
Shiv Vydyula
RAISING THE BLINDS: EFFECTS OF THE DODD-FRANK ACT'S RISK-RETENTION REQUIREMENT ON INTERNATIONAL FIRMS SEEKING FINANCING THROUGH U.S. MARKETS

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I. INTRODUCTION

The 2012 Mercedes-Benz C300 4MATIC is priced at 33,990. The car boasts touch-shift automatic shifting, four wheel drive, sport and comfort configurations, leather interior, GPS navigation and German engineering excellence. The car’s appearance and iconic symbol convey instant and unquestioned prestige for the driver. Today, the same automobile, amongst many other securatizable assets, injects fuel into investment vehicles that are vital to international business – collateralized loan obligations, or CLOs.

Commercial loans, like those used to purchase automobiles, are a valuable resource for the securities markets. As a result of the sub-prime mortgage crisis of 2008, the public perception of asset-backed securities have targeted collateralized debt obligations, or CDOs, backed by subprime-mortgages as the investment vehicle responsible for the crash. The auto loan, and other commercial loans may now receive more focus from issuers, originators, and promoters of securities to fuel creative financing solutions for businesses of all sizes and types.

This note will discuss the effects of the new Dodd-Frank Wall Street Reform and Consumer Protection Act’s risk retention requirement for the CLO on firms trading in the U.S. and how international companies seeking financing on American exchanges will be af-

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2 Id.

3 Kenneth E. Kohler, Collateralized Loan Obligations: A Powerful New Portfolio Management Tool for Banks, MAYER BROWN (1998), available at http://www.mayerbrown.com/publications/article.asp?id=2229&nid=6. “Simply stated, a “collateralized loan obligation”, or “CLO”, is a debt security collateralized by commercial loans. Perhaps more commonly, however, the term “CLO” is used to refer to the entire structured finance transaction in which multiple classes of debt or equity securities are issued by a special purpose vehicle (an “SPV”) whose assets consist principally of commercial loans.”

4 The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 941 (2010) [hereinafter “Regulation of Credit Risk Retention”].

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fected. This note will argue that the Dodd-Frank Act places a significant burden, by way of risk retention, on US trading and although admirable in its spirit, the section regarding risk retention fails to affect the sale, structuring, and purchasing of CDOs in a way that promotes transparency by the issuer or protection of consumers. Concern regarding the risk retention rule’s effectiveness has been expressed from prominent voices in U.S. regulation and the private sector.5

II. BACKGROUND

A. CLO Capital Structure

A collateralized loan obligation, or “CLO,” is a “special purpose vehicle (SPV) with securitization payments in the form of different tranches.”6 CLO’s can also contain a diverse range of underlying assets, not only asset-backed securities, but also corporate bonds, trusts, notes and certificates.7 The CLO “unlike a mutual fund, issues bonds rather than shares in the fund.”8

5 Letter from R. Bruce Josten, Exec. Vice President for Government Affairs, Chamber of Commerce, to The Members of the United States Congress (June 28, 2010) (on file with author). “Since before the economic crisis, the Chamber has called for effective financial regulatory reform. The antiquated U.S. regulatory structure is ineffective and fails to provide the certainty needed for job creation and a prosperous economy. Despite the work of the Conference Committee, the bill remains fundamentally flawed, fails to provide comprehensive regulatory reform, and should be rejected. H.R. 4173 would exacerbate flaws within existing regulatory structure, increasing uncertainty, reduce the availability of credit, and likely cause unintended harm throughout the economy.” See also, J. Paul Forrester, et al., Impact of Dodd-Frank Risk-Retention Requirement on CDOs, CLOs and the Loan Market, MAYER BROWN, July, 23, 2010, http://www.mayerbrown.com/publications/article.asp?id=9382&nid=6. “CDOs and CLOs will likely face distinct difficulties when attempting to interpret the risk-retention requirement, potentially to a much greater degree than other asset-backed securities. In a CDO or CLO, it is unclear what entity would constitute a securitizer and therefore be subject to the risk-retention requirements... If the requirement is meant to apply to the CDO issuer or CLO issuer itself, it is unclear how the obligation would work, as the issuer is generally a special purpose vehicle that already holds the loans or other assets and arguably already holds the credit risk. Similarly, if the Regulators allocate a portion of the risk retention obligation to the applicable originators, the effect and application of the obligation is still unclear: with regard to CLOs, it could be read to require any entity that makes a loan that is, or may be, sold to a CLO to satisfy the risk retention requirement (in which case, the market for syndicated loans will be dramatically affected) or might be read to refer to the manager, arranger or, in the case of a “reverse inquiry” CDO or CLO, the sponsoring investor (in which case, the economics for the affected party will be dramatically different and possibly unattractive).”

6 Collateralized Loan Obligation-CLO, INVESTOPEDIA, available at http://www.investopedia.com/terms/c/clo.asp (lasted visited April, 2011). “Collateralized loan obligations are the same as collateralized mortgage obligations (CMOs) except for the assets securing the obligation. CLOs allow banks to reduce regulatory capital requirements by selling large portions of their commercial loan portfolios to international markets, reducing the risks associated with lending.”; See also, What’s a C.D.O.? PORTFOLIO.COM, http://www.portfolio.com/interactive-features/2007/12/cdo (last visited April, 2011) [hereinafter “Portfolio.com”]. Presentation explaining the structure of a CDO through an analogy to containers and water flow.

7 See, KENNETH E. KOHLER, COLLATERALIZED LOAN OBLIGATIONS: A POWERFUL NEW PORTFOLIO MANAGEMENT TOOL FOR BANKS (1998), available at http://www.mayerbrown.com/publications/article.asp?id=22292&nid=6. [hereinafter “Kenneth E. Kohler”]. “In its pure form, a CLO can be distinguished from its transactional cousins with similar-sounding names: a “CBO” or “collateralized bond obligation”, in which the underlying assets consist of corporate bonds, and a “CMO”, or “collateralized mortgage obligation”, in which the underlying assets consist of mortgage loans.”

8 See MARK ADELSON, CDOs IN PLAIN ENGLISH A SUMMER INTERN’S LETTER HOME (2004). “A CDO is similar to a regular mutual fund that buys bonds. However, unlike a mutual fund, most of the securities sold from a CDO are themselves bonds, rather than shares. In simplest terms, a CDO is an arrangement that raises money
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The CLO includes multiple levels of debt, or tranches, backed up by different amounts of collateral. Each tranche represents a different cash amount of collateral underlying the investment level. To mitigate risk, the seniority level assigned to each tranche is intended to protect the pool of debt in the tranche directly above it. That value is incorporated into the pricing model of each tranche. The lowest tranche, usually exclusively filled with equity, is the most risky since it will be exposed to liquidity first in the event of default.

B. Reactions to the Dodd-Frank Risk Retention Rule and to the Financial Stability Oversight Council’s Study of the Risk Retention Rule’s Macroeconomic Effects

Firms in the US have given insight into how the risk retention will affect investors and issuers of CLOs. Firms point out that the risk retention rule does not allow firms any possible way of hedging the retained risk. Firms point out that the Act requires that the retained risk not be directly or indirectly hedged. Section 941 of the Act requires a securitizer or originator to retain a 5% interest in securities and to provide additional disclosures to help investors to independently assess credit quality. Industry professionals are aware that, "In order to preserve the incentive value of the statute, the regulation must stipulate that a securitizer may not hedge or transfer the credit risk required to be retained. The use of credit default swaps and other forms of hedging instruments was another concern (addressed in Title VII of the Act), especially among parties other than those who have a direct interest in the assets and securities." Effecting CLOs, "[t]he retention amount is less than five percent if the originator of the asset (other than a qualified residential mortgage) meets the underwriting standards consistent with low credit risk as described below at Asset Classes." However, it is unclear whether originator will mean the entity who created the CDO or the entity that then purchased and resold the CDO.

Academic and industry voices have expressed concerns for how the risk retention requirement will play out in the real world, pointing out that some unintended effects arising

9 See Kenneth E. Kohler, supra note 7. J. Paul Forrester, “...frequently contain a mix of bonds and secured and unsecured commercial loans.”
10 Portfolio.com, supra note 6.
11 See Press Release, UBS Investment Bank, UBS Synthetic CDO Leverage and Control (June 2005) (on file with author). “Loss protection: In the case of a Senior Tranche, the invested amount is protected from initial losses under the portfolio by subordination below the Senior Tranche in the capital structure.”
12 Id.
13 Id.
15 Id.
17 Id.
18 Id.
out of the risk retention rules implementation may stymie the remedial nature of the rule. The risk retention rule has been described as an “aggressive” and “ambitious” attempt to prevent another economic crisis.19 One unintended consequence resulting from the risk retention rule’s implementation is that the rule may effect syndicated loan transactions.20 A syndicated loan is an efficient means for firms to “obtain larger loans than it could typically obtain from a single lender, but without requiring the borrower to sacrifice the ease of dealing with a single point of contact.”21 Syndicated loans are often used in the formation and sale of CLOs.22 These loans are made up of contributions of millions of dollars from many different lenders, packaged together so that the borrower can facilitate the lending transaction through a one-on-one interaction with the administrative agent.23 The Act may treat administrative agents in syndicated loan transactions as “originators” and doing so would subject the large loans to the same scrutiny as their CLO cousins.24 This secondary loan trading market is essential to the formation of CLOs and there is an argument that since the risk retention rule could apply to syndicated loans, this is in essence a restriction on the formation of new CLOs.25

Finance and Banking industry professionals have attempted to identify the rational underpinnings for Congress’s reactionary responses embedded in the Dodd Frank Act. The California Bankers Association (“CBA”) considers the risk retention requirement with the purpose of guiding issuers and sponsors to focus on the long-term performance quality of their issued securities.26 The CBA Compliance Bulletin goes on to assert that the risk retention section or, “Section 941 of the Dodd-Frank Act (“Act”), was included to protect investors by creating incentives for issuers and sponsors of asset-backed securities to focus more on collateral quality.”27 The CBA bulletin also states that “[u]nderlying the new law is the belief that the ability of originators of assets (including residential mortgage loans) and issuers of various types of asset-backed securities to generate substantial fees from securitizing loans and transfer them without residual liability contributed to the mortgage crisis.”28

Although the spirit of the risk retention requirement is understood by the banking industry, banks and financial firms point out that the wording of the requirement will generate more harm than good. The words of the rule have been characterized as vague where “[t]he
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statue does clearly recognize the distinct differences between CDOs and CLOs on the one hand, and other traditional asset-backed securities (like car loans, student loans, commercial mortgages or residential mortgages) on the other.”

Blank Rome LLP echoed sentiments of many industry participants stating, “It is expected (and hoped) that the forthcoming regulations will (a) recognize the inapplicability of certain provisions of Section 941 of the Dodd-Frank Act to CDOs and CLOs. . .” and that “(b) promulgate rules that will adequately clarify or limit the application of the Risk Retention Requirements to CDO and CLO transactions. Interested parties will need to monitor and assess these regulations as they are promulgated in order to definitively assess the impact of the Risk Retention Requirements on their future CDO and CLO transactions.” Pending announcement of proposed rules and finalization of the definitive regulatory framework, the structured finance markets, in general, and the CDO and CLO market, in particular, may be adversely impacted and may proceed in the interim with a continued and significant lack of legal certainty.

Firms voiced concerns about the rule’s vague language regarding retained credit risk soon after the Act was passed, stating, “Credit risk is not defined in the Act, nor does the Act itself describe how a securitizer might retain credit risk.” Although much criticism of the Act’s provisions and wording came before the release of a study by the Financial Stability Oversight Council, the aftermath of the study also leaves certain concerns unaddressed. Observers note that “credit risk” is not properly defined in the Act, and although the study discusses some ways in which risk can be retained, the study does not neatly set boundaries on what combinations of risk allocation could violate the Act’s requirements.

In a comment letter to the S.E.C. shortly after the enactment of the Dodd-Frank Act, the National Association of Real Estate Investment Trusts (“NAREIT”) conveyed uncertainty about the ways in which the Act’s risk retention provision would be enforced. A more appropriate procedure would have been to have the council conduct a study on risk retention and only then to draft legislation that incorporates those findings and observations of that study. Exactly the opposite has taken place. The Act has been passed, the market has voiced concerns and only afterwards has a study been conducted on the means for firms to comply with the risk retention requirement.

29 Buerstetta & Alexander, supra note 14.
30 Id.
31 Id.
32 Id.
34 Steven A. Wechsler & Tony M. Edwards, Comments on Proposed Rule, Asset-Backed Securities, SEC. & EXCH. COMM’N., (Release Nos. 33-9117; 34-61858; File No. s7-08010), 2010 WL 316359 (2010), at 2. Another fundamental question posed in the Proposing Release is whether 5 percent is the appropriate amount of risk for the sponsor to retain. Specifically, the Commission asked “[s]hould it be higher (e.g., ten or 15 percent)? Should it be lower (e.g., one or three percent)? Should the amount of required risk retention be tied to another measure?” As discussed above, Dodd-Frank recognizes that 5 percent is just a starting point and, further, requires that 5 percent be adjusted downward if certain underwriting standards are met. Dodd-Frank also requires that the risk retention regulations to be developed reflect the different classes of assets, “including residential mortgages, commercial mortgages, commercial loans, auto loans,” as deemed appropriate by the Commission and the Federal banking agencies.)
The comment also illuminates concerns over weaknesses in the horizontal and vertical risk retention models analyzed by the Financial Stability Oversight Council. In horizontal risk retention, the securitizer is relegated to the “first loss” position, accruing the 5% risk in the form of the first loss past the amount that was projected at origination to be absorbed by the first loss position, or subordinate tranche holder.35 The Securities Exchange Commission responded to the study in a comment explaining that horizontal risk retention could lead to skewed incentive structures and that under such a model, where the sponsor holds a small horizontal slice of the securitization, the mandate would not prompt a sponsor to look to the quality of the loans or underlying assets to protect that interest.36 NAREIT argued against vertical risk retention by asserting that the method “exacerbates conflict of interests” by allowing sponsors to make decisions on the security from an informational advantage over other investors in the security.37 Law firm Clifford Chance, anticipating the risk retention rule’s consequences for international business, commented that “Dodd-Frank does not streamline the US regulatory infrastructure. It sets guidelines and basic parameters rather than adding detail and it does not end ‘too big to fail,’”38 and very plainly that “the effect of Dodd-Frank is a very significant additional restriction on cross border business.”39 The firm goes on to comment about another rule that would affect financial firms and banks – the Volcker Rule.40 According to the firm, the Volcker rule’s requirement that no bank with a branch in the US can engage in proprietary trading essentially projects to every bank in the world, “and tells them what they can and cannot do.”41 With a mere glance at the risk retention rule, only one of many new regulations arising out of the Dodd Frank Act, one can see how an international or foreign company looking for financing might start looking elsewhere.

C. The Risk Retention Rule’s Potency as a Deterrent to Bad Lending Decisions – Observations from the Financial Industry

Since its enactment, the risk retention rule has been turned over by observers and industry players. Opinions on its value as a deterrent to risky investing and bad lending practices are still being formed, but firms have released in-depth looks at the rule in order to shed light on its potency as such a deterrent.

Price-WaterhouseCoopers (“PWC”) highlights some key interpretive matters on which regulators must provide insight in order to clarify the vagueness of the risk retention rule and its anticipated consequences.42 Whether horizontal risk retention, or first-loss reten-

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37 Id.
39 Id.
40 Id.
41 Id.
tion be the primary option for originators and securitizers is pivotal since it will dictate how a firm’s operations and risk evaluation develop for the long term. Another idea that had not been clear up to this point was whether at any point the securitizer or originator could shed the credit risk that is tied to deals they created. These fundamental concerns highlight the hastiness with which the Dodd-Frank Act has seemed to come down. Rather than evaluating the changes that certain special purpose vehicles have imposed on a global economy, the legislature has decided to bring down heavy-handed regulation and to let the market adapt to a presumptively new environment focused on heightened accountability. From these questions, it seems that the markets expect regulation, but institutions are still uncertain as to how these changes equate to greater transparency or encourage a culture of less risky dealing.

D. The Study: The Financial Stability Oversight Council’s Study on the Macroeconomic Effects of Risk Retention

In January 2011, the Financial Stability Oversight Council (“Council”), headed by Council Chairman Timothy Geithner, issued a study on the macroeconomic effects of the Dodd-Frank Risk Retention requirements. The Study made three conclusions. First it conceded that certain risks associated with asset-backed securities contributed to the financial crisis and macroeconomic instability. Second, the study further stated that ongoing exposure to the credit risk of underlying assets in an asset-backed security can effectively combat the inherent risks of securitization. Finally, the study concluded that risk retention fosters better lending decisions, thus dulling securitisation’s pro-cyclical effects on the economy.

The Study reveals the government’s view of how risk retention will be an effective threat-mitigation tool and by extension, what will serve as a baseline for foreign and international firms seeking financing through U.S. Markets. The study also lays out the Council’s suggestions for the design of a risk retention framework that purportedly facilitates economic growth. The Council’s suggested design aims to allow market participants to price credit risk with greater precision and to more efficiently allocate capital. The study conveys the Council’s reasoning and motivation in arriving at the risk retention solution.

The Council’s motivation and reasoning behind adopting the risk retention rule seem, in part, to be validation for a hasty, reactionary response by Congress. The council asserts that the complex nature of securitization in the lending process distances the lender from the borrower to such a degree that unbalanced risk allocation can occur frequently.

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43 Id.
44 Id. at 4. As collateral held by an ABS issuer amortizes over the structure’s life, will the securitizer and originator be permitted to dispose of a corresponding portion of its required retention? If so, how will the adjusted required retention threshold be calculated? Should that computation consider an updated credit risk profile with respect to the remaining collateral?
45 Macroeconomic Effect of Risk Retention Requirements, supra note 35.
46 Id.
47 Id.
48 Id.
49 Id.
50 Id.
51 Id.
52 Id.
53 Id.
The Council points out that the originator and securitizer are often exposed to little or no risk, while the investor is most exposed to credit risk and has the least information on the borrower and their underwriting standards. While few would contend that this informational gap exists to varying degrees in the market, the Council seems to suggest that the informational disparity obviates the need for risk retention requirements and that such a requirement levels the playing field and properly allocates risk. The Council goes on to identify principals that drive the risk retention model that the Council encourages industry professionals to adopt.

Five principles create the foundation for the Council's risk retention framework: 1. aligning risk, 2. providing greater incentive and certainty among market participants, 3. promote efficiency of capital allocation, 4. preserve flexibility as markets and circumstances evolve, 5. allow a broad range of participants to continue to engage in lending activities while doing so in a safe manner. The Council seems to caution the reader that the solution of risk retention is not by itself a comprehensive solution, stating "[i]t cannot address all problems in the securitization chain, and will work in conjunction with other reforms. Moreover, risk retention may be more suitable in some circumstances than others, depending on the specific nature of the underlying financial assets." The Council takes into consideration the forms in which the 5% of risk retention can be drawn from the special purpose vehicle. The Council considers three options: taking a pro rata piece of every tranche or, first loss interest, or a random selection of assets from the pool to comprise the 5% retained risk for the originator-securitizer.

Any risk retention model should include a retention bypass for originators who maintain excellent standards for underwriting and credit risk evaluation. The Council attempts to speak to this when mentioning that an exemption should exist for high quality assets that meet rigorous underwriting standards and where the assets tend to show that the credit risk has been reduced. The Council tries to make a case for all three types of risk retention models. The pro rata method allows the originator or securitizer to allocate or spread the risk throughout each of the senior, subordinate, and equity tranches. The horizontal, or first loss model, calls for the originator to retain the first loss credit risk, holding the tranche first in line to absorb loss. The equivalent exposure model requires the securitizer to retain a representative sample of all the assets that are transferred to the issuing entity. Although creative, the models do not begin to suggest how each model could affect the securitizer because the timing as well as the type of loss on the value of the assets could be crucial to firms in the industry. A securitizer holding various configurations of 5% risk may avoid or move towards failure depending on the timing of the losses. Suggesting models does not alone provide sufficient guidance for managing compulsory credit risk.

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54 Macroeconomic Effect of Risk Retention Requirements, supra note 35.
55 Id.
56 Id.
57 Id.
58 Id.
59 Id.
60 Id.
61 Id.
62 Id.
63 Id.
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The Council reserves a small sub-section in the study to attempt to define “securitizer” and “originator” more clearly, apparently due to confusion stemming from the Act. Interestingly, the Council uses the definitions section to attempt to legitimize the risk retention concept by either party, as if to reinforce the legitimacy of risk retention by securitizers and originators to both the public and to themselves. The Council also makes note that third party credit guarantors can take the place of the originator or securitizer to take a portion or all of the risk retained.

Another area that observers are unclear on is the exemptions or adjustments for the retention requirements. The federal banking agencies and the SEC will issue the exemp-

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64 Id.

65 Potential Impact of Dodd-Frank Act on CDO/CLO Transactions, BLANK ROME LLP (August 2010) available at http://www.blankrome.com/index.cfm?contentID=37&itemID=2289. “While an ‘originator’ is defined as ‘a person who (A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; or (B) sells an asset directly or indirectly to a securitizer,’ a ‘securitizer’ is defined as ‘(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.’”

This “originator-securitizer” distinction is problematic in the context of a CDO or CLO as it remains unclear which entity in a CDO or CLO transaction would be the “securitizer” or the “originator.” This “originator-securitizer” distinction is problematic in the context of a CDO or CLO as it remains unclear which entity in a CDO or CLO transaction would be the “securitizer” or the “originator.” By way of an example, a “securitizer” who is required to comply with the Risk Retention Requirements could be (i) the CDO or CLO issuer, which is typically a special purpose vehicle presumptively holding all the credit risk and having no independent resources by which it could acquire the retained credit risk (this result may prove impractical), (ii) the provider of warehouse financing, typically the lead underwriting bank (as that person or an affiliate finances and subsequently sells assets into the CDO or CLO issuer), (iii) the collateral manager that initiates or organizes the structuring of the CDO or CLO or (iv) any person who sells assets to the issuer, such as a loan originator into a CLO (which could be expected to adversely affect the syndicated loan market). Similarly, an “originator” could be any entity (i) which makes loans, which are sold into a CDO or CLO (which also would have a significant adverse impact on the syndicated loan market) or (ii) the asset manager, arranger or underwriter (in the case of a cash flow CLO) of the transaction. It may be that most CDO and CLO transactions do not have an originator as contemplated by the definition. The ultimate regulatory direction on these definitions and the Risk Retention Requirements will result in a significant shift in the economics of CDO and CLO transactions among these parties, and all potentially affected persons will need to remain alert to the developments as proposed rules are announced in the coming months.

66 Macroeconomic Effect of Risk Retention Requirements, supra note 35. “Because the securitizer is a primary decision point for assets being securitized, application of risk retention requirements to the securitizer can be an effective way of creating an incentive for the monitoring of the credit quality of the assets it securitizes (regardless of the identity of the originator). . . Ultimately, having an originator retain an economic interest in the securitization can improve its incentives to originate high quality assets. To the extent the originator has ongoing responsibilities, risk retention can better align incentives with the investor.”

67 Id.

68 The Dodd-Frank Act, Commentary and Insights, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES (2010), at available at http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf. “It is unclear whether and how the proposed requirements will apply to outstanding ABS transactions.” See also Memorandum from Cadwalader, Wickersham & Taft LLP on Proposed Credit Risk Retention Requirements for Asset-Backed Securities Transactions (Apr. 6, 2011) (on file with author). “It is unclear why loans to REITs are excluded from the definition of commercial real estate loans. There is no commentary on this point. Since REITs are significant participants in the commercial real estate development industry, this restriction would appear to eliminate a high proportion of commercial mortgage loans from eligibility for transactions that seek to satisfy risk retention through the B-piece buyer structure.”
tions, and currently seek comment on the Act’s provisions to guide them in issuing the exemptions.

What does all this mean for investors and issuers who compete in the global market? A comparison of the U.S. views on market recovery against those being considered in the U.K. shed some light on the difficulties that Dodd-Frank regulation will present for international firms.

III. U.S. & U.K. FINANCIAL INDUSTRY REGULATORY REFORM INITIATIVES

Law firms engaging in US and UK securities work have expressed the difficulties faced with new regulations in both the U.K. and the U.S. Europe began tinkering with risk retention in 2009 for asset-backed securities through amendments to the Capital Requirements Directive. The entire framework for viewing risk allocation seems to be very different when compared to the U.S. view. The Capital Requirements Directive provisions are framed as investor restrictions, rather than a direct retention requirement on the originator or sponsor. Firms understand the requirements mean to target credit institutions from taking on exposure to credit risk unless the originator will retain a net economic interest of no less than five percent in the transaction. An institution seeking to execute a deal exposed to U.S. and U.K. law would first have to satisfy the U.K. rule in order to have a chance to be a part of the deal in the US. The compliance landscape is further troubled by Europe’s inability to harmonize a retention regime amongst the countries.

The legal sector has also voiced concerns that, although the Dodd-Frank Act has been crafted in an attempt to remain consistent with other US legislative initiatives, aside from remaining consistent on the 5% percent risk retention concept, the Act is otherwise substantially different there from. The Act conflicts with other legislative initiatives on the focus

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69 Lawton M. Camp, Thomas Jones, et. al., Comparison of key U.S. and EU risk retention initiatives: Not exactly eye to eye, ALLEN & OVERY (July 15, 2010) available at http://www.allenandover.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=57058&prefLangID=410. “The risk retention related provisions included in the Dodd-Frank Act stand alongside several other regulatory initiatives recently put forward in the U.S., as well as requirements already adopted, and in the process of being implemented, in Europe. Worryingly, there are significant differences between the various initiatives and it is becoming increasing clear that the authorities don’t see eye to eye on the retention question.”
70 Id.
71 Id.
72 Id.
73 Id.
74 Id. “It should also be noted that, notwithstanding the intention on the part of the European authorities to create a harmonized retention regime in Europe, cracks in the framework have already started to appear. Just last week the German parliament passed implementing legislation, which “gold-plates” the CRD2 requirements by increasing the retention level to 10 percent, effectively increasing the retention requirements in respect of securitizations where it may be desirable for the securities to be held by German credit institutions (which may be a general liquidity point for a large number of transactions). Concerns have been raised that the German legislation creates an even more challenging compliance landscape for market participants.”
75 Id.
76 Id. “For example, whereas the regulations to be made under the powers provided by the Act are intended to operate as a general requirement on the securitizer to retain the required interest in the context of ABS deals generally, the SEC’s proposals are framed as a requirement for establishing shelf eligibility and the FDIC’s proposals are framed as a condition to the availability of the safe harbor for legal isolation as described above.
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of the regulation. The Act focuses on the securitizer to retain the required risk, the SEC frames proposals as requirements for generating shelf eligibility, and the FDIC frames proposals as conditions to the availability of safe harbor. Moreover, even with the Dodd-Frank Act set, the proposals by the FDIC and SEC, while receiving feedback from the industry, still seem not to completely harmonize with the tone of the Act itself.

Observers have also identified what seem to be major differences in ideas on E.U. Regulation and the Dodd-Frank Act. The major differences stem from the inclusion or exclusion of fundamental terms. The E.U. Regulation applies to a broad class of derivatives, but only speak to those including particular underlying assets. The scope of the E.U. Regulation is silent on foreign exchange transactions. Although sharing this concept, the Dodd-Frank Act also encompasses other transaction elements not covered by E.U. regulation, including any agreement or transaction that is or becomes a swap. The E.U. definition for financial counterparties is relatively narrow, whereas the Dodd-Frank definition for financial entities might be understood to mean much more. E.U. regulation does not extend the authorization requirement it imposes on E.U. dealers to the U.S. There are some classifications for E.U. dealers that do not exist for U.S. based dealers. The Dodd-Frank Act requires all OTC dealers to be registered and is understood to impose significant conduct rules on them.

In addition, whereas the Dodd-Frank Act contemplates that provision will be made for some downward adjustment of the required retention levels if certain (to be) specified underwriting standards are met and for discretion to be held by the relevant authorities to provide in the regulations for certain exemptions, exceptions or alternative holding options in respect of the retention requirements (e.g. for deals backed solely by "qualified residential mortgages" and/or commercial mortgage backed deals), the other initiatives refer to a flat five percent minimum required interest level and provide for general application in respect of a wide range of asset-backed products. With respect to hedging, while the SEC has indicated that certain hedging arrangements should be permitted, both of the Dodd-Frank Act and the FDIC proposals suggest that direct and indirect arrangements may be restricted (although, in the case of the former, full details are left to be determined by corresponding regulation)."

77 Id.
78 Id.
80 Id.
81 Id.
82 Id.
83 Id. "Financial counterparties are defined to cover banks, investment firms, insurance companies, registered funds (UCITS), pension funds and alternative investment fund managers."
84 Id. "Financial entities are defined to cover swap dealers, major swap participants, commodity pools, private funds, employee benefit plans and other entities predominantly engaged in banking business or financial activities (but regulators can exempt certain small banks, savings associations, etc.). Major swap participants are defined to cover (a) entities with substantial positions in any class of OTC derivatives (excluding positions hedging commercial or employee benefit plan risk), (b) entities whose outstanding OTC derivatives positions create counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets and (c) highly leveraged financial entities that maintain a substantial position in any class of outstanding OTC derivatives."
85 Id.
86 Id.
87 Id.
E.U. regulation and the Dodd-Frank Act also differ on which derivatives are subject to mandatory clearing. The distinction comes from the manner in which the E.U. implement evaluation criteria for determining which OTC derivatives would be subject to clearing obligations. In the U.S., regulators can take action even on contracts that are not subject to clearing. Another glaring difference between the jurisdictions is in risk management for uncleared trades. E.U. regulation gives the counterparties the requirement of having arrangements to measure, monitor, and mitigate credit risk. A financial counterparty could hold capital against an un-cleared trade instead of requiring margin. The Dodd-Frank Act imposes margin and capital requirements on swap dealers while U.S. regulators are given power to make rules regulating swap dealers, including restrictions on their activity. The E.U. model does not delegate rule making or technical standards whereas the Dodd-Frank Act largely entrusts regulatory bodies with promulgating the rules for enforcement and implementation.

A. What This May Mean for International Firms Seeking to Utilize Asset-Backed Securities Created in the U.S.

Some law firms have tried to explain the consequences of the risk retention requirement. There is a sense that the risk retention will immediately reduce the volume of asset-backed securities issued in the market. Interestingly, the Dodd-Frank Act passes into law at nearly the same time as the Basel III requirements are being shaped. This may change the long-term effects of the risk retention rule and encourage firms originators under the act to seek the most efficient capital structures. This has some credibility because it is foreseeable that restrictions or efforts to provide more stringent market requirements would cause firms to re-evaluate their plans for offering asset-backed securities in markets where they will be forced to retain risk. This long-term vision may cause companies to consider whether or not to move their financing to locations not effected by Dodd-Frank Act’s Risk Retention.

With respect to auto loans and their place in asset-backed securities after Dodd-Frank, one opinion is that their value to remain a securatizable asset hinges on the risk retention model pushed for by legislators and the Council. Traditionally, it is claimed that first loss, or horizontal risk retention, is the position for auto loan originators. It seems that the 5% risk retention and the variety of retention models proposed would not drastically alter the auto loans place as a reliable short-duration asset for banks.

The nature of the changes to risk retention will effect the ways in which auto dealers sell to the primary customers. The originators will have to work backwards and tell the

88 Id.
89 Id.
90 Id.
91 Id.
92 Id.
94 Id.
95 Id.
96 Id.
97 Id.
98 Id.
dealers how the consumers are to be regulated regarding pricing and options.\textsuperscript{99} Moreover, there is a perception that CLOs may be exempt from risk retention because of how the vehicle is managed by third party asset managers rather than the originators.\textsuperscript{100} While true, it also creates a problem for risk retention implementation and enforcement since the risk retention rule cannot properly be applied to all types of offerings. The CLO is a large vehicle and by its nature cannot require originators to retain risk where their management capital is not being used by the SPV.

A Big Four auditor, KPMG, has attempted to explain how the risk retention rule will affect global banking and international financing.\textsuperscript{101} The firm anticipates that domestic, U.S. financial firms will be hit the hardest by regulation.\textsuperscript{102} Risk retention will especially affect small to mid-size banks, likely because they are less capable of bearing the costs of adapting to the change.\textsuperscript{103} The areas these banks will need to look to for a proper approach to life after Dodd-Frank is to technology to strip operational costs and to a review of product portfolios to determine what adjustments could enhance returns.\textsuperscript{104}

With such predictions on how the risk retention rule will affect the markets for financing across borders, the risk retention rule as it is written, may achieve the goal of culling the market of unreliable lenders and poor lending practices, but it may also remove from the same market those originators and types of assets that contribute to healthy and competitive financing with the use of CLOs.

IV. A STRATEGIC SOLUTION TO MINIMIZING MARKET RISK AND PROMOTING LESS RISKY DEALING WITHOUT A STATIC 5% RISK RETENTION RULE: INCENTIVIZE SUCCESS – REDUCE THE RISK PERCENTAGE REQUIRED TO BE RETAINED

The fundamental principles on which the risk retention rule were crafted fails to address one core value that all financial regulation should include: the promotion of best practices and healthy, competitive markets. It seems that the thrust of the Dodd-Frank Act was to punish risky CDO structuring rather than promote behavior that enhances and stabilizes markets. The risk retention rule, as is, only burdens securitizers and minimizes the amount of deals they can handle at any given time. The retention of risk does not fundamentally alter underwriting practices, change the way the market perceives risk. Arbitrary risk retention

\textsuperscript{99} Id. \\
\textsuperscript{100} Id. \\
\textsuperscript{101} Dodd-Frank for Foreign Banks, KPMG.com (October 2010) available at http://www.kca.kpmg.com/dbfetch/52616e64f6d4956472bc3905fba2a098d7dd08c36e462022f047097b7d7b/dodd-frank-for-foreign-banks-oct-2010.pdf. Smaller, domestically focused banks may suffer under the weight of new rules.” And “Overall, this bill which was expected to cripple the big investment institutions that were perceived to be the most significant contributors to the U.S. financial crisis, is so far reaching in its final scope that there are significant changes for all institutions. Consumer focused institutions could also see their business environment change substantially, potentially driving a significant shakeout amongst the smaller or weaker players.” \\
\textsuperscript{102} Id. \\
\textsuperscript{103} Id. \\
\textsuperscript{104} Id. at 4. Banks are already looking to process and technology improvements to help strip out operational costs, and reviewing product portfolios to determine what recalibration could enhance returns in this new environment.
merely raises the blinds for firms at the issuer’s table. The value of the risk retained will likely
effect increases in operational and compliance costs, delay deals, and may result in firms
forwarding the true costs to investors. There needs to be an alteration to the risk retention rule
that includes an incentive for firms to mitigate the risk retention requirement when firms
incorporate practices that promote healthy market conditions. Providing incentives for fair
dealing and results-oriented retention mitigation will create competition amongst originators
and securitizers to provide the investors and with the most transparency possible and with the
best combinations of assets in their products. Without such an incentive, the industry will
ferret out which financial instruments play within the rules the best, and promote only those
advantageous products, limiting the market’s offerings significantly.

Incentive-Based Approach Through An Earned Risk Retention Reduction for Issuers
- A Game That Both Congress and Wall St. Can Understand

Rather than only focusing on the quality of the underwriting, which has been a phan-
tom menace of fair dealing in the markets, the regulatory institutions should also focus on
tyning a firm’s duty to be subject to the risk retention requirement to the actual performance of
the products that they offer. By monitoring the performance of the products, firms should be
able to jettison the risk on individual transactions, by exchanging proof of fair dealing and
positive results for investors for a lower percentage of risk retention required on future trans-
actions. The incentive to construct products that better align goals between the investor and
originator is built in where a security’s performance can alter an originator’s risk exposure
by operation of law. This can be achieved by requiring new CDOs and CLOs to perform within a
particular target range. A range of performance, allowing for originators to include underlying
assets with a relatively healthy mix of risky and less risky components, can indicate whether
or not a firm can progress towards receiving a reduction in the amount of risk they are re-
quired to retain. This may narrow the instruments maximum possible potential for gain, but
may be the balance between government’s desire to impose regulation on the risk involved in
the creation of CDOs and the market’s desire to produce consistently competitive and useful
products. The implementation should be gradual, rather than abrupt like the enactment of the
Dodd-Frank Act, to ensure that the market is ready for the new system of regulation, and to
ensure that firms understand the reasoning behind the changes.

A. Initiating Change Through Education: Training Firms to Promote Best Practices

In order to properly address the aspirations behind the Dodd-Frank Act’s risk reten-
tion requirement, comments by the industry and rules issued by regulatory bodies are not
enough. There need to be a new departments within the SEC, focused on education for origi-
nators and issuers of CDOs. Firms who do not partake in the education program will be
subject to the Dodd-Frank Act risk retention provision as is, and in any transaction subject to
the provision, the 5% risk retention requirement must be met, with exceptions only for the
situations expressed by the Treasury study and by the Act itself. The education initiative
could be constructed by the SEC to allow registered dealers to learn precisely what the SEC
expects in terms of asset makeup for products and for underwriting standards. In this way,
firms can go through an education process and then after completing it, can gain access to risk
retention mitigation privileges.

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The vague “heightened” underwriting standards can be laid out and explained to firms seeking to unlock new exemptions and privileges under a separate scrutiny. The underwriting standards should not be so flexible to allow for a multitude of scenarios to satisfy the heightened requirement. Firms that are exempt from the risk retention by way of good underwriting practices should mimic or seem uniform in their procedures to other companies of similar size and structure. In order to promote uniform best practices across the market, the SEC can detail their oversight scheme and how firms can align their operations with those values. The firms can opt for certification to accommodate different capital structures, market needs, and firm sizes. The registration with the SEC in an education program will allow firms to obtain knowledge on how the SEC will scrutinize their actions and when completed, will provide the firm with the license to begin dealing in the market at the minimum five percent risk retention, but with the incentive that yearly performance of the products they create can decrease the amount of risk retention required until no requirement applies to them. The ability to whittle away at the risk retention requirement percentage leaves room for a powerful mechanic in the securitization game for the private sector to utilize. This Keynesian approach recognizes the desires of the private sector regarding CLOs. Rather than imposing a blanket barrier to entry for the CDO/CLO market, government’s response to market volatility arising out of these instruments should reflect an understanding that those same instruments are also vital and need room for risk in order to be effective financing tools.

Performing well can grant a firm the privilege of retaining less risk with each new transaction – for instance, being required to retain four percent of the credit risk in the vehicle. This is preferred to the idea of shedding risk over the life of the investment since uncertain market conditions or pre-determined incentives on the part of an originator could place the originator in a position to dump the risk at a time most advantageous to them. Such a status would improve an originator’s or securitizer’s competitive edge.

The reduction in risk retained per issuance of each CDO should be gradual. Performance over time must be monitored and successful results should be maintained before the reduction in risk retained is granted to that issuer. An assessment period should be in place for entities that successfully complete the education portion. During the assessment phase, the firms performance determines whether they are entitled to a reduction in the risk retention percentage. If a firm completes the education phase, but underperforms, no risk retention is reduced despite best efforts. This places the emphasis on results rather than the firm’s own risk-aversion/preventative measures.

**B. Effects on Investors Based Outside the U.S. Who Seek Financing Through U.S. Markets**

Such a model would not shy foreign companies away from American financing, knowing that firms exist that could be exempt from retention. Moreover, foreign companies will be able to quickly and accurately assess the track record of those originators who qualify for the alternative risk retention scheme. Investors can rely on firms who have a track record for consistently performing well. In 2010 alone, the OTC derivatives market ran to 603.9 trillion dollars in outstanding notional value. Assuming regulation under Dodd-Frank Act

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risk retention, the amount of risk retention required by originators could be valued at 30.2 trillion. Although hypothetical in nature, the concept of asking the market makers to remain exposed to steep amounts of risk could injure the market by wiping out firms who generate the contracts in the first place. Investors based outside of the U.S. may hesitate to seek investing with firms who pass on increased operational costs and who are scrutinized under more stringent regulation that is not tailored to curb risk taking but rather tailored to punish the market for past wrongs. The regulation on originators and securitizers should not discourage foreign investors from the U.S. markets.

C. Possible Influences on U.K./E.U. Regulatory Schemes

The differences between the U.S. and E.U. regulatory schemes have been noted to be problematic because of major differences within core concepts. As much as the schemes do line up, their differences make international lending and trading difficult. Providing an alternative risk retention model would be favored by European business dealing in US Markets and would encourage EU members to adopt similar rules that promote heightened underwriting practices and better performance from originators and securitizers. Rather than defining economic and industry terms differently, the common thread of results oriented regulation will create harmony amongst the markets rather than dissonance from reactionary regulation practices.

The current scheme, with risk retention applying across the board and exemptions still unclear, does not create the kind of incentives to promote better results amongst firms either in the U.S. or foreign firms working in the U.S. Rather, it simply forces originators to pick apart the Act for to find where the line is and where breathing space can be had – whether it is in the form of changing product makeup and offerings or passing costs onto investors. A shift to an alternative scheme for certain firms seeking to avoid the full five percent risk retention might also align those sympathetic to the efforts of Basel III. The new rules looking to hold banks responsible for up to 7% of their total risk-bearing assets\(^\text{106}\) would compound the problem originators would have in handling their own risk retention, but in cases where third party sponsors could hold risk allocated to them, the effects of Basel III could make the OTC Derivatives market an extremely difficult arena to seek creative financing solutions. It seems that Basel III and the Dodd-Frank Act both take a static approach to viewing market events, almost entirely disregarding the roles timing and monitoring take in allowing special purpose vehicles to either fly or fail. An alternative scheme allows some flexibility for institutions looking for creative financing solutions, while at the same time requiring from them a standard of excellence that can be measured in success rates. Basel III creates some significant hurdles for U.S. banks such as capital buffer requirements, a leverage ratio requirement that could be different than the U.S. version, amongst other changes that may compound the frustration caused by the risk retention rule.\(^\text{107}\) But with so much time before the full requirements are in effect, how can the interaction between regulations on banks from the Dodd-Frank Act and Basel III be fully understood?


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V. CONCLUSION

The Dodd-Frank Act leaves little creative room for the U.S. Treasury Department and S.E.C. The study released by the Treasury Council has only highlighted this and has focused market recovery on creating a “raised blinds” atmosphere to temper risky market activity. Rather than focusing on how the originator or securitizer does business, the Act focuses on the difficulty of an originator to generate contracts – assuming that fewer deals means less risk overall. The main advantages to a regulatory scheme that rewards performance are:

1. An opportunity to implement regulation that recognizes best practices in underwriting since freedom from risk retention is tied to consistent, successful originator/issuer performance.

2. Encourage harmony amongst U.S. and U.K./E.U. regulation by refocusing on market performance rather than on market restrictions that reduce aggregate market risk.

3. Promote U.S. markets to foreign investors who seek financing by reducing the fear that the U.S. markets are weighed down in regulations that make financing expensive.

These ideas can be attained with an alternative risk retention addition to the current Dodd-Frank Act risk retention model. There is no clear reason to stick with an arbitrary plan to force all market participants at the originator position to retain risk. The fears over the current mandatory risk retention rule’s application to all types of underlying assets within CLOs, including equipment asset backed securities, has been voiced effectively by ELFA President, William Sutton, plainly explaining:

The equipment finance sector provides a significant source of funding for small businesses and a valuable alternative source of funding for large businesses in the United States. We are concerned about the potential harm which risk retention regulations could impose upon the capital formation process for equipment finance companies, particular Equipment finance providers have already been harmed by the financial crisis in the United States and have suffered reduced access to the capital they need to continue to extend credit to their customers. Many equipment lessors and lenders may not survive additional costs and limitations on funding which would significantly decrease the availability of equipment leasing and loans to operating companies, increase equipment finance costs and harm.108

The financial health of firms seeking OTC derivative financing is also a large concern for policymakers, but often those concerns take a back-seat to regulations scaled to check larger institutions and dealers. The ways in which these drastic changes affect other markets will not be perceived quickly.

With a regulatory scheme that requires all securitizers to retain five percent risk on all transactions allows firms with greater resources to flourish, leaving midsize and small firms without any incentive to improve disclosure transparency through improved underwriting practices. Before the release of the Treasury Council’s study, a research firm following the subject issued a statement that properly speaks to the proper focus regulators should have while promulgating rules:

Given the current conditions of the securitization markets and the supply of credit, it is critical for regulators to assess the implications of the amount and forms of risk retentions, an analysis that economists are well equipped to address. Recent research informs the regulatory process, but further research is needed to determine the unintended consequences, such as a reduction in credit or a skewed distribution of risk that may result from a “one size fits all” approach. An economic analysis of the different forms and amount of retention, as well as the effect of different levels of retention on the supply and demand for credit, is needed to help regulators calibrate the rules to minimize negative effects and align incentives as Congress intends. By employing economic analysis, policymakers will ensure that the new rules address the alignment of incentives.109

Very simply stated, this comment brings into sharp relief the idea regulators should keep in mind going forward. Avoiding market advantages for firms with better resources is key to advancing regulation without harming the future health of the markets. It is a concept that every economist can agree with and every poker player can readily understand: When the stakes are higher, and the blinds are raised, the chip leader has the advantage.