event, fair value is not a reasonable proxy for credit risk. This Court has permitted proxies only if they are "sufficiently well-correlated" with the actual subject of regulation to serve as a reliable surrogate. *Kennecott Greens Creek Mining Co. v. Mine Safety & Health Admin.*, 476 F.3d 946, 956 (D.C. Cir. 2007). For all the foregoing reasons, however, fair value and credit risk are not well-correlated; indeed, knowing the value of one does not permit *any* inference about the value of the other. And because fair value is an unreasonable proxy, efficiency is not a sufficient basis for using it. *See Nat'l Mining Ass'n v. Babbitt*, 172 F.3d 906, 912-13 (D.C. Cir. 1999).

B. By the Agencies' Own Reasoning, the Rule Imposes Inconsistent and Excessive Levels of Credit Risk Retention.

The agencies' determination of the level of credit risk a securitizer should bear also failed basic requirements of reasoned decisionmaking. A failure to "articulate … a rational connection between the facts found and the choice made" is the essence of arbitrary and capricious decisionmaking. *State Farm*, 463 U.S. at 43. As a result, this Court has "often declined to affirm an agency decision if there

are unexplained inconsistencies in the final rule," *Dist. Hosp. Partners, L.P. v. Burwell*, 786 F.3d 46, 59 (D.C. Cir. 2015), and a "long line of precedent has established that an agency action is arbitrary when the agency offer[s] insufficient reasons for treating similar situations differently," *County of Los Angeles v. Shalala*, 192 F.3d 1005, 1022 (D.C. Cir. 1999) (alteration in original). In this case, the agencies determined that a 5 percent level of credit risk was appropriate to align investor and securitizer interests, and that imposing additional risk retention or capital outlay requirements would harm market efficiency and consumers. Yet the agencies adopted a rule that, in nearly all its applications, requires higher risk retention and capital outlays, producing these adverse effects and imposing different levels of risk retention on otherwise similarly situated securitizers.

1. Section 941 provides that, for most non-mortgage assets, the agencies shall "require a securitizer to retain … not less than 5 percent of the credit risk" for assets supporting "the issuance of an asset-backed security by the securitizer." 15 U.S.C. § 78*o*-11(c)(1)(B)(i). Although Section 941 makes 5 percent the floor, the agencies adopted that "minimum 5 percent base risk retention requirement [for] all securitization transactions," JA2176, and determined that that amount of credit risk is sufficient to align the interests of securitizers and investors by "provid[ing] securitizers an incentive to monitor and ensure the quality of the securitized assets underlying a securitization transaction." JA2173-74. They also declined to "vary

the amount of risk retention based on the quality of the assets or other factors" and noted that "parties to a securitization transaction may agree that more risk will be retained." JA2180. The agencies separately determined that the five percent of credit risk retained by a securitizer that held a "vertical" interest (*i.e.*, five percent of each tranche of the securitized notes) was an adequate level of risk retention. JA2185.

Despite these conclusions, the Rule imposes a much higher level of credit risk retention on securitizers that retain risk through a horizontal interest, in whole or part. For CLOs, that interest embodies more than 45 percent of the securitization's credit risk – that is, nine times more risk than the agencies themselves deemed sufficient, and nine times more than the vertical interest bears. *See* JA1167-72 (analysis of Harvard Prof. Victoria Ivashina, using conservative assumptions for a typically structured CLO). This disjunction between what the agencies said was necessary and what the Rule actually produces is a direct result of the agencies' misplaced focus on fair value instead of credit risk. In requiring that both the horizontal and vertical interests equal five percent of the securitization's fair value, the agencies failed to adequately account for the fact that securities constituting a vertical interest bear very different amounts of credit risk from those constituting a horizontal one. The vertical interest is composed overwhelmingly of investment grade notes, which have first priority to a

securitization's income stream and thus are shielded from credit losses that must progressively be borne by the lower-in-priority securities. The horizontal interest is composed of a securitization's riskiest securities, which have a "first loss" position that bears all the initial losses of the entire pool of securitized assets.[4] To retain 5 percent of credit risk, a securitizer associated with a typical CLO would have to hold equity securities worth only about 0.56 percent of the securitization's fair value, not the 5 percent the Rule requires.[5] *See* JA1171. For these reasons, the agencies were simply wrong in suggesting that the fair value measure "will sufficiently calibrate the actual amount of retention to … how that value [of the assets] may be affected by expected losses." JA2181.

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[4] This table illustrates the structuring of a typical CLO securitization (the top 4 tranches are investment grade, while the bottom equity tranche bears all losses first, *cf.* JA1170; *compare* JA2091):

Class of Notes	% of Value	Fair Value	Vertical Interest	Horizontal Interest
AAA	62.3%	$311.5m	$15.575m	—
AA	11.2%	$56m	$2.8m	—
A	7.8%	$39m	$1.95m	—
BBB	4.9%	$24.5m	$1.225m	—
BB	3.9%	$19m	$0.95m	—
Equity	10.0%	$50m	$2.5m	$25m
TOTAL	**100%**	**$500m**	**$25m**	**$25m**

[5] The agencies did not dispute Professor Ivashina's analysis and elsewhere acknowledged that the horizontal interest reflects concentrated credit risk. JA241; JA1291. Indeed, they even sought comments on whether this mismatch of credit risk between the vertical and horizontal interests required a revision to its rules, JA1219, only to later ignore the comments they received.

The excessive credit risk reflected in the horizontal interest has immense practical consequences for securitizers, and particularly CLO managers. The agencies understood that market and financial considerations require many securitizers to retain risk either wholly or partly in the most subordinated tranches of notes. JA191. The Rule thus enables securitizers to retain credit risk not only in a purely vertical interest, but also in a purely horizontal one or in a combination of vertical and horizontal interests that together amount to five percent of the securitization's fair value. JA2311. Thus, in all but one of its many applications, the Rule requires securitizers to retain much more than 5 percent of credit risk. The financial impact of such excess risk retention is enormous. For a typical $500 million CLO, the Rule requires a manager to commit $25 million (5 percent of fair value) towards retention, no matter how that retention is structured. But if the agencies had calibrated the horizontal interest to bear just the 5 percent of credit risk they deemed necessary, a manager could satisfy its retention requirement with just a $2.8 million equity holding (0.56 percent of the securitization's fair value, *see* JA1171).

The agencies' failure to justify requiring such excess risk retention in the horizontal interest constitutes arbitrary and capricious decisionmaking. *See* JA2167 (SEC Commissioner Piwowar, dissenting) (regulators "have decided to throw up their hands" in assessing appropriate levels of credit risk). The agencies

failed to "articulate … a rational connection" between their finding that 5 percent risk retention was sufficient and their decision to require far more than that in the horizontal interest. *See State Farm*, 463 U.S. at 43. They failed to adequately explain why horizontal interests should bear many times the risk as vertical ones.[6] *See County of Los Angeles*, 192 F.3d at 1022. And they "failed to consider an important aspect of the problem before [them]" by never even bothering to determine how much risk the horizontal interest actually bore. *See Pub. Citizen*, 374 F.3d at 1216; *see also id.* ("A statutorily mandated factor, by definition, is an important aspect of any issue before an administrative agency …."). This indifference to the operation of the Rule is the very definition of arbitrary.

2. The Rule also does not accord with the agencies' findings in another crucial respect. The agencies canvassed the harms to consumers, borrowers, and market efficiency that excessive risk retention requirements and related capital outlays would cause. However, by adopting a rule leading to far more risk retention than 5 percent, the agencies acted inconsistently with these conclusions and guaranteed that these harms would arise.

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[6] The Commission speculated that securitizers might opt for the riskier retention option to signal alignment with investors' interests. *See* JA1292. Even if that were true, however, it does not justify *requiring* horizontal risk retention above 5 percent. As the agencies recognized, parties to a securitization transaction can always agree that a securitizer will retain more risk than legally required. *See* JA2180.

In justifying the general "5 percent base risk retention requirement," the Commission explained:

> A level of risk retention that is set too high … could lead to inefficient deployment of capital by unduly restricting a sponsor's ability to structure new deals. If sponsors are limited in their ability to secure the necessary financing to retain the required amount of credit risk in their intended offerings, then this could adversely impact the flow of capital from ABS investors to originators of the assets intended for securitization. Hence, excessive risk retention levels may lead to less capital available to lenders, potentially increasing borrowing rates as borrowers compete for a more limited supply of credit.

JA2285. Indeed, the Commission warned that requiring risk retention above 5 percent could "impede capital formation in the economy by preventing the more efficient reinvestment of the sponsors' capital, while not necessarily providing significant incremental benefit to investors." *Id.*; *cf.* JA2277 (unnecessarily "[t]ying up capital" could impose "significant costs on financial markets," decreasing competition, reducing the availability of credit, and raising borrowing costs).

Yet the Rule the agencies adopted creates precisely these harms by imposing levels of credit risk far exceeding 5 percent on securitizers, including many managers of CLO assets, who have no choice but to retain risk in a horizontal form. Indeed, the agencies *predicted* that the Rule would produce these adverse results. They "acknowledge[d] that requiring open market CLO managers to satisfy the risk retention requirement could result in fewer CLO issuances and less

competition in the market."[7] JA2226. Had the agencies simply tailored the horizontal component of the rule to the base risk retention requirement of 5 percent, they would have avoided the very harms they predicted would arise in these circumstances.

This failure is especially troubling given that the agencies had recognized that the amount of credit risk embodied in the horizontal component "might be unnecessarily high," JA241, had requested comment on whether to require "very little horizontal risk retention," JA1219, had acknowledged that the mismatch of credit risk imposed by the vertical and horizontal components of the Rule may require alterations to the agencies' approach, JA1219, and had explained how a rule leading to credit risk retention in excess of 5 percent would significantly harm borrowers and consumers. JA2185. "This court has been particularly reluctant to blink at an agency's ignoring ostensibly reasonable alternatives where it admits … that the choice embraced suffers from noteworthy flaws." *City of Brookings Mun. Tel. Co. v. FCC*, 822 F.2d 1153, 1169 (D.C. Cir. 1987); *see Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1511 (D.C. Cir. 1984) (explaining that

[7] The Commission went further, presciently estimating that smaller, thinly capitalized managers faced "the greatest burden" and were most likely to exit the market, reducing "current levels of capital formation by CLOs by 37 percent" and "account[ing] for an approximately 14.8 percent reduction in supply of capital to the leveraged loan market." JA2299.

reasoned explanations for rejecting alternatives are "especially important when the agency admits its own choice is substantially flawed").

3. In briefing below, the agencies argued – and the district court agreed – that the agencies' focus on fair value rather than credit risk could be excused because a securitizer holding a purely vertical interest would retain 5 percent of credit risk. Agencies' Summary Judgment Br. 40; *see* JA2378. (That is because, solely for a purely vertical interest, the percentage of fair market value will be the same as the percentage of credit risk.) That argument fails for several reasons.

Initially, the agencies' order never suggested that they could implement risk retention through only a vertical interest or that only the vertical interest needed to align with the 5 percent baseline requirement, precluding that argument here. *See Chenery*, 318 U.S. at 87.

In fact, the agencies reached the *opposite* conclusion, reasoning that the horizontal interest was an integral component of the Rule and that permitting securitizers to mix vertical and horizontal interests (or choose either) is necessary "to ensure that the purposes of section 15G are fulfilled." JA191. As the agencies explained, securitization markets historically had employed a variety of risk retention practices, including vertical and horizontal retention, which reflected each market's need to adopt a practice suited to "the rating requirements of the [ratings agencies], investor preferences or demands, accounting considerations, and

whether there was a market for the type of interest that might ordinarily be retained." *Id.* "The options in the proposed rules," the agencies said, "are designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses."[8] *Id.*; *see also* JA1213 (touting the Rule's flexibility as one the principal ways the agencies would "minimize the potential for the proposed rule to negatively affect the availability and costs of credit to consumers and businesses"); JA2289 (observing that "any requirement to retain a vertical interest would only impose additional costs" on securitizers). The agencies' own reasoning and the text and operation of the Rule thus require that the vertical and horizontal options stand or fall together. *Cf. Davis Cty. Solid Waste Mgmt. v. EPA*, 108 F.3d 1454, 1459 (D.C. Cir. 1997) (per curiam) ("Severance and affirmance of a portion of an administrative regulation is improper if there is substantial doubt that the agency would have adopted the severed portion on its own.").

Furthermore, the rules concerning the horizontal interest are every bit as much agency action as those governing the vertical interest, and as such, they are

[8] Indeed, once the agencies concluded that the Rule would be unnecessarily costly if it mandated a one-size-fits-all approach, they *had* to create a single, integrated rule because a rule that imposed avoidable costs would plainly be unlawful. *See* 15 U.S.C. § 78w(a)(2) (prohibiting the SEC from adopting any rule that would impose a burden on competition not necessary or in furtherance of the Exchange Act).

subject to the requirements of reasoned decisionmaking set forth in the Administrative Procedure Act, 5 U.S.C. § 706. The notion that a rule may operate arbitrarily and capriciously as long as one of its applications meets a statutory standard finds support neither in the APA's text nor in this Court's decisions. Rather, the agencies' indifference to the operation of the Rule in nearly all its applications is the essence of arbitrary decisionmaking.

C. The Agencies Arbitrarily Failed to Address Significant Comments.

Agencies must "give reasoned responses to all significant comments in a rulemaking proceeding," *Interstate Nat. Gas Ass'n of Am. v. FERC*, 494 F.3d 1092, 1096 (D.C. Cir. 2007), including comments "that can be thought to challenge a fundamental premise" of the agencies' action, *MCI WorldCom, Inc. v. FCC*, 209 F.3d 760, 765 (D.C. Cir. 2000). Here, commenters repeatedly raised basic points regarding the need to focus on credit risk and to avoid imposing excessive levels of credit risk through a horizontal interest measured in terms of fair value. However, the agencies simply did not grapple with these central points or explain their approach. That failure to respond to comments on core issues in the proceeding independently renders the agencies' action arbitrary and capricious.

For example, the agencies never explained why they persisted in defining the horizontal interest in terms of fair value despite the many comments arguing that risk retention should be based on credit risk rather than fair value (or par

value, as the agencies had earlier proposed). *See, e.g.*, JA791-92 (American Bar Ass'n, arguing that that Section 941 "specifically requires the Agencies to craft regulations that relate to the retention of the credit risk of the assets rather than the par value or face amount" and pointing to fundamental economic differences between interests having the same total value); JA1020 (American Bankers' Association, describing statute's focus on "'credit risk' of the assets being securitized," rather than "a specified percentage of the principal amount of the transaction"); *infra* at 50-55 (alternatives focused on credit risk rather than baseline level of fair value). The agencies did not respond to these comments, or explain how fair value sufficed as a substitute for credit risk or why the horizontal interest should not be refined to reflect the chosen level of 5 percent of credit risk. The agencies acknowledged and addressed the comments only in terms of whether fair value was superior to par value measurement (another measure of economic value), ignoring the central question whether the agencies should base retention on credit risk directly. JA2185-86.

The agencies likewise failed to respond to comments arguing that their 5 percent baseline risk requirement should apply to the horizontal component of the Rule and that, if it did not, the Rule would cause the very harms that the agencies identified as the basis for not adopting a higher baseline requirement. *See, e.g.*,

JA791, JA1442-43; *supra* at 44. Again, that failure to respond to comments renders the agencies' action arbitrary and capricious.

D. The Agencies Failed to Explain Why They Would Not Align Risk Retention With Their Baseline 5 Percent Retention Requirement.

The agencies also failed to adequately address various proposals that would have more closely aligned the retention requirement with the agencies' 5 percent credit risk retention baseline. As to CLOs in particular, commenters proposed that: (i) the horizontal interest be limited to 1 percent of fair value, which amounted to approximately 10 percent credit risk retention (the "SFIG 1 percent proposal"), JA1717; (ii) for CLOs that met various structural requirements designed to protect investors, managers be able to satisfy risk retention by holding a residual interest in subordinated, deferred compensation plus an additional interest of 5 percent of the equity notes (each component bearing approximately 5 percent credit risk), JA1144-45 ("LSTA proposal"); or (iii) the agencies recognize the approximately 5 percent credit risk inherent in managers' residual interest as a basis to exempt them from further retention requirements, JA1106-08.[9] In support of these alternatives, commenters pointed to features of CLOs that align investor and manager interests (and that led to the strong performance of CLOs during the financial crisis), the

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[9] The issue of whether the horizontal interest should require more than 5 percent credit risk was a question of the Rule's general design, not its specific application to CLOs. But commenters also argued, in the alternative, for a CLO-specific exemption or adjustment.

agencies' own predictions of harms arising from excessive credit risk retention requirements, and the statutory directive to focus on credit risk. JA1095-96; JA1708-10.

1. The agencies' failure to adjust their risk retention standard and inadequate response to these alternatives constitute an independent basis for setting the Rule aside. "In cases where parties raise reasonable alternatives to the [agency's] position," this Court has "held that reasoned decisionmaking requires considering those alternatives," *Am. Gas Ass'n v. FERC*, 593 F.3d 14, 19 (D.C. Cir. 2010), and "giv[ing] a reasoned explanation" for rejecting them, *Am. Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 242 (D.C. Cir. 2008); *see also Chamber of Commerce v. SEC*, 412 F.3d 133, 145 (D.C. Cir. 2005) (requiring consideration of an alternative that was "neither frivolous nor out of bounds"). Here, as described above, the agencies failed to join issue with the premise underlying each of the proposed alternatives: that the horizontal interests should be tailored to embody levels of credit risk consistent with the 5 percent baseline the agencies deemed sufficient to fulfill Section 941's goals and the maximum appropriate to avoid market harms.[10]

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[10] SEC Commissioner Gallagher identified part of what enabled the agencies to avoid this central issue: "contrary to the Commission's standard practice, the adopting release fails to cite to any specific comment letters, instead consistently attributing a view to a 'commenter' or 'commenters' without citations," which in turn "makes it prohibitively difficult (or impossible) for readers to determine

Instead, the agencies' main basis for rejecting the proposed alternatives was that they were inadequate because they would allow securitizers to hold "under one percent of the fair value of the ABS interests issued to third parties (which is less than the 5 percent required for an eligible horizontal residual interest)." JA2225. This argument, however, sidestepped commenters' central challenge: that the horizontal interest must equal 5 percent of the securitization's credit risk rather than 5 percent of its fair value. Such a circular response is the opposite of reasoned decisionmaking. *See Elec. Consumers Res. Council v. FERC*, 747 F.2d 1511, 1516 (D.C. Cir. 1984) (per curiam) (invalidating agency action that was based on circular reasoning).

2. The agencies' determination to require high levels of credit risk in the horizontal component of the Rule, and their rejection of alternatives to the contrary, also failed to assess the costs and benefits of each approach. The agencies were obliged to assess the costs and benefits of their approach as a matter of basic reasoned decisionmaking, *cf. Michigan v. EPA*, 135 S. Ct. at 2706, and the Commission had an even higher, statutory duty to assess the costs and benefits of proceeding as it did, *see* 15 U.S.C. §§ 78c(f), 78w(a)(2); *Chamber of Commerce*, 412 F.3d at 143.

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whether individual comments have in fact been addressed" and amounts "quite simply, [to] an act of bad government." JA2164 (SEC Commissioner Gallagher, dissenting).

Here, the agencies had determined that retention of 5 percent credit risk was sufficient to protect the public and advance the statute's goals. *See supra* at 39-40. All the alternatives would have achieved this goal – and most would have required securitizers to retain a *higher* level of credit risk. JA1717 (SFIG proposal, approximately 10%); JA1144-45 (LSTA proposal, approximately 10%). Plus, some proposals provided other commitments that further protected investors and that were absent from the Rule itself. JA2130-34. As a result, the benefits of adjusting the Rule were greater than those of the challenged policy. Thus, declining to adjust the Rule not only imposed higher costs, in the form of the market harms from excess risk retention that the agencies identified, but also led to forgone benefits. Such irrational decisionmaking is precisely what the assessment of costs and benefits is designed to prevent.

3. Other aspects of the agencies' rejection of the proposed alternatives confirm the basic flaws identified above and further show that the agencies did not engage in reasoned decisionmaking.

For example, the agencies' order did not even address the SFIG 1 percent proposal. JA2167 (SEC Commissioner Piwowar, dissenting) (regulators undertook no careful consideration of CLO alternatives). That proposal would have used a fair value measurement while dramatically reducing the risk retention associated

with the horizontal interest and while still having the manager hold nearly twice the level of credit risk that the agencies deemed sufficient. JA1717.

Similarly, the agencies erred by dismissing the LSTA proposal on the ground that that a horizontal interest of less than five percent of fair value would not "absorb losses as expected." JA2225. This loss-absorption rationale would apply equally to disqualify the vertical interest the agencies adopted: In both cases, managers would hold a first-loss position equal to 5 percent of the equity tranche. Moreover, compared to the rejected SFIG 1 percent proposal, the vertical interest provides far *less* loss absorption; the holder of a 1 percent equity interest measured by fair value would have roughly 12 percent of the total equity, nearly two-and-a-half times that contained in the vertical interest. Loss absorption thus does not constitute an "intelligible decisional standard" for rejecting these alternatives. *Select Specialty Hosp.-Bloomington, Inc. v. Burwell*, 757 F.3d 308, 312 (D.C. Cir. 2014). Nor does loss absorption find any support in the statute's design based on retention of credit risk.

Finally, to the extent the statutory standard regarding adjustments and exemptions was relevant, the agencies' consideration of alternative approaches misapplied it. JA2225. That standard focuses on ensuring "high quality underwriting standards" and operating "in the public interest and for the protection of investors." 15 U.S.C. § 78*o*-11(c)(1)(G)(i), (e)(2)(A). Here, once the agencies

determined that securitizers' retention of 5 percent of credit risk fulfilled these objectives, they had no rational basis to reject other alternatives that would have imposed at least that amount of risk retention while providing additional benefits for investors and the public. This was especially the case because the agencies acknowledged that CLOs contain "certain structural features" that "contribute to aligning the interests of CLO managers with investors." JA2225; *see supra* at 10-12 (outlining features).

Ultimately, the agencies' errors resulted in a fun-house-mirror version of what rational decisionmaking would have produced. Residential mortgage securitizations are risky and were tied most directly to the financial crisis, but the agencies almost wholly exempted those from any risk retention requirements. JA2318-19. Other securitizations in sectors without the protections associated with CLOs, where the securitizer could readily employ the vertical form of retention, could proceed while retaining only 5 percent of the assets' credit risk. But for many CLO managers, forced by investor demands or market pressures to retain risk horizontally, the agencies required vastly higher levels of credit risk. Those managers have the same incentives and business model as managers of mutual funds and other funds (which were subject to absolutely no risk retention requirements), serve an unusually sophisticated set of investors, and operate on behalf of CLOs that have multiple structural protections for noteholders and that

performed well during the financial crisis. Without explaining why higher levels of risk retention were appropriate, the agencies imposed the most onerous requirements on the safest and best-performing securitizations and the least onerous requirements on the riskiest ones.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision of the district court granting summary judgment to Appellees and denying summary judgment to Appellant and remand the case with instructions to vacate the Rule insofar as it applies to open market CLO managers.

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CERTIFICATE OF COMPLIANCE

In accordance with Circuit Rule 32(a) and Rule 32(a)(7) of the Federal Rules of Appellate Procedure, the undersigned certifies that the accompanying brief has been prepared using 14-point Times New Roman typeface, and is double-spaced (except for headings and footnotes).

The undersigned further certifies that the brief is proportionally spaced and contains 12,925 words exclusive of the certificate required by Circuit Rule 28(a)(1), statutory and evidentiary addendum, table of contents, table of authorities, signature lines, and certificates of service and compliance. Appellant's Opening Brief does not exceed 13,000 words, as mandated by Fed. R. App. P. 32(a)(7)(B)(i). The undersigned used Microsoft Word 2016 to compute the count.

/s/ Daniel J. Feith
Daniel J. Feith

CERTIFICATE OF SERVICE

I hereby certify that on this 19th day of April, 2017, I electronically filed the foregoing Opening Brief of Appellant with the Clerk of the Court using the CM/ECF System, which will send notice of such filing to all registered CM/ECF users.

/s/ Richard Klingler
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ADDENDUM

15 U.S.C. § 78*o*-11..........ADD-1

Relevant portions of jointly promulgated Final Rule, *Credit Risk Retention*,
79 Fed Reg. 77,601, 77,740-66 (Dec. 24, 2014) ADD-7

15 U.S.C. § 78*o*-11. Credit risk retention

(a) Definitions

In this section--

(1) the term "Federal banking agencies" means the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation;

(2) the term "insured depository institution" has the same meaning as in section 1813(c) of Title 12;

(3) the term "securitizer" means--

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

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

(4) the term "originator" means 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.

(b) Regulations required

(1) In general

Not later than 270 days after July 21, 2010, the Federal banking agencies and the Commission shall 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.

(2) Residential mortgages

Not later than 270 days after July 21, 2010, the Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Federal Housing Finance Agency, shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.

(c) Standards for regulations

(1) Standards

The regulations prescribed under subsection (b) shall--

(A) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset;

(B) require a securitizer to retain--

(i) not less than 5 percent of the credit risk for any asset--

(I) that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer; or

(II) that is a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if 1 or more of the assets that collateralize the asset-backed security are not qualified residential mortgages; or

(ii) less than 5 percent of the credit risk for an asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if the originator of the asset meets the underwriting standards prescribed under paragraph (2)(B);

(C) specify--

(i) the permissible forms of risk retention for purposes of this section;

(ii) the minimum duration of the risk retention required under this section; and

(iii) that a securitizer is not required to retain any part of the credit risk for an asset that is transferred, sold or conveyed through the issuance of an asset-backed security by the securitizer, if all of the assets that collateralize the asset-backed security are qualified residential mortgages;

(D) apply, regardless of whether the securitizer is an insured depository institution;

(E) with respect to a commercial mortgage, specify the permissible types, forms, and amounts of risk retention that would meet the requirements of subparagraph (b), which in the determination of the federal banking agencies and the commission may include--

(i) retention of a specified amount or percentage of the total credit risk of the asset;

(ii) retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities, and meets the same standards for risk retention as the Federal banking agencies and the Commission require of the securitizer;

(iii) a determination by the Federal banking agencies and the Commission that the underwriting standards and controls for the asset are adequate; and

(iv) provision of adequate representations and warranties and related enforcement mechanisms; and[1]

(F) establish appropriate standards for retention of an economic interest with respect to collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other asset-backed securities; and

(G) provide for--

(i) a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors;

(ii) a total or partial exemption for the securitization of an asset issued or guaranteed by the United States, or an agency of the United States, as the Federal banking agencies and the Commission jointly determine appropriate in the public interest and for the protection of investors, except that, for purposes of this clause, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are not agencies of the United States;

(iii) a total or partial exemption for any asset-backed security that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)), or a security defined as a qualified scholarship funding bond in section 150(d)(2) of Title 26, as may be appropriate in the public interest and for the protection of investors; and

(iv) the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator, as the Federal banking agencies and the Commission jointly determine appropriate.

(2) Asset classes

(A) Asset classes

The regulations prescribed under subsection (b) shall establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the Commission deem appropriate.

(B) Contents

For each asset class established under subparagraph (A), the regulations prescribed under subsection (b) shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan.

(d) Originators

In determining how to allocate risk retention obligations between a securitizer and an originator under subsection (c)(1)(E)(iv), the Federal banking agencies and the Commission shall--

(1) reduce the percentage of risk retention obligations required of the securitizer by the percentage of risk retention obligations required of the originator; and

(2) consider--

(A) whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk;

(B) whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and

(C) the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms, which may not include the transfer of credit risk to a third party.

(e) Exemptions, exceptions, and adjustments

(1) In general

The Federal banking agencies and the Commission may jointly adopt or issue exemptions, exceptions, or adjustments to the rules issued under this section, including exemptions, exceptions, or adjustments for classes of institutions or assets relating to the risk retention requirement and the prohibition on hedging under subsection (c)(1).

(2) Applicable standards

Any exemption, exception, or adjustment adopted or issued by the Federal banking agencies and the Commission under this paragraph shall--

(A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and

(B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.

(3) Certain institutions and programs exempt

(A) Farm credit system institutions

Notwithstanding any other provision of this section, the requirements of this section shall not apply to any loan or other financial asset made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

(B) Other Federal programs

This section shall not apply to any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States. For purposes of this subsection, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal home loan banks shall not be considered an agency of the United States.

(4) Exemption for qualified residential mortgages

(A) In general

The Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency shall jointly issue regulations to exempt qualified residential mortgages from the risk retention requirements of this subsection.

(B) Qualified residential mortgage

The Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency shall jointly define the term "qualified residential mortgage" for purposes of this subsection, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as--

(i) documentation and verification of the financial resources relied upon to qualify the mortgagor;

(ii) standards with respect to--

(I) the residual income of the mortgagor after all monthly obligations;

(II) the ratio of the housing payments of the mortgagor to the monthly income of the mortgagor;

(III) the ratio of total monthly installment payments of the mortgagor to the income of the mortgagor;

(iii) mitigating the potential for payment shock on adjustable rate mortgages through product features and underwriting standards;

(iv) mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and

(v) prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default.

(C) Limitation on definition

The Federal banking agencies, the Commission, the Secretary of Housing and Urban Development,

and the Director of the Federal Housing Finance Agency in defining the term "qualified residential mortgage", as required by subparagraph (B), shall define that term to be no broader than the definition 'qualified mortgage' as the term is defined under section 129C(c)(2) of the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010, and regulations adopted thereunder.

(5) Condition for qualified residential mortgage exemption

The regulations issued under paragraph (4) shall provide that an asset-backed security that is collateralized by tranches of other asset-backed securities shall not be exempt from the risk retention requirements of this subsection.

(6) Certification

The Commission shall require an issuer 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.

(f) Enforcement

The regulations issued under this section shall be enforced by--

(1) the appropriate Federal banking agency, with respect to any securitizer that is an insured depository institution; and

(2) the Commission, with respect to any securitizer that is not an insured depository institution.

(g) Authority of Commission

The authority of the Commission under this section shall be in addition to the authority of the Commission to otherwise enforce the securities laws.

(h) Authority to coordinate on rulemaking

The Chairperson of the Financial Stability Oversight Council shall coordinate all joint rulemaking required under this section.

(i) Effective date of regulations

The regulations issued under this section shall become effective--

(1) with respect to securitizers and originators of asset-backed securities backed by residential mortgages, 1 year after the date on which final rules under this section are published in the Federal Register; and

(2) with respect to securitizers and originators of all other classes of asset-backed securities, 2 years after the date on which final rules under this section are published in the Federal Register.

among such three-to-four unit mortgages securitized through private-label securitizations in 2000–2009 was 36 percent, whereas among two unit mortgages it was 41 percent. Moreover, the difference in delinquency rates are not statistically different when controlling for other factors known to influence delinquency rates like credit score, loan-to-value ratio, debt-to-income ratio, etc.[488] These results indicate that historical three-to-four unit residential mortgage delinquency rates are no higher than those of two unit residential mortgages, and thus do not provide any evidence that exempting such mortgages from risk retention would introduce additional risk into securitizations that would include such loans. The Commission believes that this equivalent performance is likely to continue after the implementation of this exemption because both two unit and three-to-four unit mortgages would be required to satisfy the same QM underwriting criteria.

D. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104–4 (UMRA) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in an expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more, adjusted for inflation ($152 million in 2014) in any one year. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC has determined this final rule is likely to result in the expenditure by the private sector of $152 million or more in any one year. The OCC has prepared a budgetary impact analysis and identified and considered alternative approaches, including approaches suggested by commenters and discussed in the **SUPPLEMENTARY INFORMATION** section above. When the final rule is published in the **Federal Register**, the full text of the OCC's analysis will be available at: *http://www.regulations.gov*, Docket ID OCC–2013–0010.

E. FHFA: Considerations of Differences Between the Federal Home Loan Banks and the Enterprises

Section 1313 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks (Banks), to consider the following differences between the Banks and the Enterprises (Fannie Mae and Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability.[489] The Director also may consider any other differences that are deemed appropriate. In preparing the portions of this final rule over which FHFA has joint rulemaking authority, the Director considered the differences between the Banks and the Enterprises as they relate to the above factors and determined that the rule was appropriate. No comments were received on the reproposed rule with respect to this issue.

Text of the Common Rule

(All Agencies)

The text of the common rule appears below:

PART __—CREDIT RISK RETENTION

Subpart A—Authority, Purpose, Scope and Definitions

Sec.
__.1 [Reserved]
__.2 Definitions.

Subpart B—Credit Risk Retention

__.3 Base risk retention requirement.
__.4 Standard risk retention.
__.5 Revolving pool securitizations.
__.6 Eligible ABCP conduits.
__.7 Commercial mortgage-backed securities.
__.8 Federal National Mortgage Association and Federal Home Loan Mortgage Corporation ABS.
__.9 Open market CLOs.
__.10 Qualified tender option bonds.

Subpart C—Transfer of Risk Retention

__.11 Allocation of risk retention to an originator.
__.12 Hedging, transfer and financing prohibitions.

Subpart D—Exceptions and Exemptions

__.13 Exemption for qualified residential mortgages.
__.14 Definitions applicable to qualifying commercial loans, commercial real estate loans, and automobile loans.
__.15 Qualifying commercial loans, commercial real estate loans, and automobile loans.
__.16 Underwriting standards for qualifying commercial loans.
__.17 Underwriting standards for qualifying CRE loans.
__.18 Underwriting standards for qualifying automobile loans.
__.19 General exemptions.
__.20 Safe harbor for certain foreign-related transactions.
__.21 Additional exemptions.
__.22 Periodic review of the QRM definition, exempted three-to-four unit residential mortgage loans, and community-focused residential mortgage exemption.

Subpart A—Authority, Purpose, Scope and Definitions

§ __.1 [Reserved]

§ __.2 Definitions.

For purposes of this part, the following definitions apply:

ABS interest means:

(1) Any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest (other than an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors, or a non-economic residual interest issued by a REMIC), payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity; and

(2) Does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that:

(i) Are issued primarily to evidence ownership of the issuing entity; and

(ii) The payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity; and

(3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.

Affiliate of, or a person *affiliated* with, a specified person means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

Appropriate Federal banking agency has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

[488] Specifically, DERA staff ran the predictive logit regression from the White and Bauguess (2013) study (see footnote 446) for privately securitized 2, 3, and 4 unit mortgages in the MBSData database satisfying QM criteria and originated over the period 2000–2009. Adding an indicator variable marking three-to-four unit residential mortgages does not generate a statistically significant coefficient estimate, and does not improve the regression's goodness-of-fit measure (pseudo-R-squared).

[489] *See* 12 U.S.C. 4513.

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Asset means a self-liquidating financial asset (including but not limited to a loan, lease, mortgage, or receivable).

Asset-backed security has the same meaning as in section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)).

Collateral means, with respect to any issuance of ABS interests, the assets that provide the cash flow and the servicing assets that support such cash flow for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in or rights to cash flow from such assets and related servicing assets. Assets or other property *collateralize* an issuance of ABS interests if the assets or property serve as collateral for such issuance.

Commercial real estate loan has the same meaning as in § __.14.

Commission means the Securities and Exchange Commission.

Control including the terms ''controlling,'' ''controlled by'' and ''under common control with'':

(1) Means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(2) Without limiting the foregoing, a person shall be considered to control another person if the first person:

(i) Owns, controls or holds with power to vote 25 percent or more of any class of voting securities of the other person; or

(ii) Controls in any manner the election of a majority of the directors, trustees or persons performing similar functions of the other person.

Credit risk means:

(1) The risk of loss that could result from the failure of the borrower in the case of a securitized asset, or the issuing entity in the case of an ABS interest in the issuing entity, to make required payments of principal or interest on the asset or ABS interest on a timely basis;

(2) The risk of loss that could result from bankruptcy, insolvency, or a similar proceeding with respect to the borrower or issuing entity, as appropriate; or

(3) The effect that significant changes in the underlying credit quality of the asset or ABS interest may have on the market value of the asset or ABS interest.

Creditor has the same meaning as in 15 U.S.C. 1602(g).

Depositor means:

(1) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity;

(2) The sponsor, in the case of a securitization transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or

(3) The person that receives or purchases and transfers or sells the securitized assets to the issuing entity in the case of a securitization transaction where the person transferring or selling the securitized assets directly to the issuing entity is itself a trust.

Eligible horizontal residual interest means, with respect to any securitization transaction, an ABS interest in the issuing entity:

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

(2) With respect to which, on any payment date or allocation date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and

(3) That, with the exception of any non-economic REMIC residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity.

Eligible horizontal cash reserve account means an account meeting the requirements of § __.4(b).

Eligible vertical interest means, with respect to any securitization transaction, a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same proportion of each such class.

Federal banking agencies means the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

GAAP means generally accepted accounting principles as used in the United States.

Issuing entity means, with respect to a securitization transaction, the trust or other entity:

(1) That owns or holds the pool of assets to be securitized; and

(2) In whose name the asset-backed securities are issued.

Majority-owned affiliate of a person means an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. 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 interest in the entity, as determined under GAAP.

Originator means a person who:

(1) Through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and

(2) Sells the asset directly or indirectly to a securitizer or issuing entity.

REMIC has the same meaning as in 26 U.S.C. 860D.

Residential mortgage means:

(1) A transaction that is a covered transaction as defined in § 1026.43(b) of Regulation Z (12 CFR 1026.43(b)(1));

(2) Any transaction that is exempt from the definition of ''covered transaction'' under § 1026.43(a) of Regulation Z (12 CFR 1026.43(a)); and

(3) Any other loan secured by a residential structure that contains one to four units, whether or not that structure is attached to real property, including an individual condominium or cooperative unit and, if used as a residence, a mobile home or trailer.

Retaining sponsor means, with respect to a securitization transaction, the sponsor that has retained or caused to be retained an economic interest in the credit risk of the securitized assets pursuant to subpart B of this part.

Securitization transaction means a transaction involving the offer and sale of asset-backed securities by an issuing entity.

Securitized asset means an asset that:

(1) Is transferred, sold, or conveyed to an issuing entity; and

(2) Collateralizes the ABS interests issued by the issuing entity.

Securitizer means, with respect to a securitization transaction, either:

(1) The depositor of the asset-backed securities (if the depositor is not the sponsor); or

(2) The sponsor of the asset-backed securities.

Servicer means any person responsible for the management or collection of the securitized assets or making allocations or distributions to holders of the ABS interests, but does not include a trustee for the issuing entity or the asset-backed securities that makes allocations or distributions to

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holders of the ABS interests if the trustee receives such allocations or distributions from a servicer and the trustee does not otherwise perform the functions of a servicer.

Servicing assets means rights or other assets designed to assure the servicing or timely distribution of proceeds to ABS interest holders and rights or other 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 securitized assets, including proceeds of rights or other assets, whether as remittances by obligors or as other recoveries.

Single vertical security means, with respect to any securitization transaction, an ABS interest entitling the sponsor to a specified percentage of the amounts paid on each class of ABS interests in the issuing entity (other than such single vertical security).

Sponsor means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

State has the same meaning as in Section 3(a)(16) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(16)).

United States or U.S. means the United States of America, including its territories and possessions, any State of the United States, and the District of Columbia.

Wholly-owned affiliate means a person (other than an issuing entity) that, directly or indirectly, wholly controls, is wholly controlled by, or is wholly under common control with, another person. For purposes of this definition, ''wholly controls'' means ownership of 100 percent of the equity of an entity.

Subpart B—Credit Risk Retention

§ _.3 Base risk retention requirement.

(a) *Base risk retention requirement.* Except as otherwise provided in this part, the sponsor of a securitization transaction (or majority-owned affiliate of the sponsor) shall retain an economic interest in the credit risk of the securitized assets in accordance with any one of §§ _.4 through __.10. Credit risk in securitized assets required to be retained and held by any person for purposes of compliance with this part, whether a sponsor, an originator, an originator-seller, or a third-party purchaser, except as otherwise provided in this part, may be acquired and held by any of such person's majority-owned affiliates (other than an issuing entity).

(b) *Multiple sponsors.* If there is more than one sponsor of a securitization transaction, it shall be the responsibility of each sponsor to ensure that at least one of the sponsors of the securitization transaction (or at least one of their majority-owned or wholly-owned affiliates, as applicable) retains an economic interest in the credit risk of the securitized assets in accordance with any one of §§ __.4, _.5, _.8, __.9, or _.10.

§ _.4 Standard risk retention.

(a) *General requirement.* Except as provided in §§ __.5 through __.10, the sponsor of a securitization transaction must retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of this section.

(1) If the sponsor retains only an eligible vertical interest as its required risk retention, the sponsor must retain an eligible vertical interest in a percentage of not less than 5 percent.

(2) If the sponsor retains only an eligible horizontal residual interest as its required risk retention, the amount of the interest must equal at least 5 percent of the fair value of all ABS interests in the issuing entity issued as a part of the securitization transaction, determined using a fair value measurement framework under GAAP.

(3) If the sponsor retains both an eligible vertical interest and an eligible horizontal residual interest as its required risk retention, the percentage of the fair value of the eligible horizontal residual interest and the percentage of the eligible vertical interest must equal at least five.

(4) The percentage of the eligible vertical interest, eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction.

(b) *Option to hold base amount in eligible horizontal cash reserve account.* In lieu of retaining all or any part of an eligible horizontal residual interest under paragraph (a) of this section, the sponsor may, at closing of the securitization transaction, cause to be established and funded, in cash, an eligible horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof, provided that the account meets all of the following conditions:

(1) The account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;

(2) Amounts in the account are invested only in cash and cash equivalents; and

(3) Until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved:

(i) Amounts in the account shall be released only to:

(A) Satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest; or

(B) Pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses and:

(*1*) Such expenses, in the absence of available funds in the eligible horizontal cash reserve account, would be paid prior to any payments to holders of ABS interests; and

(*2*) Such payments are made to parties that are not affiliated with the sponsor; and

(ii) Interest (or other earnings) on investments made in accordance with paragraph (b)(2) of this section may be released once received by the account.

(c) *Disclosures.* A sponsor relying on this section shall provide, or cause to be provided, to potential investors, under the caption ''Credit Risk Retention'', a reasonable period of time prior to the sale of the asset-backed securities in the securitization transaction the following disclosures in written form and within the time frames set forth in this paragraph (c):

(1) *Horizontal interest.* With respect to any eligible horizontal residual interest held under paragraph (a) of this section, a sponsor must disclose:

(i) A reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests,

(A) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor expects to retain at the closing of the securitization transaction. If the specific prices, sizes, or rates of interest of each tranche of the securitization are not available, the sponsor must disclose a range of fair values (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding

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amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor expects to retain at the close of the securitization transaction based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitization. A sponsor disclosing a range of fair values based on a range of bona fide estimates or specified prices, sizes or rates of interest of each tranche of the securitization must also disclose the method by which it determined any range of prices, tranche sizes, or rates of interest.

(B) A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;

(C) A description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;

(D) All key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the eligible horizontal residual interest to be retained by the sponsor.

(E) To the extent applicable to the valuation methodology used, the disclosure required in paragraph (c)(1)(i)(D) of this section shall include, but should not be limited to, quantitative information about each of the following:

(*1*) Discount rates;

(*2*) Loss given default (recovery);

(*3*) Prepayment rates;

(*4*) Default rates;

(*5*) Lag time between default and recovery; and

(*6*) The basis of forward interest rates used.

(F) The disclosure required in paragraphs (c)(1)(i)(C) and (D) of this section shall include, at a minimum, descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations. To the extent the disclosure required in this paragraph (c)(1) includes a description of a curve or curves, the description shall include a description of the methodology that was used to derive each curve and a description of any aspects or features of each curve that could materially impact the fair value calculation or the ability of a prospective investor to evaluate the sponsor's fair value calculation. To the extent a sponsor uses information about the securitized assets in its calculation of fair value, such information shall not be as of a date more than 60 days prior to the date of first use with investors; provided that for a subsequent issuance of ABS interests by the same issuing entity with the same sponsor for which the securitization transaction distributes amounts to investors on a quarterly or less frequent basis, such information shall not be as of a date more than 135 days prior to the date of first use with investors; provided further, that the balance or value (in accordance with the transaction documents) of the securitized assets may be increased or decreased to reflect anticipated additions or removals of assets the sponsor makes or expects to make between the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security and the closing date of the securitization.

(G) A summary description of the reference data set or other historical information used to develop the key inputs and assumptions referenced in paragraph (c)(1)(i)(D) of this section, including loss given default and default rates;

(ii) A reasonable time after the closing of the securitization transaction:

(A) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest the sponsor retained at the closing of the securitization transaction, based on actual sale prices and finalized tranche sizes;

(B) The fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest that the sponsor is required to retain under this section; and

(C) To the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale and required under paragraph (c)(1)(i) of this section materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.

(iii) If the sponsor retains risk through the funding of an eligible horizontal cash reserve account:

(A) The amount to be placed (or that is placed) by the sponsor in the eligible horizontal cash reserve account at closing, and the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) of the eligible horizontal residual interest that the sponsor is required to fund through the eligible horizontal cash reserve account in order for such account, together with other retained interests, to satisfy the sponsor's risk retention requirement;

(B) A description of the material terms of the eligible horizontal cash reserve account; and

(C) The disclosures required in paragraphs (c)(1)(i) and (ii) of this section.

(2) *Vertical interest.* With respect to any eligible vertical interest retained under paragraph (a) of this section, the sponsor must disclose:

(i) A reasonable period of time prior to the sale of an asset-backed security issued in the same offering of ABS interests,

(A) The form of the eligible vertical interest;

(B) The percentage that the sponsor is required to retain as a vertical interest under this section; and

(C) A description of the material terms of the vertical interest and the amount that the sponsor expects to retain at the closing of the securitization transaction.

(ii) A reasonable time after the closing of the securitization transaction, the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount disclosed under paragraph (c)(2)(i) of this section.

(d) *Record maintenance.* A sponsor must retain the certifications and disclosures required in paragraphs (a) and (c) of this section 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.

§ __.5 Revolving pool securitizations.

(a) *Definitions.* For purposes of this section, the following definitions apply:

Revolving pool securitization means an issuing entity that is established to issue on multiple issuance dates more than one series, class, subclass, or tranche of asset-backed securities that are collateralized by a common pool of

the conservatorship or receivership of the Federal Housing Finance Agency pursuant to section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617) with capital support from the United States; or

(2) Any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation pursuant to section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617(i)), provided that the entity is operating with capital support from the United States.

(b) *Certain provisions not applicable.* The provisions of § __.12(b), (c), and (d) shall not apply to a sponsor described in paragraph (a)(1) or (2) of this section, its affiliates, or the issuing entity with respect to a securitization transaction for which the sponsor has retained credit risk in accordance with the requirements of this section.

(c) *Disclosure.* A sponsor relying on this section shall provide to investors, in written form under the caption ''Credit Risk Retention'' and, upon request, to the Federal Housing Finance Agency and the Commission, a description of the manner in which it has met the credit risk retention requirements of this part.

§ __.9 Open market CLOs.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

CLO means a special purpose entity that:

(i) Issues debt and equity interests, and

(ii) Whose assets consist primarily of loans that are securitized assets and servicing assets.

CLO-eligible loan tranche means a term loan of a syndicated facility that meets the criteria set forth in paragraph (c) of this section.

CLO manager means an entity that manages a CLO, which entity is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (15 U.S.C. 80b-1 *et seq.*), or is an affiliate of such a registered investment adviser and itself is managed by such registered investment adviser.

Commercial borrower means an obligor under a corporate credit obligation (including a loan).

Initial loan syndication transaction means a transaction in which a loan is syndicated to a group of lenders.

Lead arranger means, with respect to a CLO-eligible loan tranche, an institution that:

(i) Is active in the origination, structuring and syndication of commercial loan transactions (as defined in § __.14) and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche.

(ii) Has taken an allocation of the funded portion of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20 percent of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group that funded at origination has taken a greater allocation; and

(iii) Is identified in the applicable agreement governing the CLO-eligible loan tranche; represents therein to the holders of the CLO-eligible loan tranche and to any holders of participation interests in such CLO-eligible loan tranche that such lead arranger satisfies the requirements of paragraph (i) of this definition and, at the time of initial funding of the CLO-eligible tranche, will satisfy the requirements of paragraph (ii) of this definition; further represents therein (solely for the purpose of assisting such holders to determine the eligibility of such CLO-eligible loan tranche to be held by an open market CLO) that in the reasonable judgment of such lead arranger, the terms of such CLO-eligible loan tranche are consistent with the requirements of paragraphs (c)(2) and (3) of this section; and covenants therein to such holders that such lead arranger will fulfill the requirements of paragraph (c)(1) of this section.

Open market CLO means a CLO:

(i) Whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions and of servicing assets,

(ii) That is managed by a CLO manager, and

(iii) That holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO manager or originated by originators that are affiliates of the CLO or the CLO manager.

Open market transaction means:

(i) Either an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or

(ii) A reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

Secondary market transaction means a purchase of a senior, secured syndicated loan not in connection with an initial loan syndication transaction but in the secondary market.

Senior, secured syndicated loan means a loan made to a commercial borrower that:

(i) Is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower,

(ii) Is secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan, and

(iii) The value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO manager exercised at the time of investment) to repay the loan and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO manager certifies, on or prior to each date that it acquires a loan constituting part of a new CLO-eligible tranche, that it has policies and procedures to evaluate the likelihood of repayment of loans acquired by the CLO and it has followed such policies and procedures in evaluating each CLO-eligible loan tranche.

(b) *In general.* A sponsor satisfies the risk retention requirements of § __.3 with respect to an open market CLO transaction if:

(1) The open market CLO does not acquire or hold any assets other than CLO-eligible loan tranches that meet the requirements of paragraph (c) of this section and servicing assets;

(2) The governing documents of such open market CLO require that, at all times, the assets of the open market CLO consist of senior, secured syndicated loans that are CLO-eligible loan tranches and servicing assets;

(3) The open market CLO does not invest in ABS interests or in credit derivatives other than hedging

transactions that are servicing assets to hedge risks of the open market CLO;

(4) All purchases of CLO-eligible loan tranches and other assets by the open market CLO issuing entity or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's ABS interests are made in open market transactions on an arms-length basis;

(5) The CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS interests.

(c) *CLO-eligible loan tranche.* To qualify as a CLO-eligible loan tranche, a term loan of a syndicated credit facility to a commercial borrower must have the following features:

(1) A minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the lead arranger thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche, provided that such lead arranger complies with limitations on hedging, transferring and pledging in § __.12 with respect to the interest retained by the lead arranger.

(2) Lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to the calculation or payments of amounts due to the holders of the CLO-eligible tranche, alterations to *pro rata* provisions, changes to voting provisions, and waivers of conditions precedent; and

(3) The pro rata provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranches are not materially less advantageous to the holder(s) of such CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

(d) *Disclosures.* 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 at least annually with respect to the information required by paragraph (d)(1) of this section 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'':

(1) *Open market CLOs.* A complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing), including the following information:

(i) The full legal name, Standard Industrial Classification (SIC) category code, and legal entity identifier (LEI) issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (if an LEI has been obtained by the obligor) of the obligor of the loan or asset;

(ii) The full name of the specific loan tranche held by the CLO;

(iii) The face amount of the entire loan tranche held by the CLO, and the face amount of the portion thereof held by the CLO;

(iv) The price at which the loan tranche was acquired by the CLO; and

(v) For each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions of § __.12; and

(2) *CLO manager.* The full legal name and form of organization of the CLO manager.

§ __.10 Qualified tender option bonds.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

Municipal security or *municipal securities* shall have the same meaning as the term ''municipal securities'' in Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)) and any rules promulgated pursuant to such section.

Qualified tender option bond entity means an issuing entity with respect to tender option bonds for which each of the following applies:

(i) Such entity is collateralized solely by servicing assets and by municipal securities that have the same municipal issuer and the same underlying obligor or source of payment (determined without regard to any third-party credit enhancement), and such municipal securities are not subject to substitution.

(ii) Such entity issues no securities other than:

(A) A single class of tender option bonds with a preferred variable return payable out of capital that meets the requirements of paragraph (b) of this section, and

(B) One or more residual equity interests that, in the aggregate, are entitled to all remaining income of the issuing entity.

(C) The types of securities referred to in paragraphs (ii)(A) and (B) of this definition must constitute asset-backed securities.

(iii) The municipal securities held as assets by such entity are issued in compliance with Section 103 of the Internal Revenue Code of 1986, as amended (the ''IRS Code'', 26 U.S.C. 103), such that the interest payments made on those securities are excludable from the gross income of the owners under Section 103 of the IRS Code.

(iv) The terms of all of the securities issued by the entity are structured so that all holders of such securities who are eligible to exclude interest received on such securities will be able to exclude that interest from gross income pursuant to Section 103 of the IRS Code or as ''exempt-interest dividends'' pursuant to Section 852(b)(5) of the IRS Code (26 U.S.C. 852(b)(5)) in the case of regulated investment companies under the Investment Company Act of 1940, as amended.

(v) Such entity has a legally binding commitment from a regulated liquidity provider as defined in § __.6(a), to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding tender option bonds.

(vi) Such entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003–84, as amended or supplemented from time to time.

Tender option bond means a security which has features which entitle the holders to tender such bonds to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase price equal to the approximate amortized cost of the security, plus accrued interest, if any, at the time of tender.

(b) *Risk retention options.* Notwithstanding anything in this section, the sponsor with respect to an issuance of tender option bonds may retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of § __.4. In order to satisfy its risk retention requirements under this section, the sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may retain:

(1) An eligible vertical interest or an eligible horizontal residual interest, or any combination thereof, in accordance with the requirements of § __.4; or

(2) An interest that meets the requirements set forth in paragraph (c) of this section; or

(3) A municipal security that meets the requirements set forth in paragraph (d) of this section; or

(4) Any combination of interests and securities described in paragraphs (b)(1) through (b)(3) of this section such that the sum of the percentages held in each form equals at least five.

(c) *Tender option termination event.* The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a ''tender option termination event'' as defined in Section 4.01(5) of IRS Revenue Procedure 2003–84, as amended or supplemented from time to time will meet the requirements of an eligible vertical interest.

(d) *Retention of a municipal security outside of the qualified tender option bond entity.* The sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity may satisfy its risk retention requirements under this Section by holding municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.

(e) *Disclosures.* The sponsor shall provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of 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'':

(1) The name and form of organization of the qualified tender option bond entity;

(2) A description of the form and subordination features of such retained interest in accordance with the disclosure obligations in § __.4(c);

(3) To the extent any portion of the retained interest is claimed by the sponsor as an eligible horizontal residual interest (including any interest held in compliance with § __.10(c)), the fair value of that interest (expressed as a percentage of the fair value of all of the ABS interests issued in the securitization transaction and as a dollar amount);

(4) To the extent any portion of the retained interest is claimed by the sponsor as an eligible vertical interest (including any interest held in compliance with § __.10(c)), the percentage of ABS interests issued represented by the eligible vertical interest; and

(5) To the extent any portion of the retained interest claimed by the sponsor is a municipal security held outside of the qualified tender option bond entity, the name and form of organization of the qualified tender option bond entity, the identity of the issuer of the municipal securities, the face value of the municipal securities deposited into the qualified tender option bond entity, and the face value of the municipal securities retained by the sponsor or its majority-owned affiliates and subject to the transfer and hedging prohibition.

(f) *Prohibitions on Hedging and Transfer.* The prohibitions on transfer and hedging set forth in § __.12, apply to any interests or municipal securities retained by the sponsor with respect to an issuance of tender option bonds by a qualified tender option bond entity pursuant to of this section.

Subpart C—Transfer of Risk Retention

§ __.11 Allocation of risk retention to an originator.

(a) *In general.* A sponsor choosing to retain an eligible vertical interest or an eligible horizontal residual interest (including an eligible horizontal cash reserve account), or combination thereof under § __.4, with respect to a securitization transaction may offset the amount of its risk retention requirements under § __.4 by the amount of the eligible interests, respectively, acquired by an originator of one or more of the securitized assets if:

(1) At the closing of the securitization transaction:

(i) The originator acquires the eligible interest from the sponsor and retains such interest in the same manner and proportion (as between horizontal and vertical interests) as the sponsor under § __.4, as such interest was held prior to the acquisition by the originator;

(ii) The ratio of the percentage of eligible interests acquired and retained by the originator to the percentage of eligible interests otherwise required to be retained by the sponsor pursuant to § __.4, does not exceed the ratio of:

(A) The unpaid principal balance of all the securitized assets originated by the originator; to

(B) The unpaid principal balance of all the securitized assets in the securitization transaction;

(iii) The originator acquires and retains at least 20 percent of the aggregate risk retention amount otherwise required to be retained by the sponsor pursuant to § __.4; and

(iv) The originator purchases the eligible interests from the sponsor at a price that is equal, on a dollar-for-dollar basis, to the amount by which the sponsor's required risk retention is reduced in accordance with this section, by payment to the sponsor in the form of:

(A) Cash; or

(B) A reduction in the price received by the originator from the sponsor or depositor for the assets sold by the originator to the sponsor or depositor for inclusion in the pool of securitized assets.

(2) *Disclosures.* In addition to the disclosures required pursuant to § __.4(c), the sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of the asset-backed securities as part of the securitization transaction and, upon request, to the Commission and its appropriate Federal banking agency, if any, in written form under the caption ''Credit Risk Retention'', the name and form of organization of any originator that will acquire and retain (or has acquired and retained) an interest in the transaction pursuant to this section, including a description of the form and amount (expressed as a percentage and dollar amount (or corresponding amount in the foreign currency in which the ABS interests are issued, as applicable)) and nature (*e.g.,* senior or subordinated) of the interest, as well as the method of payment for such interest under paragraph (a)(1)(iv) of this section.

(3) *Hedging, transferring and pledging.* The originator and each of its affiliates complies with the hedging and other restrictions in § __.12 with respect to the interests retained by the originator pursuant to this section as if it were the retaining sponsor and was required to retain the interest under subpart B of this part.

(b) *Duty to comply.* (1) The retaining sponsor shall be responsible for compliance with this section.

(2) A retaining sponsor relying on this section:

(i) Shall maintain and adhere to policies and procedures that are reasonably designed to monitor the compliance by each originator that is allocated a portion of the sponsor's risk retention obligations with the requirements in paragraphs (a)(1) and (3) of this section; and

(ii) In the event the sponsor determines that any such originator no longer complies with any of the requirements in paragraphs (a)(1) and (3) of this section, shall promptly notify, or cause to be notified, the holders of the ABS interests issued in the

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securitization transaction of such noncompliance by such originator.

§ __.12 Hedging, transfer and financing prohibitions.

(a) *Transfer.* Except as permitted by § __.7(b)(8), and subject to § __.5, a retaining sponsor may not sell or otherwise transfer any interest or assets that the sponsor is required to retain pursuant to subpart B of this part to any person other than an entity that is and remains a majority-owned affiliate of the sponsor and each such majority-owned affiliate shall be subject to the same restrictions.

(b) *Prohibited hedging by sponsor and affiliates.* A retaining sponsor and its affiliates may not purchase or sell a security, or other financial instrument, or enter into an agreement, derivative or other position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative, or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction pursuant to subpart B of this part or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.

(c) *Prohibited hedging by issuing entity.* The issuing entity in a securitization transaction may not purchase or sell a security or other financial instrument, or enter into an agreement, derivative or position, with any other person if:

(1) Payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor for the transaction (or any of its majority-owned affiliates) is required to retain with respect to the securitization transaction pursuant to subpart B of this part; and

(2) The security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the retaining sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the sponsor (or any of its majority-owned affiliates) is required to retain pursuant to subpart B of this part.

(d) *Permitted hedging activities.* The following activities shall not be considered prohibited hedging activities under paragraph (b) or (c) of this section:

(1) Hedging the interest rate risk (which does not include the specific interest rate risk, known as spread risk, associated with the ABS interest that is otherwise considered part of the credit risk) or foreign exchange risk arising from one or more of the particular ABS interests required to be retained by the sponsor (or any of its majority-owned affiliates) under subpart B of this part or one or more of the particular securitized assets that underlie the asset-backed securities issued in the securitization transaction; or

(2) Purchasing or selling a security or other financial instrument or entering into an agreement, derivative, or other position with any third party where payments on the security or other financial instrument or under the agreement, derivative, or position are based, directly or indirectly, on an index of instruments that includes asset-backed securities if:

(i) Any class of ABS interests in the issuing entity that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index; and

(ii) All classes of ABS interests in all issuing entities that were issued in connection with any securitization transaction in which the sponsor (or any of its majority-owned affiliates) is required to retain an interest pursuant to subpart B of this part and that are included in the index represent, in the aggregate, no more than 20 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index.

(e) *Prohibited non-recourse financing.* Neither a retaining sponsor nor any of its affiliates may pledge as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any ABS interest that the sponsor is required to retain with respect to a securitization transaction pursuant to subpart B of this part unless such obligation is with full recourse to the sponsor or affiliate, respectively.

(f) *Duration of the hedging and transfer restrictions*—(1) *General rule.* Except as provided in paragraph (f)(2) of this section, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire on or after the date that is the latest of:

(i) The date on which the total unpaid principal balance (if applicable) of the securitized assets that collateralize the securitization transaction has been reduced to 33 percent of the total unpaid principal balance of the securitized assets as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction;

(ii) The date on which the total unpaid principal obligations under the ABS interests issued in the securitization transaction has been reduced to 33 percent of the total unpaid principal obligations of the ABS interests at closing of the securitization transaction; or

(iii) Two years after the date of the closing of the securitization transaction.

(2) *Securitizations of residential mortgages.* (i) If all of the assets that collateralize a securitization transaction subject to risk retention under this part are residential mortgages, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire on or after the date that is the later of:

(A) Five years after the date of the closing of the securitization transaction; or

(B) The date on which the total unpaid principal balance of the residential mortgages that collateralize the securitization transaction has been reduced to 25 percent of the total unpaid principal balance of such residential mortgages at the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction.

(ii) Notwithstanding paragraph (f)(2)(i) of this section, the prohibitions on sale and hedging pursuant to paragraphs (a) and (b) of this section shall expire with respect to the sponsor of a securitization transaction described in paragraph (f)(2)(i) of this section on or after the date that is seven years after the date of the closing of the securitization transaction.

(3) *Conservatorship or receivership of sponsor.* A conservator or receiver of the

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sponsor (or any other person holding risk retention pursuant to this part) of a securitization transaction is permitted to sell or hedge any economic interest in the securitization transaction if the conservator or receiver has been appointed pursuant to any provision of federal or State law (or regulation promulgated thereunder) that provides for the appointment of the Federal Deposit Insurance Corporation, or an agency or instrumentality of the United States or of a State as conservator or receiver, including without limitation any of the following authorities:

(i) 12 U.S.C. 1811;

(ii) 12 U.S.C. 1787;

(iii) 12 U.S.C. 4617; or

(iv) 12 U.S.C. 5382.

(4) *Revolving pool securitizations.* The provisions of paragraphs (f)(1) and (2) are not available to sponsors of revolving pool securitizations with respect to the forms of risk retention specified in § __.5.

Subpart D—Exceptions and Exemptions

§ __.13 Exemption for qualified residential mortgages.

(a) *Definitions.* For purposes of this section, the following definitions shall apply:

Currently performing means the borrower in the mortgage transaction is not currently thirty (30) days or more past due, in whole or in part, on the mortgage transaction.

Qualified residential mortgage means a ''qualified mortgage'' as defined in section 129C of the Truth in Lending Act (15 U.S.C.1639c) and regulations issued thereunder, as amended from time to time.

(b) *Exemption.* A sponsor shall be exempt from the risk retention requirements in subpart B of this part with respect to any securitization transaction, if:

(1) All of the assets that collateralize the asset-backed securities are qualified residential mortgages or servicing assets;

(2) None of the assets that collateralize the asset-backed securities are asset-backed securities;

(3) As of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction, each qualified residential mortgage collateralizing the asset-backed securities is currently performing; and

(4)(i) The depositor with respect to the securitization transaction certifies that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages or servicing assets and has concluded that its internal supervisory controls are effective; and

(ii) The evaluation of the effectiveness of the depositor's internal supervisory controls must be performed, for each issuance of an asset-backed security in reliance on this section, as of a date within 60 days of the cut-off date or similar date for establishing the composition of the asset pool collateralizing such asset-backed security; and

(iii) The sponsor provides, or causes to be provided, a copy of the certification described in paragraph (b)(4)(i) of this section to potential investors a reasonable period of time prior to the sale of asset-backed securities in the issuing entity, and, upon request, to the Commission and its appropriate Federal banking agency, if any.

(c) *Repurchase of loans subsequently determined to be non-qualified after closing.* A sponsor that has relied on the exemption provided in paragraph (b) of this section with respect to a securitization transaction shall not lose such exemption with respect to such transaction if, after closing of the securitization transaction, it is determined that one or more of the residential mortgage loans collateralizing the asset-backed securities does not meet all of the criteria to be a qualified residential mortgage *provided that:*

(1) The depositor complied with the certification requirement set forth in paragraph (b)(4) of this section;

(2) The sponsor repurchases the loan(s) from the issuing entity at a price at least equal to the remaining aggregate unpaid principal balance and accrued interest on the loan(s) no later than 90 days after the determination that the loans do not satisfy the requirements to be a qualified residential mortgage; and

(3) The sponsor promptly notifies, or causes to be notified, the holders of the asset-backed securities issued in the securitization transaction of any loan(s) included in such securitization transaction that is (or are) required to be repurchased by the sponsor pursuant to paragraph (c)(2) of this section, including the amount of such repurchased loan(s) and the cause for such repurchase.

§ __.14 Definitions applicable to qualifying commercial loans, qualifying commercial real estate loans, and qualifying automobile loans.

The following definitions apply for purposes of §§ __.15 through __.18:

Appraisal Standards Board means the board of the Appraisal Foundation that develops, interprets, and amends the Uniform Standards of Professional Appraisal Practice (USPAP), establishing generally accepted standards for the appraisal profession.

Automobile loan:

(1) Means any loan to an individual to finance the purchase of, and that is secured by a first lien on, a passenger car or other passenger vehicle, such as a minivan, van, sport-utility vehicle, pickup truck, or similar light truck for personal, family, or household use; and

(2) Does not include any:

(i) Loan to finance fleet sales;

(ii) Personal cash loan secured by a previously purchased automobile;

(iii) Loan to finance the purchase of a commercial vehicle or farm equipment that is not used for personal, family, or household purposes;

(iv) Lease financing;

(v) Loan to finance the purchase of a vehicle with a salvage title; or

(vi) Loan to finance the purchase of a vehicle intended to be used for scrap or parts.

Combined loan-to-value (CLTV) ratio means, at the time of origination, the sum of the principal balance of a first-lien mortgage loan on the property, plus the principal balance of any junior-lien mortgage loan that, to the creditor's knowledge, would exist at the closing of the transaction and that is secured by the same property, divided by:

(1) For acquisition funding, the lesser of the purchase price or the estimated market value of the real property based on an appraisal that meets the requirements set forth in § __.17(a)(2)(ii); or

(2) For refinancing, the estimated market value of the real property based on an appraisal that meets the requirements set forth in § __.17(a)(2)(ii).

Commercial loan means a secured or unsecured loan to a company or an individual for business purposes, other than any:

(1) Loan to purchase or refinance a one-to-four family residential property;

(2) Commercial real estate loan.

Commercial real estate (CRE) loan means:

(1) A loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50 percent or more) of repayment for which is expected to be:

(i) The proceeds of the sale, refinancing, or permanent financing of the property; or

(ii) Rental income associated with the property;

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investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person (as defined in paragraph (i) of this section);

(D) An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country;

(E) Any agency or branch of a U.S. person (as defined in paragraph (i) of this section) located outside the United States if:

(*1*) The agency or branch operates for valid business reasons; and

(*2*) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located;

(F) The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

(b) *In general.* This part shall not apply to a securitization transaction if all the following conditions are met:

(1) The securitization transaction is not required to be and is not registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*);

(2) No more than 10 percent of the dollar value (or equivalent amount in the currency in which the ABS interests are issued, as applicable) of all classes of ABS interests in the securitization transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons;

(3) Neither the sponsor of the securitization transaction nor the issuing entity is:

(i) Chartered, incorporated, or organized under the laws of the United States or any State;

(ii) An unincorporated branch or office (wherever located) of an entity chartered, incorporated, or organized under the laws of the United States or any State; or

(iii) An unincorporated branch or office located in the United States or any State of an entity that is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State; and

(4) If the sponsor or issuing entity is chartered, incorporated, or organized under the laws of a jurisdiction other than the United States or any State, no more than 25 percent (as determined based on unpaid principal balance) of the assets that collateralize the ABS interests sold in the securitization transaction were acquired by the sponsor or issuing entity, directly or indirectly, from:

(i) A majority-owned affiliate of the sponsor or issuing entity that is chartered, incorporated, or organized under the laws of the United States or any State; or

(ii) An unincorporated branch or office of the sponsor or issuing entity that is located in the United States or any State.

(c) *Evasions prohibited.* In view of the objective of these rules and the policies underlying Section 15G of the Exchange Act, the safe harbor described in paragraph (b) of this section is not available with respect to any transaction or series of transactions that, although in technical compliance with paragraphs (a) and (b) of this section, is part of a plan or scheme to evade the requirements of section 15G and this Part. In such cases, compliance with section 15G and this part is required.

§ __.21 Additional exemptions.

(a) *Securitization transactions.* The federal agencies with rulewriting authority under section 15G(b) of the Exchange Act (15 U.S.C. 78o-11(b)) with respect to the type of assets involved may jointly provide a total or partial exemption of any securitization transaction as such agencies determine may be appropriate in the public interest and for the protection of investors.

(b) *Exceptions, exemptions, and adjustments.* The Federal banking agencies and the Commission, in consultation with the Federal Housing Finance Agency and the Department of Housing and Urban Development, may jointly adopt or issue exemptions, exceptions or adjustments to the requirements of this part, including exemptions, exceptions or adjustments for classes of institutions or assets in accordance with section 15G(e) of the Exchange Act (15 U.S.C. 78o-11(e)).

§ __.22 Periodic review of the QRM definition, exempted three-to-four unit residential mortgage loans, and community-focused residential mortgage exemption

(a) The Federal banking agencies and the Commission, in consultation with the Federal Housing Finance Agency and the Department of Housing and Urban Development, shall commence a review of the definition of qualified residential mortgage in § __.13, a review of the community-focused residential mortgage exemption in § ___.19(f), and a review of the exemption for qualifying three-to-four unit residential mortgage loans in § ____.19(g):

(1) No later than four years after the effective date of the rule (as it relates to securitizers and originators of asset-backed securities collateralized by residential mortgages), five years following the completion of such initial review, and every five years thereafter; and

(2) At any time, upon the request of any Federal banking agency, the Commission, the Federal Housing Finance Agency or the Department of Housing and Urban Development, specifying the reason for such request, including as a result of any amendment to the definition of qualified mortgage or changes in the residential housing market.

(b) The Federal banking agencies, the Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development shall publish in the **Federal Register** notice of the commencement of a review and, in the case of a review commenced under paragraph (a)(2) of this section, the reason an agency is requesting such review. After completion of any review, but no later than six months after the publication of the notice announcing the review, unless extended by the agencies, the agencies shall jointly publish a notice disclosing the determination of their review. If the agencies determine to amend the definition of qualified residential mortgage, the agencies shall complete any required rulemaking within 12 months of publication in the **Federal Register** of such notice disclosing the determination of their review, unless extended by the agencies.

End of Common Rule

List of Subjects

12 CFR Part 43

Automobile loans, Banks and banking, Commercial loans, Commercial real estate, Credit risk, Mortgages, National banks, Reporting and recordkeeping requirements, Risk retention, Securitization.

12 CFR Part 244

Auto loans, Banks and banking, Bank holding companies, Commercial loans, Commercial real estate, Credit risk, Edge and agreement corporations, Foreign banking organizations, Mortgages, Nonbank financial companies, Reporting and recordkeeping requirements, Risk retention, Savings and loan holding companies, Securitization, State member banks.

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12 CFR Part 373

Automobile loans, Banks and banking, Commercial loans, Commercial real estate, Credit risk, Mortgages, Reporting and recordkeeping requirements, Risk retention, Savings associations, Securitization.

12 CFR Part 1234

Government sponsored enterprises, Mortgages, Securities.

17 CFR Part 246

Reporting and recordkeeping requirements, Securities.

24 CFR Part 267

Mortgages.

Adoption of the Common Rule Text

The adoption of the common rule, as modified by agency-specific text, is set forth below:

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

For the reasons stated in the common preamble and under the authority of 12 U.S.C. 93a, 1464, 5412(b)(2)(B), and 15 U.S.C. 78o-11, the Office of the Comptroller of the Currency is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 43, chapter I of title 12, Code of Federal Regulations, and further amends part 43 as follows:

PART 43—CREDIT RISK RETENTION

■ 1. The authority citation for part 43 is added to read as follows:

Authority: 12 U.S.C. 1 *et seq.,* 93a, 161, 1464, 1818, 5412(b)(2)(B), and 15 U.S.C. 78o-11.

■ 2. Section 43.1 is added to read as follows:

§ 43.1 Authority, purpose, scope, and reservation of authority.

(a) *Authority.* This part is issued under the authority of 12 U.S.C. 1 *et seq.,* 93a, 161, 1464, 1818, 5412(b)(2)(B), and 15 U.S.C. 78o-11.

(b) *Purpose.* (1) This part requires securitizers 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. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards.

(2) Nothing in this part shall be read to limit the authority of the OCC to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

(c) *Scope.* This part applies to any securitizer that is a national bank, a Federal savings association, a Federal branch or agency of a foreign bank, or a subsidiary thereof.

(d) *Compliance dates.* Compliance with this part is required:

(1) With respect to any securitization transaction collateralized by residential mortgages, on and after December 24, 2015; and

(2) With respect to any other securitization transaction, on and after December 24, 2016.

Federal Reserve System

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 244 to chapter II of title 12, Code of Federal Regulations, and further amends part 244 as follows:

PART 244—CREDIT RISK RETENTION (REGULATION RR)

■ 3. The authority citation for part 244 is added to read as follows:

Authority: 12 U.S.C. 221 *et seq.,* 1461 *et seq.,* 1818, 1841 *et seq.,* 3103 *et seq.,* and 15 U.S.C. 78o–11.

■ 4. The part heading for part 244 is revised to read as set forth above.

■ 5. Section 244.1 is added to read as follows:

§ 244.1 Authority, purpose, and scope.

(a) *Authority.* (1) *In general.* This part (Regulation RR) is issued by the Board of Governors of the Federal Reserve System under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 78o–11), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 *et seq.*); section 8 of the Federal Deposit Insurance Act (FDI Act), as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (BHC Act) (12 U.S.C. 1841 *et seq.*); the Home Owners' Loan Act of 1933 (HOLA) (12 U.S.C. 1461 *et seq.*); section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (12 U.S.C. 5365); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(2) Nothing in this part shall be read to limit the authority of the Board to take action under provisions of law other than 15 U.S.C. 78o–11, including action to address unsafe or unsound practices or conditions, or violations of law or regulation, under section 8 of the FDI Act.

(b) *Purpose.* This part requires 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 in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) *Scope.* (1) This part applies to any securitizer that is:

(i) A state member bank (as defined in 12 CFR 208.2(g)); or

(ii) Any subsidiary of a state member bank.

(2) Section 15G of the Exchange Act and the rules issued thereunder apply to any securitizer that is:

(i) A bank holding company (as defined in 12 U.S.C. 1842);

(ii) A foreign banking organization (as defined in 12 CFR 211.21(o));

(iii) An Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3));

(iv) A nonbank financial company that the Financial Stability Oversight Council has determined under section 113 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank Act) (12 U.S.C. 5323) shall be supervised by the Board and for which such determination is still in effect; or

(v) A savings and loan holding company (as defined in 12 U.S.C. 1467a); and

(vi) Any subsidiary of the foregoing.

(3) Compliance with this part is required:

(i) With respect to any securitization transaction collateralized by residential mortgages on December 24, 2015; and

(ii) With respect to any other securitization transaction on December 24, 2016.

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal

Deposit Insurance Corporation adds the text of the common rule as set forth at the end of the Supplementary Information as part 373 to chapter III of title 12, Code of Federal Regulations, and further amends part 373 as follows:

PART 373—CREDIT RISK RETENTION

■ 6. The authority citation for part 373 is added to read as follows:

Authority: 12 U.S.C. 1811 *et seq.* and 3103 *et seq.,* and 15 U.S.C. 78o–11.

■ 7. Section 373.1 is added to read as follows:

§ 373.1 Purpose and scope.

(a) *Authority.* (1) *In general.* This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 15G of the Securities Exchange Act of 1934, as amended (Exchange Act) (15 U.S.C. 78o–11), as well as the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*) and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(2) Nothing in this part shall be read to limit the authority of the FDIC to take action under provisions of law other than 15 U.S.C. 78o–11, including to address unsafe or unsound practices or conditions, or violations of law or regulation under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) *Purpose.* This part requires securitizers 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 in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(c) *Scope.* This part applies to any securitizer that is:

(1) A state nonmember bank (as defined in 12 U.S.C. 1813(e)(2));

(2) An insured state branch of a foreign bank (as defined in 12 CFR 347.202);

(3) A state savings association (as defined in 12 U.S.C. 1813(b)(3)); or

(4) Any subsidiary of an entity described in paragraph (c)(1), (2), or (3) of this section.

Federal Housing Finance Agency

12 CFR Chapter XII

Authority and Issuance

For the reasons stated in the Supplementary Information, and under the authority of 12 U.S.C. 4526, the Federal Housing Finance Agency is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 1234 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, and further amends part 1234 as follows:

PART 1234—CREDIT RISK RETENTION

■ 8. The authority citation for part 1234 is added to read as follows:

Authority: 12 U.S.C. 4511(b), 4526, 4617; 15 U.S.C. 78o–11(b)(2).

■ 9. Section 1234.1 is added to read as follows:

§ 1234.1 Purpose, scope and reservation of authority.

(a) *Purpose.* This part requires securitizers to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party in a transaction within the scope of section 15G of the Exchange Act. This part specifies the permissible types, forms, and amounts of credit risk retention, and it establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or that otherwise qualify for an exemption.

(b) *Scope.* (1) Effective December 24, 2015, this part will apply to any securitizer that is an entity regulated by the Federal Housing Finance Agency with respect to a securitization transaction collateralized by residential mortgages.

(2) Effective December 24, 2016, this part will apply to any securitizer that is an entity regulated by the Federal Housing Finance Agency with respect to a securitization transaction collateralized by assets other than residential mortgages.

(c) *Reservation of authority.* Nothing in this part shall be read to limit the authority of the Director of the Federal Housing Finance Agency to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, or violations of law.

■ 10. Amend § 1234.14 as follows:

■ a. Revise the section heading;

■ b. In the introductory text, remove the reference ''§§ 1234.15 through 1234.18'' and add in its place the reference ''§§ 1234.15 and 1234.17'';

■ c. Remove the definitions of ''Automobile loan'', ''Commercial loan'', ''Debt to income (DTI) ratio'', ''Earnings before interest, taxes, depreciation, and amortization (EBITDA)'', ''Leverage Ratio'', ''Model year'', ''Payments-in-kind'', ''Purchase price'', ''Salvage title'', ''Total debt'', ''Total liabilities ratio'', and ''Trade-in allowance''; and

■ d. Revise the definition of ''Debt service coverage (DSC) ratio''.

The revisions read as follows:

§ 1234.14 Definitions applicable to qualifying commercial real estate loans.

* * * * *

Debt service coverage (DSC) ratio means the ratio of:

(1) The annual NOI less the annual replacement reserve of the CRE property at the time of origination of the CRE loan(s); to

(2) The sum of the borrower's annual payments for principal and interest (calculated at the fully indexed rate) on any debt obligation.

* * * * *

■ 11. Revise § 1234.15 to read as follows:

§ 1234.15 Qualifying commercial real estate loans.

(a) *General exception.* Commercial real estate loans that are securitized through a securitization transaction shall be subject to a 0 percent risk retention requirement under subpart B of this part, provided that the following conditions are met:

(1) The CRE assets meet the underwriting standards set forth in § 1234.17;

(2) The securitization transaction is collateralized solely by CRE loans and by servicing assets;

(3) The securitization transaction does not permit reinvestment periods; and

(4) The sponsor provides, or causes to be provided, to potential investors a reasonable period of time prior to the sale of asset-backed securities of the issuing entity, and, upon request, to the Commission, and to the FHFA, in written form under the caption ''Credit Risk Retention'' a description of the manner in which the sponsor determined the aggregate risk retention requirement for the securitization transaction after including qualifying CRE loans with 0 percent risk retention.

(b) *Risk retention requirement.* For any securitization transaction described in paragraph (a) of this section, the percentage of risk retention required under § 1234.3(a) is reduced by the percentage evidenced by the ratio of the unpaid principal balance of the qualifying CRE loans to the total unpaid principal balance of CRE loans that are included in the pool of assets collateralizing the asset-backed securities issued pursuant to the securitization transaction (the qualifying asset ratio); provided that;

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(1) The qualifying asset ratio is measured as of the cut-off date or similar date for establishing the composition of the securitized assets collateralizing the asset-backed securities issued pursuant to the securitization transaction;

(2) If the qualifying asset ratio would exceed 50 percent, the qualifying asset ratio shall be deemed to be 50 percent; and

(3) The disclosure required by paragraph (a)(4) of this section also includes descriptions of the qualifying CRE loans and descriptions of the CRE loans that are not qualifying CRE loans, and the material differences between the group of qualifying CRE loans and CRE loans that are not qualifying loans with respect to the composition of each group's loan balances, loan terms, interest rates, borrower credit information, and characteristics of any loan collateral.

(c) *Exception for securitizations of qualifying CRE only.* Notwithstanding other provisions of this section, the risk retention requirements of subpart B of this part shall not apply to securitization transactions where the transaction is collateralized solely by servicing assets and qualifying CRE loans.

(d) Record maintenance. A regulated entity must retain the disclosures required in paragraphs (a) and (b) of this section and the certification required in § 1234.17(a)(10) of this part, in its records until three years after all ABS interests issued in the securitization are no longer outstanding. The regulated entity must provide the disclosures and certifications upon request to the Commission and the FHFA.

§§ 1234.16 and 1234.18 [Removed and Reserved]

■ 12. Remove and reserve §§ 1234.16 and 1234.18.

Securities and Exchange Commission

17 CFR Chapter II

Authority and Issuance

For the reasons stated in the Supplementary Information, the Securities and Exchange Commission is adopting the text of the common rule as set forth at the end of the Supplementary Information as part 246, title 17, chapter II of the Code of Federal Regulations, under the authority set forth in Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 15G, 23 and 36 of the Exchange Act, and further amends part 246 as follows:

PART 246—CREDIT RISK RETENTION

■ 13. The authority citation for part 246 is added to read as follows:

Authority: 15 U.S.C. 77g, 77j, 77s, 77z–3, 78c, 78m, 78o, 78o–11, 78w, 78mm.

■ 14. Section 246.1 is added to read as follows:

§ 246.1 Purpose, scope, and authority.

(a) *Authority and purpose.* This part (Regulation RR) is issued by the Securities and Exchange Commission (''Commission'') jointly with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and, in the case of the securitization of any residential mortgage asset, together with the Secretary of Housing and Urban Development and the Federal Housing Finance Agency, pursuant to Section 15G of the Securities Exchange Act of 1934 (15 U.S.C. 78o–11). The Commission also is issuing this part pursuant to its authority under Sections 7, 10, 19(a), and 28 of the Securities Act and Sections 3, 13, 15, 23, and 36 of the Exchange Act. This part requires securitizers 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. This part specifies the permissible types, forms, and amounts of credit risk retention, and establishes certain exemptions for securitizations collateralized by assets that meet specified underwriting standards or otherwise qualify for an exemption.

(b) The authority of the Commission under this part shall be in addition to the authority of the Commission to otherwise enforce the federal securities laws, including, without limitation, the antifraud provisions of the securities laws.

Department of Housing and Urban Development

24 CFR Chapter II

Authority and Issuance

For the reasons stated in the preamble, HUD is adopting the text of the common rule as set forth at the end of the Supplementary Information as 24 CFR part 267, and further amends part 267 as follows:

PART 267—CREDIT RISK RETENTION

■ 15. The authority citation for part 267 is added to read as follows:

Authority: 15 U.S.C. 78–o–11; 42 U.S.C. 3535(d).

■ 16. Section 267.1 is added to read as follows:

§ 267.1 Credit risk retention exceptions and exemptions for HUD programs.

The credit risk retention regulations codified at 12 CFR part 43 (Office of the Comptroller of the Currency); 12 CFR part 244 (Federal Reserve System); 12 CFR part 373 (Federal Deposit Insurance Corporation); 17 CFR part 246 (Securities and Exchange Commission); and 12 CFR part 1234 (Federal Housing Finance Agency) include exceptions and exemptions in subpart D of each of these codified regulations for certain transactions involving programs and entities under the jurisdiction of the Department of Housing and Urban Development.

Dated: October 21, 2014.

Thomas J. Curry,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, October 23, 2014.

Robert deV. Frierson,

Secretary of the Board.

Dated at Washington, DC, this 21st day of October, 2014.

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: October 22, 2014.

By the Securities and Exchange Commission.

Kevin M. O'Neill,

Deputy Secretary.

Dated: October 21, 2014.

Melvin L. Watt,

Director, Federal Housing Finance Agency.

By the Department of Housing and Urban Development.

Julián Castro,

Secretary.

[FR Doc. 2014–29256 Filed 12–23–14; 8:45 am]

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