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Editorial Offices

630 Central Ave., New Providence, NJ 07974 (908) 464-6800

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Implications of the Final Risk Retention Requirements for ABCP Conduit Sponsors—Part I

Karsten Giesecke, Eric P. Marcus, Henry G. Morriello, Kurt Skonberg, Gary B. Bernstein, and George M. Williams Jr.*

The final Dodd-Frank risk retention regulations provide challenges for asset-backed commercial paper (“ABCP”) sponsors. A special rule tailored to “eligible ABCP conduits” is included in the regulations, but it may not always be feasible to comply with requirements for qualification as an eligible ABCP conduit or to meet the other requirements of that rule. In this first part of a two-part article, the authors review the basic principle of risk retention, explain the exception for eligible ABCP conduits under the regulations, and discuss utilizing the ABCP exemption, which would permit assignment of risk retention to participating originator-sellers. The second part of this article, which will appear in an upcoming issue of The Banking Law Journal, will discuss the availability of an exemption by limiting assets, risk retention by the ABCP conduit sponsor as they assess the alternative ways to comply with the new regulations, and issues faced by ABCP conduit sponsors.

On October 22, 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission and the Department of Housing and Urban Development (the “Joint Regulators”) issued a release (the “Adopting Release”) adopting final risk retention regulations (the “Regulations”) to implement the requirements of Section 15G of the Securities Exchange Act of 1934, as amended (“1934 Act”), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The adoption of the Regulations followed a long period of consideration, including an initial proposal on March 29, 2011 (the “Initial Proposal”) and a reproposal on August 28, 2014 (the “Reproposal”). The Regulations were published in the Federal Register on December 24, 2014, and compliance is required for

* Karsten Giesecke, Eric P. Marcus, and George M. Williams Jr. are special counsel, and Henry G. Morriello, Kurt Skonberg, and Gary B. Bernstein are partners at Kaye Scholer LLP in New York. The authors may be reached at karsten.giesecke@kayescholer.com, eric.marcus@kayescholer.com, george.williams@kayescholer.com, henry.morriello@kayescholer.com, kurt.skonberg@kayescholer.com, and gary.bernstein@kayescholer.com, respectively.

residential mortgage securitizations one year after publication, and for other securitizations two years after publication.

This article focuses on aspects of the Regulations that are relevant to participants in the asset-backed commercial paper (“ABCP”) market, including some matters specific to ABCP, and some applicable to asset-backed securities (“ABS”) generally.

BASIC PRINCIPLE OF RISK RETENTION

Except as otherwise specifically provided in the Regulations, the sponsor¹ of a securitization transaction (or a majority-owned affiliate of the sponsor) must retain a five percent economic interest in the credit risk of the securitized assets in one of the forms prescribed in the Regulations. The Regulations define a securitization transaction as a transaction involving the offer and sale of an “asset-backed security,” as defined under the 1934 Act,² by an issuing entity.³

The “standard” form of risk retention available for all structures and asset

¹ A “sponsor” is defined in Section 2 of the Regulations to be “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” The release specifically notes that an ABCP arranger or manager should be viewed as a sponsor and “securitizer” for purposes of the Regulations and Section 15G notwithstanding that it does not itself transfer assets to the ABCP conduit. If there are multiple sponsors, each is responsible for ensuring that at least one of the sponsors (or majority-owned affiliates) satisfies the risk retention requirement.

² Section 3(a)(79) of the 1934 Act states that “the term ‘asset-backed security’

(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

- (i) a collateralized mortgage obligation;
- (ii) a collateralized debt obligation;
- (iii) a collateralized bond obligation;
- (iv) a collateralized debt obligation of asset-backed securities;
- (v) a collateralized debt obligation of collateralized debt obligations; and
- (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.”

³ The issuing entity is defined in Section 2 of the Regulations as “the trust or other entity: (1) That owns or holds the pool of assets to be securitized; and (2) In whose name the asset-backed securities are issued.”

classes is through retention of (1) an eligible vertical interest, (2) an eligible horizontal residual interest or (3) any combination thereof. An eligible vertical interest is a five percent interest in each ABS interest⁴ issued by the issuing entity, although it may be represented by a single security rather than separate portions of each such ABS interest. An eligible horizontal residual interest is a percent first loss ABS interest issued by the issuing entity. An eligible horizontal cash reserve account may be established instead of some or all of an eligible horizontal residual interest. Specific alternative forms of risk retention are available for revolving master trusts, eligible ABCP conduits, commercial mortgage-backed securities, Fannie Mae and Freddie Mac asset-backed securities, open-market CLOs and qualified tender option bonds. Risk is not required to be retained, or the amount of risk required to be retained is reduced, with respect to securitizations involving certain types of assets deemed to be of high credit quality.

The percentage represented by an eligible horizontal residual interest is measured by its fair value as compared with the fair value of all ABS interests issued by such issuing entity. The fair value is to be determined in accordance with GAAP, on the closing date of the securitization transaction. A sponsor electing to satisfy the requirement by utilizing an eligible horizontal residual interest is also required to disclose, a reasonable period of time prior to sale, the material terms and fair value (as a percentage of the fair value of all ABS interests to be issued) of the retained eligible horizontal residual interest, the valuation methodology used to determine such fair values, and all significant inputs used to measure such fair values. Certain requirements in the Reproposal that would have required reporting of a closing date projected cash flow rate and principal repayment rate, as well as restrictions on the rate of payment on an eligible horizontal residual interest, were not included in the Regulations as finally adopted.

Complete exemptions from the risk retention requirement are provided if all

⁴ An ABS interest is defined in Section 2 of the Regulations as “(1) Any type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest (other than an uncertificated regular interest in a REMIC that is held by another REMIC, where both REMICs are part of the same structure and a single REMIC in that structure issues ABS interests to investors, or a non-economic residual interest issued by a REMIC), payments on which are primarily dependent on cash flows of the collateral owned or held by the issuing entity; and (2) Does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests that: (i) Are issued primarily to evidence ownership of the issuing entity; and (ii) The payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity; and (3) Does not include the right to receive payments for services provided by the holder of such right, including servicing, trustee services and custodial services.”

of the assets supporting the asset-backed security consist entirely of qualified residential mortgages (“QRMs”), qualified commercial loans, qualified commercial real estate loans or qualified automobile loans. Further exemptions are provided to the extent the assets are issued by the United States or an agency thereof, or are 100 percent guaranteed by the United States or an agency thereof;⁵ or where the securities themselves are so guaranteed. There are further exemptions relating to residential, multifamily or health care facility mortgage loans fully or partially insured or guaranteed by the United States or an agency thereof, certain agricultural loan securitizations, state and municipal securitizations, qualified scholarship funding bonds, certain public utility securitizations, certain resecuritizations and securitizations of seasoned loans.

In a number of cases, the risk retention requirements may be satisfied to the extent originators, rather than securitizers, satisfy the risk retention requirements. Under the general rule, the risk retention interest may be assumed only by originators contributing at least 20 percent of the assets, and only up to a *pro rata* portion equivalent to the portion of assets contributed. Further, each originator must retain risk on the entire pool, and not just on the assets contributed by it. The special provisions relating to an eligible ABCP conduit allocate risk retention to all originators regardless of percentage contribution, and in each case solely with respect to assets contributed by them.

The sponsor, or other permitted retainer of risk, may not transfer or hedge the risk retention interest (other than by way of broad market hedges) until expiration of the applicable seasoning period, nor may it finance its position on an effective nonrecourse basis, although it may retain its interest by way of a controlled subsidiary. For residential mortgage-backed securities (“RMBS”), transfer or hedging is permitted at the earlier of (a) any time after five years when the pool is down to 25 percent or less of the original balance, or (b) seven years. For other asset classes, transfer or hedging is permitted after the latest of (a) the date when the pool is down to 33 percent of the original pool balance, (b) the date when the total principal obligations under the transaction’s ABS interests are down to 33 percent of the original principal obligation balance, and (c) two years after the closing.⁶

⁵ A special provision is included in the Regulations with respect to student loans made under the Federal Family Education Loan Program (“FFELP”) that are only partially guaranteed. Risk retention is still required, but may be limited to a portion of the assets depending on the amount that is guaranteed. If the loans are at least 98 percent guaranteed, the risk retention requirement is reduced to two percent. For securitizations of other FFELP loans, the requirement is reduced to three percent.

⁶ There is a special provision for commercial mortgage-backed securities (“CMBS”),

RISK RETENTION FOR ABCP CONDUITS UNDER THE REGULATIONS

Although ABCP does not appear to clearly fit within the definition of “asset-backed security” under the 1934 Act, it nevertheless is arguably treated as such in other contexts,⁷ and the Regulations clearly state that ABCP is to be treated as an asset-backed security for purposes of risk retention. In addition, although commenters noted that the requirement for 100 percent liquidity coverage represents full retention of credit risk by the liquidity provider, the Joint Regulators continue to view an unfunded provision of full liquidity and credit support as not constituting the retention of risk.

An ABCP conduit must satisfy applicable risk retention requirements upon its first issuance of ABCP after the date on which compliance is required, even if the conduit itself was formed and active prior to such compliance date.

A sponsor of an ABCP conduit can approach risk retention in three different ways:

- 1) It can structure the program to come within an exemption (the “ABCP Exemption”) for an “eligible ABCP conduit” (as defined below), including holding only ABS interests issued by “intermediate SPVs”⁸ owned by participating originator-sellers and requiring each such originator-seller to hold a risk retention interest;
- 2) It can limit the conduit’s assets to those, such as QRMs, qualifying commercial loans, qualifying commercial real estate loans, or qualifying automobile loans, that would provide a complete exemption from risk retention requirements; or

permitting transfer after five years to third-party purchasers that satisfy certain asset review and other requirements applicable to permitted initial third-party purchasers, subject to the further requirement that there never be more than two third-party purchasers of such ABS interests.

⁷ See, for example, Rule 3a-7 promulgated under the Investment Company Act of 1940, as amended, which explicitly addresses ABCP and, as described in the adopting release therefor, SEC Release IC-19105, treats ABCP notes as “securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets” (a concept similar to that used in the definition of an asset-backed security), notwithstanding that payments are largely made from rolling the commercial paper and from a liquidity facility.

⁸ An “intermediate SPV” is defined in Section 6 of the Regulations as an SPV that (1) is a direct or indirect wholly-owned affiliate of the originator-seller or is an “orphan” subsidiary owned by a trust or corporate service provider, (2) is bankruptcy-remote, (3) acquires assets originated by the originator-seller or a majority-owned affiliate or ABS issued by another intermediate SPV that are collateralized solely by such assets, and (4) issues ABS interests collateralized solely by such assets.

- 3) It (or a majority-owned affiliate) can hold a “standard” risk retention interest in the conduit itself.⁹

The three approaches cannot be combined, except to the extent holding certain assets described in clause two may reduce the amount of risk retention required under clause two. In particular, an ABCP conduit relying on the ABCP Exemption must rely exclusively on compliance with such exemption in full.

UTILIZING THE ABCP EXEMPTION AND ASSIGNING RISK RETENTION TO PARTICIPATING ORIGINATOR-SELLERS

An ABCP conduit generally can satisfy the requirements of the ABCP Exemption if (1) it qualifies as an eligible ABCP conduit, (2) for each ABS interest the ABCP conduit acquires, the participating originator-seller¹⁰ retains an economic interest in the credit risk of the underlying assets as required under the standard risk retention or revolving pool securitization risk retention provisions of the Regulations, and (3) the ABCP conduit sponsor complies with certain procedural and administrative requirements required by the Regulations. This approach can be applied to an ABCP conduit that acquires assets in the form of ABS or in the form of loans secured by and payable from underlying receivables.¹¹

An eligible ABCP conduit is defined in Section 6 of the Regulations as an ABCP conduit that:

- Is bankruptcy remote or otherwise isolated for insolvency purposes

⁹ Although the sponsor of the ABCP conduit would satisfy its obligations under the Regulations with standard risk retention without imposing any requirements on participating originator-sellers, such originator-sellers may themselves be regarded as issuing asset-backed securities and accordingly may have their own risk retention requirements.

¹⁰ The term “originator-seller” is defined in Section 6 of the Regulations as “an entity that originates assets and sells or transfers those assets, directly or through a majority-owned affiliate, to an intermediate SPV, and includes (except for the purposes of identifying the sponsorship and affiliation of an intermediate SPV pursuant to [this definition]) any affiliate of the originator-seller that, directly or indirectly, controls, is majority controlled by or is under common majority control with, the originator-seller. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.” The inclusion of majority-owned affiliates in the definition of “originator-seller” in the Regulations as finally adopted permitted deletion of references to “Majority Owned OS Affiliate” that appeared in the Reproposal.

¹¹ Though commenters had encouraged the Joint Regulators to permit direct ownership of assets originated by participating originator-sellers subject to appropriate recourse, the Regulations as adopted require that the assets of the ABCP conduit be in the form of ABS interests.

from the sponsor of the ABCP conduit and from any intermediate SPV;

- Acquires ABS interests that are
 - Collateralized solely by assets originated by an originator-seller, and by servicing assets;
 - Special units of beneficial interest (or similar ABS interests) in a trust or special purpose vehicle (SPV) that retains legal title to leased property underlying leases originated by an originator-seller that were transferred to an intermediate SPV in connection with a securitization collateralized solely by such leases and by servicing assets;
 - ABS interests in a revolving pool securitization collateralized solely by assets originated by an originator-seller, and by servicing assets; or
 - ABS interests of the foregoing types secured in whole or in part by assets acquired in certain business combinations;
- Acquires such ABS interests in an initial issuance by or on behalf of the intermediate SPV¹² and not in the secondary market;
- Is collateralized solely by ABS interests acquired from intermediate SPVs as described above and servicing assets; and
- Is 100 percent supported by a regulated liquidity provider,¹³ without regard to the credit performance of the underlying ABS.¹⁴

¹² Specifically, the ABS interests must be acquired (a) directly from the intermediate SPV, (b) from an underwriter of the ABS interests issued by the intermediate SPV, or (c) from another person who acquired the ABS interests directly from the intermediate SPV.

¹³ A regulated liquidity provider is defined in Section 6 of the Regulations to be (1) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); (2) a bank holding company (as defined in 12 U.S.C. 1841), or a subsidiary thereof; (3) a savings and loan holding company (as defined in 12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), or a subsidiary thereof; or (4) a foreign bank whose home country supervisor (as defined in Section 211.21 of the Federal Reserve Board's Regulation K (12 CFR 211.21) has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof.

¹⁴ It is noteworthy that, in describing 100 percent liquidity coverage, the Regulations note that "amounts due pursuant to the required liquidity coverage may not be subject to credit performance of the ABS interests held by the ABCP conduit or reduced by the amount of credit support provided to the ABCP conduit." Accordingly, despite use of the terminology "liquidity coverage," the requirement is essentially one of 100 percent credit enhancement. It is stated in

If the ABCP conduit is to qualify for the ABCP Exemption, each participating originator-seller must retain the risk with respect to the ABS interest issued by its intermediate SPV and acquired by the ABCP conduit in the form of standard risk retention (vertical, horizontal, or a combination) or in the form of a seller interest in an issuing entity as provided with respect to revolving pool securitizations.¹⁵ The originator-seller may well itself be a sponsor of a securitization transaction and be independently required to comply with the Regulations with respect to the ABS interests issued by its intermediate SPV, but the ABCP conduit sponsor relying on the ABCP Exemption is also made responsible for assuring that originator-sellers hold their risk retention interests subject to all restrictions (including the restrictions on transfer and hedging) generally applicable to risk retention interests. To the extent the ABCP conduit sponsor determines that an originator-seller is not complying with its risk retention obligations, it is required to report such breach to ABCP investors and to regulators (including identifying such originator-seller by name), together with a disclosure concerning the remedial steps being taken, which may include removal of the ABS interest of such originator-seller from the ABCP conduit.

To utilize the ABCP Exemption, the sponsor must:

- approve each originator-seller permitted to sell or transfer assets, directly or indirectly, to an intermediate SPV from which the ABCP conduit acquires ABS interests;
- approve each intermediate SPV from which it is permitted to acquire ABS interests;
- establish criteria governing the ABS interests, and the securitized assets underlying the ABS interests the ABCP conduit acquires;
- properly administer the ABCP conduit and the ABS interests held by it; and
- maintain and adhere to policies and procedures for ensuring that the requirements for such form of risk retention have been met.

footnote 131 of the Adopting Release, however, that “liquidity coverage that does not require the regulated liquidity provider to pay in the event of a bankruptcy of the ABCP conduit would meet the requirements of the ABCP option adopted in the final rule.”

¹⁵ Although the Regulations provide that each originator-seller must satisfy risk retention requirements through standard risk retention or revolving pool securitization risk retention, without reference to exceptions to risk retention requirements, certain provisions in the Adopting Release (in particular those making reference to seasoned loans underlying the ABS interests) and in the release for the Reproposal indicate that risk retention would not be required with respect to ABS interests to which exemptions from risk retention would be available.

In addition, the ABCP conduit sponsor is required to make periodic disclosures to each purchaser of its ABCP and to applicable regulators, which disclosures are comparable to the disclosures generally required of holders of risk retention interests. Such disclosures must be made before or contemporaneously with the first sale of the ABCP and monthly thereafter, including specified information with respect to: (i) the liquidity provider and liquidity facility; (ii) the ABS interests held by the ABCP conduit and the originator-sellers (including their SIC Codes but without a requirement to disclose their individual names¹⁶); and (iii) a description of the percentage and form of risk retention held by each originator-seller.

The second part of this article, which will appear in an upcoming issue of *The Banking Law Journal*, will discuss the availability of an exemption by limiting assets, risk retention by the ABCP conduit sponsor as they assess the alternative ways to comply with the new regulations and issues faced by ABCP conduit sponsors.

¹⁶ Note that the Initial Proposal would have required disclosure of the names of the participating originator-sellers, but that requirement was not included in the Regulations.