

**PROPOSED RISK RETENTION AND EXCESS SPREAD RESERVE ACCOUNT
REQUIREMENTS FOR SECURITIZED COMMERCIAL MORTGAGES****Overview**

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “*Dodd-Frank Act*”) added new Section 15G of the Securities Exchange Act (the “*Exchange Act*”) requiring the federal banking agencies,¹ the Securities and Exchange Commission (the “*SEC*”) and certain federal housing authorities² to jointly prescribe regulations that (i) require a securitizer to retain not less than 5% of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (“*ABS*”), transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G and the implementing rules.³

A joint notice of proposed rulemaking on risk retention requirements (the “*Proposed Rules*”) implementing Section 15G of the Exchange Act was approved by the FDIC and the Federal Reserve on March 29, 2011, and by the SEC on March 30, 2011. Approval of the joint notice is expected to follow shortly from the other agencies.

Section 15G specifically identified commercial real estate (“*CRE*”) mortgages as an asset class calling for flexibility in risk retention (such as retention of the first-loss position by a third-party purchaser, or “B-piece buyer,” of the lowest tranche of the related commercial mortgage-backed securities (“*CMBS*”). Section 15G also required that the implementing rules permit a securitizer to retain less than 5% of the credit risk of commercial mortgages that are transferred, sold, or conveyed through the issuance of ABS by the securitizer if those loans meet underwriting standards established by the federal banking agencies.⁴

Although the agencies have, as expected, affirmed the use of “B-piece buyers” in satisfying risk retention requirements for commercial mortgage securitizations, the agencies have also included a reserve account provision that effectively negates the ability of CMBS sponsors to monetize and retain excess spread at closing without further economic exposure to asset performance.

¹ The Office of the Comptroller of the Currency (“*OCC*”), the Board of Governors of the Federal Reserve System (“*Federal Reserve*”), and the Federal Deposit Insurance Corporation (“*FDIC*”).

² The Federal Housing Finance Agency (“*FHFA*”) and the Department of Housing and Urban Development (“*HUD*”).

³ See 15 U.S.C. § 78o-11(b), (c)(1)(A) and (c)(1)(B)(ii).

⁴ See 15 U.S.C. § 78o-11(c)(1)(B)(ii) and (C).

A summary of the Proposed Rules as applied to the securitization of commercial mortgages is set forth below.⁵ The Proposed Rules must be approved separately by each of the agencies before being officially published, and then will be subject to a public comment period ending on June 10, 2011. If adopted, the final version of the Proposed Rules would become effective with respect to CMBS two years after publication of the final rules in the Federal Register.

Application of Proposed Rules to Commercial Mortgage Securitizations

The Proposed Rules generally apply risk retention requirements to the securitizer in each “securitization transaction,” which is defined as a transaction involving the offer and sale of ABS (and thus, CMBS) by an issuing entity.⁶ The risk retention requirements will apply equally to both public and private securitization transactions.

The term “securitizer” with respect to an issuance of ABS includes both “(A) an issuer of an asset-backed security; [and] (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.”⁷ Because of the similarity of the second clause to the SEC’s existing definition of a “sponsor” under Regulation AB, the Proposed Rules provide that a “sponsor” of an ABS transaction is a “securitizer” for the purposes of Section 15G, and define the term “sponsor” in a manner consistent with the definition of that term in the SEC’s Regulation AB.⁸

The proposed risk retention requirements would apply to all CMBS transactions that are within the scope of Section 15G, regardless of whether the sponsor is an insured depository institution, a bank holding company or subsidiary thereof, a registered broker-dealer, or other type of federally supervised financial institution. Thus, for example, it would apply to CMBS transactions by any nonbank entity that is not an insured depository institution (such as an independent mortgage firm).

⁵ The Proposed Rules also address risk retention requirements for other assets classes, including residential mortgages, auto loans and credit card receivables. Also included is a proposed exemption for asset-backed securities that are collateralized exclusively by residential mortgages that qualify as “qualified residential mortgages,” or QRMs. This memorandum addresses the Proposed Rule solely with respect to commercial mortgages.

⁶ CMBS qualify as “asset-backed securities” as defined in Section 3(a)(77) of the Exchange Act, which also was added to the Exchange Act by Section 941 of the Dodd-Frank Act. Section 3(a)(77) of the Exchange Act generally defines an “asset-backed security” to mean “a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.”

⁷ See 15 U.S.C. § 78o-11(a)(3).

⁸ In circumstances where two or more entities each meet the definition of sponsor for a single securitization transaction, the Proposed Rules require that one of the sponsors retain a portion of the credit risk of the underlying assets in accordance with the requirements of the proposal. In addition, the Proposed Rules generally would apply the risk retention requirements of Section 15G to a sponsor of a securitization transaction (and not the depositor for the securitization transaction).

Risk Retention Requirements

A. Minimum of 5% Risk Retention

Consistent with Section 15G of the Exchange Act, the Proposed Rules generally would require (subject to specific exemptions) that a CMBS sponsor retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing an issuance of ABS (this is referred to as the “base” risk retention requirement). The CMBS sponsor also would be prohibited from hedging or otherwise transferring this retained interest.

Moreover (and more controversially), the Proposed Rules would require that a CMBS sponsor, in certain circumstances, fund a premium capture cash reserve account in connection with certain securitization transactions where excess spread is monetized or otherwise retained by the sponsor in an interest-only class. Any amount a CMBS sponsor might be required to place in a premium capture cash reserve account would be in addition to the 5% “base” risk retention requirement of the Proposed Rules, and would be available to cover losses on the underlying commercial mortgage loans before such losses are allocated to any other CMBS tranche (including the tranche held by the B-piece buyer).

B. Permissible Forms of Risk Retention

The Proposed Rules provide a nonexclusive list of permissible forms of risk retention:

- a “vertical” slice of the ABS interests, whereby the sponsor or other entity retains a specified pro rata piece of every class of ABS interests issued in the transaction;
- a “horizontal” first-loss position, whereby the sponsor or other entity retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests;
- a “seller’s interest” in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor or other entity holds a separate interest that is *pari passu* with the investors’ interest in the pool of receivables (unless and until the occurrence of an early amortization event); or
- a representative sample, whereby the sponsor retains a representative sample of the assets to be securitized that exposes the sponsor to credit risk that is equivalent to that of the securitized assets.

In providing this list, the agencies note that in connection with CMBS, a form of horizontal risk retention often has been employed, with the horizontal first-loss position being initially held by a third-party purchaser that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.

C. B-Piece Buyer Risk Retention for CMBS

As suggested by the Dodd-Frank Act, the Proposed Rules permit a sponsor of CMBS to meet its risk retention requirements through a third-party purchaser, or “B-piece buyer,” that acquires an eligible horizontal residual interest in the issuing entity in the same form, amount, and manner as the sponsor would have been required to retain under the horizontal risk retention option, with certain additional conditions being met (including that CRE loans constitute at least 95% of the unpaid principal balance of the assets being securitized).

Although the B-piece buyer may retain the credit risk, the Proposed Rules provide that the sponsor remains responsible for compliance with the risk retention requirements. Therefore, the sponsor must maintain and adhere to policies and procedures for monitoring the B-piece buyer’s compliance with the risk retention requirements. In the event that the sponsor determines that the B-piece buyer no longer complies with the requirements of the rule (for example, because the B-piece buyer has sold the interest it was required to retain), the sponsor must promptly notify the investors in the CMBS transaction of such noncompliance.

Conditions for B-Piece Buyer Risk Retention

The Proposed Rules impose six conditions on the B-piece buyer risk retention for CMBS:

- First, the B-piece buyer must retain an eligible horizontal residual interest in the securitization in the same form, amount, and manner as would be required of the sponsor under the horizontal risk retention option. Accordingly, the interest acquired by the third-party purchaser must be the most junior interest in the issuing entity, and must be subject to the same limits on payments as would apply if the eligible horizontal residual interest were held by the sponsor pursuant to the horizontal risk retention option.
- Second, the B-piece buyer must pay for the first-loss subordinated interest in cash at the closing of the securitization without financing being provided, directly or indirectly, from any other person that is a party to the CMBS transaction (including, but not limited to, the sponsor, depositor, or an unaffiliated servicer), other than a person that is a party solely by reason of being an investor.
- Third, the B-piece buyer must perform a review of the credit risk of each CRE loan in the pool prior to the sale of the CMBS. This review must include, at a minimum, a review of the underwriting standards, collateral, and expected cash flows of each CRE loan in the pool.
- Fourth, the B-piece buyer must be prohibited from (i) being affiliated with any other party to the CMBS transaction (other than investors); and (ii) having control rights in the securitization (including, but not limited to, acting as servicer or special servicer)

that are not collectively shared by all other investors in the securitization.⁹ The proposed prohibition of control rights related to servicing would be subject to an exception, however, if the underlying CMBS documents provide for the appointment of an independent operating advisor with certain powers and responsibilities. (See “Operating Advisor Requirements,” below.)

- Fifth, the sponsor must provide, or cause to be provided, to potential purchasers certain information concerning the B-piece buyer and other information concerning the CMBS transaction. (See “B-Piece Buyer Disclosure Requirements,” below.)
- Sixth, any B-piece buyer acquiring an eligible horizontal residual interest under this option must comply with the hedging, transfer and other restrictions applicable to such interest under the Proposed Rules as if the B-piece buyer were a sponsor who had acquired the interest under the horizontal risk retention option.

Operating Advisor Requirements

Under the B-piece buyer proposal, an “Operating Advisor” would be defined as a party that (i) is not affiliated with any other party to the securitization, (ii) does not directly or indirectly have any financial interest in the securitization other than in fees from its role as Operating Advisor, and (iii) is required to act in the best interest of, and for the benefit of, investors as a collective whole.

Further, in order for a B-piece buyer to have servicing rights in connection with the CMBS transaction, the CMBS transaction documents must require the following:

- Any servicer for the CRE loans that is, or is affiliated with, the B-piece buyer must consult with the Operating Advisor in connection with, and prior to, any major decision in connection with the servicing of the CRE loans, including, without limitation:
 - (1) any material modification of, or waiver with respect to, any provision of a loan agreement (including a mortgage, deed of trust, or other security agreement);
 - (2) foreclosure upon or comparable conversion of the ownership of a property; or
 - (3) any acquisition of a property.

⁹ The proposal includes a *de minimis* exception to the general prohibition on affiliation with other parties to the securitization transaction. Under this *de minimis* exception, the B-piece buyer would be permitted to be affiliated with one or more originators of the CRE loans as long as the CRE loans contributed by such originator(s) collectively comprised less than 10% of the assets in the pool (as measured by dollar volume).

- The Operating Advisor must be responsible for reviewing the actions of any servicer that is, or is affiliated with, the B-piece buyer and for issuing a report to investors and the issuing entity on a periodic basis concerning:
 - (1) whether the Operating Advisor believes, in its sole discretion exercised in good faith, that such servicer is operating in compliance with any standard required of the servicer as provided in the applicable transaction documents; and
 - (2) what, if any, standard(s) the Operating Advisor believes, in its sole discretion exercised in good faith, with which such servicer has failed to comply.
- The Operating Advisor must have the authority to recommend that a servicer that is, or is affiliated with, a B-piece buyer be replaced by a successor servicer if the Operating Advisor determines, in its sole discretion exercised in good faith, that:
 - (1) the servicer that is, or is affiliated with, the B-piece buyer has failed to comply with a standard required of the servicer as provided in the transaction documents; and
 - (2) such replacement would be in the best interest of the investors as a collective whole.
- If the Operating Advisor makes a recommendation to replace such an affiliated servicer, then the servicer that is, or is affiliated with, the B-piece buyer must be replaced unless a majority of each class of CMBS eligible to vote on the matter votes to retain the servicer.

B-Piece Buyer Disclosure Requirements

In order to avail itself of B-piece buyer risk retention, a sponsor must disclose to potential investors a reasonable time before the sale of the CMBS (and, upon request, to the SEC and its appropriate federal banking agency (if any)), the following information:¹⁰

- the name and form of organization of the B-piece buyer;
- a description of the B-piece buyer's experience in investing in commercial mortgage-backed securities;
- any other information regarding the B-piece buyer or the B-piece buyer's retention of the eligible horizontal residual interest that is material to investors in light of the circumstances of the particular CMBS transaction;

¹⁰ The information described in the first seven bullet points must be included under the caption "Credit Risk Retention."

- a description of the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest that will be retained (or was retained) by the B-piece buyer, as well as the amount of the purchase price paid by the B-piece buyer for such interest;
- the amount (expressed as a percentage and dollar amount) of the eligible horizontal residual interest in the securitization transaction that the sponsor would have been required to retain if the sponsor had to meet the horizontal retention requirements with respect to the CMBS transaction;
- a description of the material terms of the eligible residual horizontal interest retained by the B-piece buyer;
- the material assumptions and methodology used in determining the aggregate amount of CMBS interests issued by the issuing entity in the securitization transaction, including those pertaining to any estimated cash flows and the discount rate used; and
- the representations and warranties concerning the CRE loans, a schedule of any CRE loans that are determined to not comply with such representations and warranties, and what factors were used to make the determination that such CER loans should be included in the pool notwithstanding that the CER loans did not comply with such representations and warranties, such as compensating factors or a determination that the exceptions were not material.

D. Premium Capture Cash Reserve Account

CMBS sponsors should note that the Proposed Rules also increase the required amount of risk retention to account for any excess spread that is monetized at the closing of a securitization transaction. If a CMBS sponsor structures a securitization to monetize excess spread on the underlying CRE loans—for example, through the sale of interest-only tranches or premium bonds—the Proposed Rules would “capture” the premium or purchase price received on the sale of the tranches that monetize the excess spread and require that the CMBS sponsor place such amounts into a separate “premium capture cash reserve account.”

According to the agencies, the reasons for reserving monetized excess spread is (1) to preclude sponsors from reducing their economic exposure to the risk retention otherwise required by the Proposed Rules, and (2) to better align the interests of sponsors and investors and promote more robust monitoring by the sponsor of the credit risk of securitized assets. The agencies’ belief is that this reserve requirement will encourage the use of sound underwriting in connection with securitized loans.

The amount placed into the premium capture cash reserve account would be separate from and in addition to the CMBS sponsor’s base risk retention requirement under the proposal’s menu of options, and would be used to cover losses on the underlying CRE loans before such losses were allocated to any other CMBS interest or account.

Calculation of Reserve Amount; Anti-Evasion Rule

A CMBS sponsor retaining credit risk under the vertical, horizontal or L-shaped options must establish and fund (in cash) at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between (i) the gross proceeds received by the issuing entity from the sale of ABS interests in the issuing entity to persons other than the sponsor (net of closing costs paid by a sponsor or the issuing entity to unaffiliated parties); and (ii) 95% of the par value of all ABS interests in the issuing entity issued as part of the transaction. The 95% of par value amount is designed to take into account the 5% interest that the sponsor is required to retain in the issuing entity under each of these options.

If the CMBS sponsor will retain (or cause to be retained) credit risk under the representative sample or CMBS B-piece buyer options, the sponsor would have to fund in cash at closing a premium capture cash reserve account in an amount equal to the difference (if a positive amount) between (i) the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor (net of the closing costs described above) and (ii) 100% of the par value of the ABS interests in the issuing entity issued as part of the transaction. In these cases, the proposal uses 100% (rather than 95%) of the par value of the ABS interests issued because the relevant menu options do not require that the sponsor itself retain any of the ABS interests issued in the transaction and, accordingly, potentially all of such interests could be sold to third parties.

For purposes of calculating gross proceeds, the Proposed Rules state that gross proceeds received by the issuing entity include the par value (or if an ABS interest does not have a par value, the fair value) of any ABS interest in the issuing entity that is directly or indirectly transferred to the sponsor in connection with the closing of the securitization transaction and that either (i) the sponsor does not intend to hold to maturity or (ii) represents a contractual right to receive some or all of the interest (and no more than a minimal amount of principal) received by the issuing entity, with a priority of payment senior to the most subordinated class of ABS interests in the issuing entity.¹¹

A premium capture cash reserve account must be established and funded whenever a positive amount results from the relevant calculation described above. A CMBS sponsor is not required to establish and fund a premium capture cash reserve account if the sponsor does not structure the securitization to immediately monetize excess spread, thus resulting in the absence of any “premium” that would be captured by the calculations described above.

¹¹ Clause (ii) does not apply to any ABS interest that (1) does not have a par value, (2) that is held by a sponsor that is relying on the vertical or L-shaped risk retention option and (3) that the sponsor is otherwise required to retain pursuant to the risk retention requirements.

Disclosure and Other Requirements

A sponsor that is required to establish and fund a premium capture cash reserve account must provide, or cause to be provided, to potential investors a reasonable period of time prior to the sale of the ABS (and, upon request, to the SEC and its appropriate federal banking agency, if any), under the caption “Credit Risk Retention,” (i) the dollar amount required to be placed in the reserve account and any other amounts the sponsor will place (or has placed) in the account in connection with the securitization, and (ii) the material assumptions and methodology used in determining the fair value of any ABS interest in the issuing entity that does not have a par value and that was used in calculating the amount required for the premium capture cash reserve account.

The premium capture cash reserve account must be held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity, and amounts in the account may be invested only in (A) United States Treasury securities with maturities of 1 year or less; and (B) deposits in one or more insured depository institutions that are fully insured by federal deposit insurance.¹²

Furthermore, until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved, no funds may be withdrawn or distributed from the account except to provide credit enhancement for *all* tranches of the CMBS—including the B-piece buyer tranche or other eligible horizontal retained interest.

E. Other Available Forms of Risk Retention for CMBS

Although the B-piece buyer option can be expected to be used in the great majority of (if not all) CMBS transactions, sponsors of CMBS transactions may avail themselves of other permissible forms of risk retention, as described below.¹³

Vertical Risk Retention

As proposed, a sponsor may satisfy its risk retention requirements with respect to a CMBS securitization transaction by retaining at least 5% of each class of ABS interest issued as part of the CMBS transaction. A sponsor using this approach must retain at least 5% of each class of ABS interests issued in the CMBS transaction regardless of the nature of the class of ABS interests (*e.g.*, senior or subordinated) and regardless of whether the class of interests has a par value, was issued in certificated form or was sold to unaffiliated investors.¹⁴

¹² Interest on such investments may be released to any person once received by the account.

¹³ Other forms of risk retention also carry mandatory disclosure requirements to investors similar, but not identical, to the disclosure requirements required for the CMBS-specific risk retention.

¹⁴ The term “ABS interest” refers to all types of interests or obligations issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, the payments on which are primarily dependent on the cash flows on the collateral held by the issuing entity. The term “ABS interest,” however, does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity, and the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity.

Horizontal Risk Retention

A CMBS sponsor also may satisfy its risk retention obligations by retaining an “eligible horizontal residual interest” in the issuing entity in an amount that is equal to at least 5% of the par value of all ABS interests in the issuing entity that are issued as part of the CMBS transaction. The eligible horizontal residual interest would expose the sponsor to a 5% first-loss exposure to the credit risk of the entire pool of securitized assets.

An ABS interest qualifies as an “eligible horizontal residual interest” under the Proposed Rules only if it is an ABS interest that is allocated all losses on the securitized assets until the par value of the class is reduced to zero, and has the most subordinated claim to payments of both principal and interest by the issuing entity. Further, until all other ABS interests in the issuing entity are paid in full, the eligible horizontal residual interest generally cannot receive any payments of principal made on a securitized asset.¹⁵

In lieu of holding an eligible horizontal residual interest, a sponsor may cause to be established and funded, in cash, a reserve account at closing (a “horizontal cash reserve account”) in an amount equal to at least 5% of the par value of all the ABS interests issued as part of the transaction (*i.e.*, the same dollar amount as would be required if the sponsor held an eligible horizontal residual interest). The horizontal cash reserve account must be held by the trustee (or person performing functions similar to a trustee) for the benefit of the issuing entity.¹⁶

L-Shaped Risk Retention

A CMBS sponsor may also use an equal combination of vertical risk retention and horizontal risk retention as a means of retaining the required 5% exposure to the credit risk of the securitized CRE loans. This form of risk retention is referred to as an “L-Shaped” form of risk retention because it combines both vertical and horizontal forms. Specifically, a sponsor may meet its risk retention obligations under the rules by retaining:

- not less than 2.5% of each class of ABS interests in the issuing entity issued as part of the securitization transaction (the vertical component); and
- an eligible horizontal residual interest in the issuing entity in an amount equal to at least 2.5% of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction, other than those interests required to be retained as part of the vertical component (the horizontal component).

¹⁵ However, the interest may receive its proportionate share of scheduled payments of principal received on the securitized assets in accordance with the relevant transaction documents.

¹⁶ There are several important restrictions and limitations on the use of a horizontal cash reserve account. These limitations and restrictions are intended to ensure that a sponsor that establishes a horizontal cash reserve account would be exposed to the same amount and type of first-loss credit risk on the underlying assets as would be the case if the sponsor held an eligible horizontal residual interest.

Representative Sample

A sponsor of a CMBS transaction may meet its risk retention requirements by retaining a randomly selected representative sample of CRE loans that is equivalent, in all material respects, to the assets that are transferred to the issuing entity and securitized, subject to certain conditions.¹⁷

Consistent with other risk retention options, a CMBS sponsor using the representative sample approach would be required to retain at least 5% of the credit risk of the CRE loans the sponsor identifies for securitization. Therefore, the unpaid principal balance of all the assets in the representative sample would be required to equal at least 5% of the aggregate unpaid principal balance of all the CRE loans in the pool of loans initially identified for securitization (including those that end up in the representative sample).

The sponsor would be prohibited from removing any assets from the representative sample and, until all ABS interests are repaid, causing or permitting the assets in the representative sample to be included in any other designated pool or representative sample established in connection with any other securitization transaction. Furthermore, after the sale of the ABS, the sponsor would be required to provide, or cause to be provided, to investors at the end of each distribution period a comparison of the performance of the pool of securitized assets for the related distribution period with the performance of the assets in the representative sample for the related distribution period. A sponsor selecting the representative sample option also would be required to provide investors with disclosure concerning the assets in the representative sample in the same form, level, and manner as it provides, pursuant to rule or otherwise, concerning the securitized assets. Therefore, if loan-level disclosure concerning the securitized assets were required, by rule or otherwise, to be provided to investors, the same level of disclosure would also be required concerning the representative sample.

F. Allocation to the Originator

Subject to conditions and restrictions discussed below, the Proposed Rules permit a CMBS sponsor electing the vertical risk retention option or the horizontal risk retention option to reduce its required risk retention obligations in a securitization transaction by allocating a portion of its risk retention obligation under such option to any originator of the underlying assets that contributed at least 20% of the underlying assets in the pool.

The amount of the retention interest held by each originator that is allocated credit risk in accordance with the proposal must be at least 20%, but could not exceed the percentage of the securitized assets it originated. The originator would also have to hold its allocated share of the risk retention obligation in the same manner as would have been required of the sponsor and subject to the same restrictions on transferring, hedging, and financing the retained interest that would apply to the sponsor.

¹⁷ These conditions include (i) the construction of the representative sample from a designated pool using a random selection process, (ii) an assessment of the characteristics of the representative sample, and (iii) the delivery of an agreed-upon procedures report from an independent public accounting firm.

G. Hedging, Transfer and Financing Restrictions

Under the Proposed Rules, a sponsor is prohibited (whether directly or through any consolidated affiliate) from hedging the credit risk the sponsor is required to retain under the Proposed Rules. Specifically, the proposal prohibits a sponsor and its consolidated affiliates from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person if:

- 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, assets, or securitized assets that the retaining sponsor is required to retain, or one or more of the particular securitized assets that collateralize the asset-backed securities; and
- the security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests, assets, or securitized assets, or one or more of the particular securitized assets that collateralize the asset-backed securities.

Hedge positions that are not materially related to the credit risk of the particular ABS interests or exposures required to be retained by the sponsor or its affiliate would not be prohibited under the proposal. Furthermore, the following activities will not be considered prohibited hedging activities by a retaining sponsor, a consolidated affiliate or an issuing entity:

- 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, assets, or securitized assets required to be retained by the sponsor or one or more of the particular securitized assets that underlie the asset-backed securities issued in the securitization transaction; or
- 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% of the dollar-weighted average 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 was 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% of the dollar-weighted average of all instruments included in the index.

A sponsor and its consolidated affiliates are also prohibited from pledging as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any interest or asset that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or consolidated affiliate.¹⁸

H. Reduced Risk Retention Requirements for ABS Backed by Qualifying Commercial Real Estate Loans

The Proposed Rules include a zero percent risk retention requirement (*i.e.*, a complete exemption from risk retention) for CMBS collateralized exclusively by qualifying CRE loans that meet certain underwriting standards, which focus predominately on the following criteria: the borrower's ability to repay the loan; the value of, and the originator's security interest in, the collateral; the LTV ratio; and whether the loan documentation includes the appropriate covenants to protect the collateral.¹⁹

Ability to Repay

For qualifying CRE loans, the proposed underwriting standards generally require the borrower to have a DSC ratio of 1.7 or greater. However, a CRE loan on properties with a demonstrated history of stable NOI may have a DSC ratio of 1.5 or greater.²⁰

To qualify for the lower DSC ratio requirement, the CRE loan must be secured by either (1) a residential property (other than a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents) that consists of five or more dwelling units primarily for residential use, and where at least 75% of the CRE property's NOI is derived from residential rents and tenant amenities (such as a swimming pool, gym membership, or parking fees); or (2) commercial nonfarm real property (other than a multifamily property or a hotel, inn

¹⁸ If the sponsor or its consolidated affiliate pledged the interest or asset to support recourse financing and subsequently allowed (whether by consent, pursuant to the exercise of remedies by the counterparty or otherwise) the interest or asset to be taken by the counterparty to the financing transaction, the sponsor will have violated the prohibition on transfer.

¹⁹ For purposes of the Proposed Rules, a "CRE loan" is defined as a loan secured by a property with five or more single-family units, or by nonfarm nonresidential real property, the primary source (50% or more) of repayment for which is expected to be derived from (a) the proceeds of the sale, refinancing, or permanent financing of the property; or (b) rental income associated with the property other than rental income that is derived from any affiliate of the borrower. However, a CRE loan does not include a land development and construction loan (including one-to-four family residential or commercial construction loans), loans on raw or unimproved land, a loan to a real estate investment trust (REIT), or an unsecured loan.

²⁰ The DSC ratio for a CRE loan equals the CRE property's annual NOI less the annual replacement reserve of the CRE property at the time of origination divided by the sum of the borrower's annual payments for principal and interest on any debt obligation. NOI equals income generated by a CRE property, net of all expenses that have been deducted for federal income tax purposes (except depreciation, debt service expenses, and federal and state income taxes) and any unusual or nonrecurring income items.

or similar property) that is occupied by, and derives at least 80% of its aggregate gross revenue from, one or more “qualified tenants.”²¹

The originator of a qualifying CRE loan must also determine whether the borrower has the ability to service its other outstanding debt obligations, net of any income generated from the CRE (based on the NOI). Accordingly, the Proposed Rules require that the originator conduct an analysis of the borrower’s ability, and determine that the borrower has the ability, to service all outstanding debt obligations over the two years following the origination date for the loan, based on reasonable projections and including the new debt obligation. As part of this analysis, the originator also must document and verify that the borrower has satisfied all debt obligations over a look-back period of at least two years.

The Proposed Rules generally require that a qualifying CRE loan have a fixed stated interest rate to reduce the potential for the borrower to experience payment shock. However, the interest rate may be adjustable if the borrower obtains, prior to or concurrently with the origination date for the CRE loan, a derivative product that effectively results in the borrower paying a fixed interest rate on the CRE loan. In addition, qualifying CRE loans must prohibit loan terms that (1) permit the borrower to defer principal or interest payments; (2) allow the originator to establish an interest reserve to fund all or part of a payment on the loan; or (3) provide a maturity date that is earlier than ten years following the closing date for the loan. Further, the loan payment amount must be based on straight-line amortization of the debt over the term of the loan not to exceed twenty (20) years, with payments made no less frequently than monthly over a term of at least ten (10) years.

Loan-to-Value Requirement

A qualifying CRE loan must have a combined loan-to-value (CLTV) ratio of less than or equal to 65%. However, where the capitalization rate used in the appraisal is less than the ten-year interest rate swap rate plus 300 basis points, the maximum CLTV ratio requirement will be 60% (to mitigate the effect of an artificially low capitalization rate).

Valuation of the Collateral

To ensure adequate valuation of the CRE property, the Proposed Rules require the following:

- The CRE loan must be secured by a first lien on the commercial real estate.
- Prior to origination of the CRE loan, the originator:

²¹ Under the Proposed Rules, a qualified tenant is defined as a tenant that (1) is subject to a triple net lease that is current and performing with respect to the CRE property, or (2) was subject to a triple net lease that has expired, currently is leasing the property on a month-to-month basis, has occupied the property for at least three years prior to closing, and is current and performing with respect to all obligations associated with the CRE property. All outstanding triple net leases must have a remaining maturity of at least six months, unless the tenant leases the property on a month-to-month basis as described above.

- (i) verified and documented the current financial condition of the borrower;
- (ii) obtained a written appraisal of the real property securing the loan that:
 - a. was performed not more than six months from the origination date of the loan by an appropriately state-certified or state-licensed appraiser;
 - b. conforms to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board and the appraisal requirements of the federal banking agencies;
 - c. provides an “as is” opinion of the market value of the real property, which includes an income valuation approach that uses a discounted cash flow analysis;
- (iii) qualified the borrower for the CRE loan based on a monthly payment amount derived from a straight-line amortization of principal and interest over the term of the loan (but not exceeding 20 years);
- (iv) conducted an environmental risk assessment to gain environmental information about the property securing the loan and took appropriate steps to mitigate any environmental liability determined to exist based on this assessment; and
- (v) conducted an analysis of the borrower’s ability to service its overall debt obligations during the next two years, based on reasonable projections.

In addition, at the closing of the securitization transaction, all payments due on the CRE loan must be contractually current.

Loan Documentation, Risk Management and Monitoring Requirements

The loan documentation for a qualifying CRE loan must provide covenants requiring the borrower to provide to the originator and any subsequent holder of the commercial loan, and the servicer, the borrower’s financial statements and supporting schedules on an ongoing basis, but not less frequently than quarterly, including information on existing, maturing and new leasing or rent-roll activity for the property securing the loan, as appropriate.

The loan documentation for a qualifying CRE loan also must include the following covenants:

- a prohibition on the creation or existence of any other security interest with respect to any collateral for the CRE loan;
- no transfer of any collateral pledged to support the CRE loan;

- no change to the name, location or organizational structure of the borrower, or any other party that pledges collateral for the loan;
- the borrower and any other party that pledges collateral for the loan must:
 - (i) maintain insurance that protects against loss on any collateral for the CRE loan, at least up to the amount of the loan, and names the originator or any subsequent holder of the loan as an additional insured or loss payee;
 - (ii) pay taxes, charges, fees, and claims, where nonpayment might give rise to a lien on any collateral for the CRE loan;
 - (iii) take any action required to perfect or protect the security interest of the originator or any subsequent holder of the loan in the collateral for the CRE loan or the priority thereof, and to defend such collateral against claims adverse to the originator's or subsequent holder's interest;
 - (iv) permit the originator or any subsequent holder of the loan, and the servicer, to inspect the collateral for the CRE loan and the books and records of the borrower or other party relating to the collateral for the CRE loan;
 - (v) maintain the physical condition of the collateral for the CRE loan;
 - (vi) comply with all environmental, zoning, building code, licensing and other laws, regulations, agreements, covenants, use restrictions, and proffers applicable to the collateral;
 - (vii) comply with leases, franchise agreements, condominium declarations, and other documents and agreements relating to the operation of the collateral, and to not modify any material terms and conditions of such agreements over the term of the loan without the consent of the originator or any subsequent holder of the loan, or the servicer; and
 - (viii) not materially alter the collateral for the CRE loan without the consent of the originator or any subsequent holder of the loan, or the servicer.

The loan documentation for the CRE loan must also prohibit the borrower from obtaining a loan secured by a junior lien on any property that serves as collateral for the CRE loan, unless such loan finances the purchase of machinery and equipment and the borrower pledges such machinery and equipment as additional collateral for the CRE loan.

Buy-Back Requirements

Under the Proposed Rules, for a securitizer to qualify for a zero percent risk retention requirement under the qualifying CRE loan exemption, the depositor must have (and certify that it has) effective internal supervisory controls with respect to its process for ensuring that all assets that collateralize the CMBS meet the applicable underwriting standards set forth above.²²

A sponsor that has relied on an exemption from the retention requirement under the qualifying CRE loan provisions would not lose the exemption, if, after the closing of the securitization transaction, it is determined that one or more of the CRE loans collateralizing the CMBS do not meet all of the required criteria, provided that:

- the depositor certified the effectiveness of its internal supervisory controls for ensuring that all of the loans backing the ABS are qualified CRE loans;
- the sponsor repurchases the loan(s) determined to not meet the qualifying CRE loan underwriting standards from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) no later than ninety (90) days after the determination that the CRE loans do not satisfy the underwriting standards; and
- the sponsor discloses to the investors of the ABS any loan(s) that are repurchased by the sponsor, including the principal amount of such repurchased loan(s) and the cause for such repurchase.

Request for Comments Regarding the Proposed Rule

While it can be expected that the final rule will be very similar to the Proposed Rule, the federal agencies have made a number of specific requests for comment regarding various aspects of the Proposed Rule that are expected to be addressed in the final rule. Comments are due June 10, 2011.

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If you have any questions regarding this memorandum, please contact Steven D. Klein (212-728-8221, sklein@willkie.com), Thomas H. French (212-728-8124, tfrench@willkie.com), David S. Katz (202-303-1149, dkatz@willkie.com), Michael C. Petronio (212-728-8671, mpetronio@willkie.com), or the attorney with whom you regularly work.

²² The evaluation of the effectiveness of the depositor's internal supervisory controls must be performed, for each issuance of CMBS, 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 CMBS. The sponsor also must provide, or cause to be provided, a copy of the certification to potential investors a reasonable period of time prior to the sale of CMBS, and, upon request, to its appropriate Federal banking agency, if any.

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