MEMORANDUM FOR DRAFTERS

Revisions of S. 3217– H.R. 4173 Needed to Protect Investors in Offerings of Collateralized Debt Obligations and Other Structured Finance Securities

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INTRODUCTION AND SUMMARY

By dint of systemic effects associated with the near collapse of the financial system, collateralized debt obligations ('CDOs') now constitute a *cause célèbre*. It is therefore surprising to discover the following. *The pending financial reform bills do not institute any significant regulation of CDOs. This leaves markets unprotected from a recently exposed and damaging conflict of interest inherent in the structure of a CDO offering.* For Congress to leave untouched transactions of a sort whose previous incantations have wreaked havoc does not jibe with the aspirations of the bills' proponents. Nor does it comport with popular understanding of what the legislation will accomplish.

The following furnishes a textual analysis revealing how this regulatory lacuna presently arises. The discussion begins with a brief statement of the impact of CDOs. Then follows analysis of the pending provisions concerning asset-backed securities ('ABSs'), namely, Title IX, Subtitle D of S. 3217, The Restoring American Financial Stability Act of 2010, and Title I, Subtitle F of H.R. 4173, The Wall Street Reform and Consumer Protection Act of 2009. In popular understanding, a CDO is a derivative, but in financial parlance, a CDO is not a derivative but a type of ABS.

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The analysis herein leads to recommended revisions of S. 3217—this because it, of the two bills, contains the broader definition of an ABS. On that definition depend the two major substantive provisions found in the subtitles. The following summarizes the analysis.

1. The definition of an ABS in S. 3217 does not encompass synthetic CDOs. The definition manifests an intent to encompass cash (nonsynthetic) CDOs, but the language by which such inclusion is attempted verges on self-contradiction. H.R. 4173 lacks any suggestion of reaching CDOs, cash or synthetic. I suggest a definition of an ABS that encompasses all CDOs and other types of securities recognized as ABSs, while facilitating distinctions among them.

2. (a) The first major substantive provision of the two subtitles authorizes agency rulemaking to impose *credit risk retention* in transactions that create ABSs collateralized by assets originated by lenders or other providers of credit. The bills predicate this "skin in the game" rule on events and circumstances characteristic of such transactions but not of CDO issuances. The provision, so far as it goes, requires revision for the sake of clarity and to place the onus of credit risk retention upon the parties upon which it properly should fall. But it is clear that on any reading, the provision does not and should not apply to CDOs.

(b) The second major substantive provision consists of *disclosure requirements*. As to CDOs and other higher-level ABSs, the combined effect of the pending legislation and proposed SEC regulations consists only in requiring that in private placements pursuant to Rule 144A or Rule 506—offerings in which issuers already produce fulsome disclosure documents—issuers shall make available the extent of information required in registered offerings. Neither the bills nor the regulations contain an effective counterincentive against a salient conflict of interest.

3. For any underwriter of a CDO offering who wishes to maintain, or elects to favor, a short position in the portfolio or notes,[2] a conflict of interest arises by virtue of, on the one hand, the duty not to mislead investors in any material re-

[2] For brevity's sake, I use 'underwriter' for any initial purchaser and immediate reseller of securities even though, in a Rule 144A transaction, an initial purchaser is not deemed an underwriter for purposes of §4(1) of the Securities Act.

spect concerning the method and criteria used to select the issuer's portfolio, and, on the other hand, a self-benefiting interest in crippling the portfolio to serve that short position. Multiple reasons suggest that disclosure will not suffice to prevent harm from the conflict of interest. Protection of investors requires a constraint.

4. A feasible constraint or countervailing incentive mechanism must connect with the structure of CDOs and other structured finance securities. I propose a provision on point. The provision requires an underwriter to maintain a net long position in an underwritten CDO's portfolio and notes. This will align the underwriter in economic interest with investors. The provision authorizes the Commission to impose a similar constraint for non-CDO transactions presenting similar financial incentives to the transacting parties. This provision may be thought of as the counterpart, for underwriters of CDOs and other structured finance securities, of the credit risk retention rule imposed on securitizers of ABSs.

5. It seems unlikely that the universe of prudent regulatory responses to the risks posed by CDOs comprises only a disclosure mandate and the proposed constraint against an underwriter short position. A path toward additional prudent protections may be laid by authorizing SEC rulemaking.

ECONOMIC SIGNIFICANCE OF CDOS

The scale of CDO issuance reveals how CDOs could produce systemic effects. Aggregate notional value of CDO issuances in the last five years has been conservatively estimated at more than $1 trillion, of which an estimated three-quarters are synthetic CDOs. The mechanism of their disastrous effect began with large scale defaults on residential mortgage loans coincident with bursting of the housing bubble. Whereupon the value of CDOs collateralized by residential mortgage-backed securities fell. In the absence of a well-articulated market, CDO holders were unable to ascertain the value of their holdings. The ensuing chain reaction froze the flow of credit.

An underwriter of a CDO transaction has an opportunity to determine or influence selection of the reference portfolio on which investors depend. Recently the bright light of public exposure has come to shine on the good fortune of some underwriters of synthetic CDOs who managed to profit by taking short positions in risky reference portfolios on which investors lost. Such deals were exposed at the hearing on April 27, 2010 conducted by the Permanent Subcommittee on Investigations, Senate Committee on Homeland Security and Governmental Affairs, at which executives of Goldman, Sachs & Co testified. The gravamen of senators' objections to the testimony was that underwriters had acted while motivated by a conflict of interest. But it was unclear precisely what the conflict of interest was. This predicament gave fresh voice to the view that S. 3217 should introduce new rules regulating CDO transactions. The predicament also prompted me to consider carefully what conflict of interest, if any, obtains in such a transaction. No constraints appear in pending legislation or rulemaking. My study has led to the provision proposed in ¶4 below.

ANALYSIS

1. Achieving Inclusiveness in Definition of 'Asset-Backed Security'

Title IX, Subtitle D of S. 3217 begins by introducing, in § 941(a) as new § 3(a)(77) of the Exchange Act, a definition of an ABS (1044, 11 to 1045, 5).[3] I refer to subsection (A) of the foregoing definition as '<*Senate ABS*>'.[4] An underlying asset of an ABS, according to <*Senate ABS*>, is a

> self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) (1044, 14–16).

I shall call such an asset a 'self-liquidating obligatory flow' (or 'SLOF'). An asset is 'self-liquidating,' in the sense of the term evidently used here, if the asset entitles the party who financed the asset to receive return of the amount financed within a fixed time.[5]

[3] Numbers in parentheses herein take the form (page number, line number), and refer to S. 3217, as set forth in Amendment No. 3739, and H.R. 4173, as the may be. Copies of S. 3217, Title IX, Subtitle D and of H.R. 4173, Title I, Subtitle F are included as Appendix A and Appendix B, respectively.

[4] Throughout, an italicized expression framed by angle brackets signifies a definition.

[5] In a stronger sense of the term, an asset is self-liquidating only if *whatever is acquired with the proceeds from creation of the asset produces revenue* that within a fixed time returns the amount of the proceeds to the party who advanced the proceeds. The weaker sense adduced in the foregoing interpretation comports with the SEC's reference to assets "that by their terms convert into cash within a finite time period" in its definition of an ABS (as given in ¶1.1 below). Only in the

According to <*Senate ABS*>, an ABS is a fixed income or other security that is "collateralized by" SLOFs and that "allows the holder of the security to receive payments that depend primarily on cash flow from" the SLOFs (1044, 11–19).[6]

1.1 *Synthetic Securities Not Encompassed by Legislative Definitions*

The SEC has undertaken to meet "concerns about the lack of information available to investors in the private markets for structured finance products." It has introduced a definition of 'structured finance product' intended to include all known variants, cash and synthetic, of ABSs and CDOs ('<*SEC SFP*>').[7] <*Senate ABS*> closely follows a portion of <*SEC SFP*>,[8] but omits <*SEC SFP*>'s mention of a synthetic ABS.[9] The reach of <*Senate ABS*> therefore falls as follows. Synthetic ABSs are not collateralized by SLOFs. The issuer of a synthetic CDO enters into a credit default swap on a hypothetical reference portfolio composed of securities backed by SLOFs, but that issuer never acquires or obtains a security interest in any of the portfolio securities or what underlies them. Nowhere in §§ 941–945 of S. 3217 does there appear a passage that seems to suggest an intent to reach synthetic securities. We therefore conclude that <*Senate ABS*> does not encompass synthetic securities.

Nor does H.R. 4173 reach synthetic securities. Because an issuer of synthetic securities does not own its reference portfolio securities, a synthetic security is not "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period." That is to say that synthetic securities do not satisfy the definition of 'asset-backed security' in Regulation AB

weaker sense does the garden variety case of an owner-occupied residential mortgage loan qualify as self-liquidating, because in that case, the asset that the loan finances, the residence, does not produce revenue to repay the loan.

[6] Here "collateralized by" covers not only the common case in which payment of ABSs is secured by a security interest in SLOFs, but also a case such as that of pass-through mortgage-backed certificates whose issuer owns mortgages in which each certificate holder owns a pro rata undivided beneficial interest.

[7] Securities and Exchange Commission, "Asset-Backed Securities," 75 Fed. Reg. 23328, 23395, 23435–6 (May 3, 2010), proposed amendments of 17 C.F.R. § 230.144A.

[8] 17 C.F.R. § 230.144A(a)(8)(ii).

[9] 17 C.F.R. § 230.144A(a)(8)(i).

(‘<*SEC ABS*>’),[10] the definition adopted by the House.[11]

1.2 *Confusion Lurks in Definitional Structure*

<*Senate ABS*> consists of

◊ a *conceptual definition* of ‘asset-backed security’ as a fixed income or other security that is collateralized by SLOFs and that allows the holder of the security to receive payments that depend primarily on cash flow from the SLOFs (1044, 11–19), followed by

◊ an *enumeration*, by type, of securities said to fall within the extension of ‘asset-backed security’ as defined by the conceptual definition (1044, 19 to 1045, 5).

This structure, like the structure in <*SEC SFP*> that it imitates, subsumes ABSs of different levels under one concept, but thereby harbors contradiction. We shall see this upon observing how several of the enumerands may fail to satisfy the conceptual definition.

At the outset, we use ‘ABS’ at is used in financial parlance, without presupposing any proffered legislative definition.

Let us call an ABS that is not collateralized by ABSs a **ground-level ABS**. The issuer of a ground-level ABS holds as collateral SLOFs that are not ABSs. Let us call a security that is collateralized by ground-level ABSs a **second-level ABS**. The issuer of a second-level ABS holds as collateral (or, in the case of a synthetic ABS, sells credit protection on) ground-level ABSs. In general, a security collateralized by ABSs of level *n* or less is an **(*n* +1)-level ABS**.

The distinction between ground- and second-level has practical consequences. In an offering of second-level ABSs, the SEC expects issuers to disclose information about the ground-level ABSs constituting collateral, but not about SLOFs underlying the collateral.[12] Whereas in an offering of ground-level ABSs, the SEC proposes that issuers provide extensive “asset-level” data, i.e., data about the

[10] 17 C.F.R. § 229.1101(c)(1). The SEC has noted at 75 Fed. Reg. 23394, n. 459, that synthetic securities do not satisfy <*SEC ABS*>.

[11] H.R. 4173, § 1502, (318, 16–19).

[12] 75 Fed. Reg. 23396.

underlying SLOFs.[13] For example, the Commission proposes that in an offering of ground-level ABSs backed by residential mortgages, an issuer must relate 137 data points for each mortgage.

Consider now the enumerand "(ii) a collateralized debt obligation" (1044, 22). Does a CDO satisfy the conceptual definition in <*Senate ABS*>? A CDO's collateral consists in ground-level ABSs (e.g., residential mortgage-backed securities) and other securities pledged to an indenture trustee for benefit of noteholders. Each ground-level ABS is backed by SLOFs (e.g., mortgages). The CDO is not collateralized by those SLOFs. Do the ground-level ABSs qualify as SLOFs? In respect of the definition of 'self-liquidating,' it cannot be said that the entitlement of holders of the "equity" tranches of ABSs consists in return of their principal within a fixed time. Rather it is the case that those investors, placed at the bottom of the distribution waterfall, bear the greatest risk of suffering the effects of SLOF defaults, and, on the other hand, they are entitled to more than what they have invested if actual SLOF defaults fall short of projected defaults and the issuer receives payments from SLOFs whose amount exceeds the fixed amounts owed to senior tranches. Thus understood, equity tranche securities are *not self-liquidating*, not SLOFs. Not every ABS is a SLOF. Insofar as equity tranches of ABSs are collateral of CDOs—as was true of the ABACUS-2007 AC1 synthetic CDOs underwritten by Goldman, Sachs & Co., all of whose reference obligations were rated Baa2 by Moody's—the CDOs do not satisfy the conceptual definition's requirement of collateralization by SLOFs.

Thus although CDOS are said to be included within the extension of the definiendum by enumeration, they are excluded by the conceptual definiens. The right hand giveth, the left hand taketh away. This exclusion, as it happens, aids clarity. We have good reason to distinguish CDOs from other ABSs. CDOs are second-level ABSs. (It is notable that the parenthetical phrase at (1044, 15–16) contains no mention of a second-level ABS.) We have seen how differences in expected disclosure turn on the distinction between second-level CDOs and ground-level

[13] 75 Fed. Reg. 23355, 23361ff., 23389. Ground-level ABSs satisfy <*SEC ABS*>.

ABSs; we shall later employ this distinction in order to clarify the reach of credit risk retention. Relying on this distinction, and paying close attention to the mechanics of second-level transactions, we shall also arrive at a counterpart to credit risk retention for CDOs. All of which militates against attempting to subsume a CDO under the present conceptual definition, and in favor of an ABS definition that lists a CDO separately from that concept. Such a definition is given shortly below.

We turn to the other enumerands. "(i) a collateralized mortgage obligation" ('CMO') will commonly be a second-level ABS whose collateral may include equity tranches of ABSs backed by mortgages. It will thus fail the conceptual definition for the same reason that (ii) does. It warrants separate mention in the ABS definition. (Under the name 'CMO,' one may also recognize a ground-level ABS differing from a pass-through mortgage-backed security by virtue of possessing a tranche structure. Given the conceptual definition, no type of ground-level ABS requires enumeration, and if the definition mentions a CMO as a second-level type of ABS, mention of its ground-level namesake would best be foregone to avoid confusion.) "(iii) a collateralized bond obligation" ('CBO') is an ABS that in a typical case is backed by junk bonds not backed by SLOFs. Hence a CBO is a ground-level ABS. Another type of ground-level ABS is a collateralized loan obligation ('CLO'), an ABS backed by commercial loans not backed by SLOFs. Again by virtue of the conceptual definition, mention of a CBO and CLO is not required. But their mention would not risk confusion.

Definition by enumeration of "a collateralized debt obligation of asset-backed securities" results in using the definiendum 'asset-backed security' in the definiens. By reason of this circularity, (iv) adds nothing to <*Senate ABS*>. "(v) a collateralized debt obligation of collateralized debt obligations" (a "CDO squared") is a third-level ABS. It should receive separate mention for the same reason that (i) and (ii) should receive such.

Concerning the exclusion–inclusion of (i), (ii), and (v), someone might venture that an enumerative definition controls over a conceptual definition. But another observer—perhaps one seeking to escape regulation—could respond that a conceptual definition constrains a nonexhaustive enumeration. On the latter view, the enumeration in <*Senate ABS*> succeeds only in including within the extension of ‘asset-backed security,’ under the names used, securities collateralized by SLOFs. This ostensibly will not capture all that the marketplace familiarly knows as CDOs, CDOs squared, and second-level CMOs. The risk of the second interpretation suffices to motivate revision of the text.

H.R. 4173, by adoption of <*SEC ABS*>, does not reach any second-level ABSs. By virtue of other provisions predicated upon <*Senate ABS*>, and that definition’s ostensibly intended greater breadth than that of <*SEC ABS*>, <*Senate ABS*> is the preferable definition to revise. Salutary provisions predicated on <*Senate ABS*> now include or may include the following: § 932 (1026, 22), amendment 3808 (by Sen. Franken) agreed to on May 13, 2010,[14] portions of forthcoming revisions of S. 3217 in conference,[15] and portions of future amendments of the Exchange Act.

Thus we have seen that in default of repair of <*Senate ABS*>, any provision predicated upon that definition will not reach synthetic CDOs, and may not reach the cash CDOs and second-level CMOs known to the marketplace.

1.3 *Proposed Revised* <Senate ABS>

I therefore suggest revising <*Senate ABS*> to read as follows.

‘‘(77) ASSET-BACKED SECURITY.—The term ‘asset-backed security’—

‘‘(A) means

“(i) a fixed-income or other security collateralized by one or more self-liquidating financial assets (including loans, leases, mortgages, or secured or unsecured accounts receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the assets, including, without limitation—

(I) a collateralized bond obligation; and

[14] See, as established by § 939D thereof, Exchange Act § 15E(1)(C)(i)(I)).

[15] One or more proposed amendments would have prohibited at least some synthetic securities. I assume that since no treatment of synthetic securities now appears in either bill, enactment of a categorical prohibition is unlikely. Even if synthetic CDOs were prohibited, the need would remain to revise <*Senate ABS*> so as to encompass cash CDOs.

(II) a collateralized loan obligation;

"(ii) a fixed-income or other security collateralized by securities of the type described in (i), including, without limitation—

(I) a collateralized debt obligation; and

(II) a collateralized mortgage obligation;

"(iii) a fixed-income or other security collateralized by securities of the type described in (ii), including, without limitation, a collateralized debt obligation of collateralized debt obligations;

"(iv) a synthetic version of a security of a type described in (i), (ii), or (iii) above; and

''(v) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and[16]

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''(78) STRUCTURED FINANCE SECURITY.—The term 'structured finance security' means—

"(A) an asset-backed security (as defined in paragraph (77) of this subsection); and

"(B) any other security that the Commission, in the public interest and for the protection of investors, determines to classify with an asset-backed security as a structured finance product."

I shall refer to the foregoing as *<Senate ABS rev.>*. *<Senate ABS rev.>* incorporates the following changes to *<Senate ABS.>*.

''(77) ASSET-BACKED SECURITY.—The term 'asset-backed security'—

[16] Subparagraph (B) is omitted here.

''(A) means

"(i) a fixed-income or other security collateralized by ~~type of~~one or more self-liquidating financial assets (including ~~a~~ loans, ~~a~~ leases, ~~a~~ mortgages, or ~~a~~ secured or unsecured accounts receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the assets, including, without limitation—

(I) a collateralized bond obligation; and

(II) a collateralized loan obligation;~~,~~

"(ii) a fixed-income or other security collateralized by securities of the type described in (i), including, without limitation, —

(I) a collateralized debt obligation; and

(II) a collateralized mortgage obligation~~-~~;

~~'(i) a collateralized mortgage obligation;~~

~~"(ii) a collateralized debt obligation;~~

~~"(iii) a collateralized bond obligation;~~

~~"(iv) a collateralized debt obligation of asset-backed securities;~~

"(iii) a fixed-income or other security collateralized by securities of the type described in (ii), including, without limitation, a collateralized debt obligation of collateralized debt obligations;

"(iv) a synthetic version of a security of a type described in (i), (ii), or (iii) above; and

''(v~~i~~) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

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"(A) an asset-backed security (as defined in paragraph (77) of this subsection); and

"(B) any other security that the Commission, in the public interest and for the protection of investors, determines to classify with an asset-backed security as a structured finance product."

The following explanatory remarks may be helpful.

1. <*Senate ABS rev.*> eliminates confusion consequent on mistakenly subsuming types within a type. It resolves the clash between conceptual exclusion and enumerative inclusion so as to include, within the extension of 'asset-backed security,' all enumerands in the present text. The definition now encompasses, in noncontradictory form, all CDOs and CMOs, including synthetics.

2. Assets serve as collateral, a type does not. An issuer's collateral could be one asset, but commonly is many. (<*SEC SFP*>, whose drafting manifests recognition of the last two points, speaks of a pool as collateral. While demanding a pool, or a "discrete pool" as in <*SEC ABS*>, avails when stating a condition for an offering to qualify under rules pertaining to registration and disclosure requirements, the purpose of Subtitle D is to impose constraints. A broader rather than narrower definition of ABS better serves the latter purpose.)

3. The bill could define 'synthetic.' It could advert, for example, to dependence of a security's value on the value of securities not held by the issuer but referenced in a credit default swap in which the issuer sells credit protection. It may be relevant to note that for purposes of <*SEC SFP*>, the SEC has not seen the need to define 'synthetic.'

4. As we shall see later, 'structured finance security' will avail outside the credit risk retention context of S. 3217, § 941(b).

Someone might suggest a different method of revising <*Senate ABS*>. Suppose that we merely insert, immediately after "collateralized by" (1044, 14), the expression ", or a fixed income or other security collateralized by a fixed income or other security collateralized by." This is a cumbrous expression. Even at that, it does not capture third-level ABSs, so that a CDO squared would require listing in a separate subparagraph. Suppose instead that we insert 'directly or indirectly' ahead of "collateralized by" (1044, 14). 'Directly or indirectly' might capture too much. It could be argued that any bond of a corporation owning CDOs is "indirectly" collateralized by SLOFs, and the same could even be said of its common stock. A CBO would still require a separate subparagraph. Insertion of either of the foregoing two expressions would also leave the text without a demarcated description of a ground-level ABS. Later we shall find reason for a cross-reference (within the new §15G of the Exchange Act, and within other provisions of Subtitle D) to the definition of a ground-level ABS. The revised text enables such a cross-reference to new § 3(a)(77)(A)(i).

1.4 *Proposed Revision of* <SEC SFP>

<SEC SFP> contains two incongruities of the sort just noted in *<Senate ABS.>*. First, *<SEC SFP>*'s definition of an ABS does not capture second-level ABSs, this because such securities are not primarily serviced by cash flows from SLOFs.[17] This treatment conflicts with common parlance—as exemplified in the SEC's own comment that CDOs are "types of asset-backed securities."[18] Second, *<SEC SFP>*'s enumeration presents the same problems noted in ¶1.2 that led to *<Senate ABS rev.>*[19] The solution is the same as before: recognize ABSs of various levels, but avoid mistakenly subsuming one level under another.[20] Assuming *<Senate ABS rev.>* in effect, this solution could be achieved as follows.

- Firstly, one could define 'asset-backed security' and 'structured finance security' in Rule 144A as such terms are defined in new Exchange Act § 3(a)(77)(A)(i) and (78).

- Secondly, one could define 'structured finance product' as "an asset-backed security, structured finance security, or any other security that at the time of offering is commonly known as a structured finance product."

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[17] 75 Fed. Reg. 23435, proposed 17 C.F.R. § 230.144A(a)(8)(ii) referencing 17 C.F.R. § 229.1101(c)(1).

[18] 75 Fed. Reg. 23330.

[19] The effect of "collateralized by" renders moot the difference between "principally serviced by" in 17 C.F.R. § 229.1101(c)(1) and "depend on" in proposed 17 C.F.R. § 230.144A(a)(8)(ii).

[20] *<Senate ABS>* as revised mentions no level higher than third. Higher levels may be recognized as ABSs by the SEC as and when such securities are created.

The second of the foregoing suggestions supposes that the Commission will have expanded the definition of 'asset-backed security,' as its sees fit, as authorized by Exchange Act § 3(a)(77)(A) (in both *<Senate ABS>* and *<Senate ABS rev.>*). Hence what is 'commonly known as'[21] need only be used here to include non-ABSs.

2. Analysis of Substantive Provisions

2.1 *Credit Risk Retention Provision*

2.1 [i] No Constraint of CDO Participants

Because § 941(b) of the Senate bill[22] provides for credit risk retention as to an ABS, a reader would naturally think that such requirement will bind as to all things defined as an ABS in § 941(a). But that understanding proves incorrect. A reader cannot reconcile the two subsections until eventually realizing that a mismatch has occurred between the scope of the defined term 'asset-backed security' and the reach of the rule using that term. This mismatch, devolving from the very terms of the rule in § 941(b), occurs independently of whether *<Senate ABS>* or *<Senate ABS rev.>* occupies § 941(a).[23]

The result is a credit risk retention provision that does not capture CDOs. We see this upon reviewing the SLOF securitization scenario to which § 941(b) refers. I illustrate by referring to a loan, but the structure is similar for any other kind of SLOF. A bank extends credit to a borrower, originating a loan. The loan originator, as is its custom, sells the loan to a securitizer of ABSs (a private party, Fannie Mae, or Freddie Mac). Having acquired many loans from originators, the securitizer classifies this loan with similar loans in what it calls a "pool." The securitizer then transfers the pool loans to a trust established solely for the purpose of issuing ABSs backed by the pool loans. Investors purchase these ground-level ABSs.

The foregoing sequence of transactions concludes with the loan originator

[21] The phrase used in proposed 17 C.F.R. § 230.144A(a)(8)(ii)(G)).

[22] Setting forth new §15G of the Exchange Act (1045, 16 to 1052, 2).

[23] The SEC's proposed amendments to Regulation AB couple (1) credit risk retention of 5% as a condition of eligibility for shelf registration and (2) *<SEC ABS>* (75 Fed. Reg. 23339, 23444, 23446). Standing apart is (3) *<SEC SFP>*. The mismatch evidently has originated from decoupling (1) and (2), then joining (1) with a revision of (3), viz., *<Senate ABS>*.

and the securitizer not bearing any risk of borrower defaults. Hence the transaction fees that originators and securitizers can earn in transactions of this sort provide an incentive to originate and securitize as many SLOFs as possible. The risk-free opportunity encourages a strategy of "originate to distribute." Our recent economic debacle has resulted in part from the origination and securitization of loans too large for their borrowers' financial capacities.

Requiring credit risk retention installs a countervailing incentive. S. 3217 would authorize rulemaking that would require a securitizer to retain at least 5% of the credit risk on assets transferred to an ABS issuer.[24] The bill also allows for allocating some risk to originators. H.R. 4173 appears to require that originators and securitizers each bear 5% of the risk unless the appropriate agency otherwise determines.[25]

As salutary as this policy plainly seems for the securitization of SLOFs, it does not apply to CDOs. It is framed in terms that do not comport with the structure of second-level ABSs. In the House and SEC credit risk retention provisions, the exclusion of ABSs from the reach of the rule is clear from the outset. The House and SEC provisions do not mismatch defined term and rule predicated upon it, since they each start with a definition of 'asset-backed security' that captures only ground-level ABSs (<*SEC ABS*>). Then, like § 941(b) of S. 3217, they impose credit risk retention by reference to parties and transactions peculiar to ground-level ABSs.[26] The following explains by reference to S. 3217 why these terms pertinent to ground-level ABSs do not fit second-level ABSs. In the issuance of a CDO, no "originator" of a financial asset (1046, 8–12) participates. A cash CDO issuer may

[24] As the SEC writes of its credit retention condition, "Retention of five percent net economic interest is intended to align incentives of sponsors with investors, such that the quality of the assets in the pool or other aspects of the offering is likely to be higher than for a securitization without risk retention. . . ." 75 Fed. Reg. 23339.

[25] H.R. 4173, § 1502, (312, 20–23).

[26] Although the House bill adverts to ABSs backed by assets other than loans (311, 17–23), it defines a 'securitizer,' on whom it imposes credit risk retention, by reference to securities backed by loans (319, 14–20), i.e., ground-level ABSs. All of its credit risk retention provisions are predicated on securities backed by loans. The House bill also provides for a study of the effect of credit risk retention by originators and securitizers on the real estate market. H.R. 4173, § 1506, (323, 12 to 324, 21)

acquire its collateral not from the organizer but in arm's length transactions in the open market where sellers do not retain interests in assets sold. The collateral will usually comprise asset-backed and other securities, and might not include any loans or unsecuritized obligations. In the case of synthetic CDOs, no one ever sells reference portfolio obligations to the issuer. The remaining provisions of the passage, (1047, 9 to 1052, 2), are rife with references that will be interpreted to confirm that senators had only ground-level ABSs in mind.

The CDO transactional party whose stake in the outcome matters—whose opportunity for short side profits evokes concern about conflict of interest—is the underwriter. But no allusion to an underwriter, by name or role, occurs in the credit risk retention provisions of the Senate, House, or SEC. (One might claim that an underwriter of a synthetic CDO "transfers assets" to the issuer when, acting as credit protection buyer, the underwriter pays premiums, but no indication appears that drafters had that in mind. Even if that interpretation prevailed, an underwriter could easily dodge the provision by arranging that some other firm be protection buyer.)

Even if S. 3217's credit risk retention provision could be stretched to reach CDOs, it would put the onus on the wrong entity. It would put the onus on the CDO issuer, defined as a "securitizer" (1046, 1–2). But a CDO issuer is a special purpose entity holding, or selling credit protection on, the portfolio obligations. Mandating that it retain 5% of the credit risk is pointless. The issuer already bears 100%. And thus so do its noteholders.

In addition to providing for the 5% rule, §941(b) confers authority for consideration and rulemaking about incentives for "imprudent origination" of SLOFs, disclosures concerning underlying loans and other SLOFs,[27] and encouragement of risk management practices. As there expressed, none of these provisions is applicable to second-level ABSs.

Not only would it be tedious to attempt to extend § 941(b) to second-level

[27] Extensive treatment of appropriate disclosures is given by the SEC in its proposed amendments to Regulation AB.

ABSs, but credit risk retention and the other provisions there found would not be an appropriate constraint for second-level ABSs. The reasons for this will become clear from the constraint that is proposed as appropriate in ¶4.

2.1 [ii] Clarifications Within Scope

Taking § 941(b) as what it is, a provision concerning ground-level ABSs, the text would benefit from the following revisions eliminating definitional discordances.

- ❑ To avoid the confusing impression that all ABSs are covered by the provisions that follow the definition of ABS in § 941(a), one could choose either of the following alternatives (here assuming adoption of <*Senate ABS rev.*>).

  - Subsection (b) of new § 15G of the Exchange Act may begin at (1046, 14) with "This section applies to all and only asset-backed securities described in section 3(a)(77)(A)(i))."

  - A definition may be added to subsection (b), § 15G at (1046, 13) of a 'ground-level asset-backed security' as "an asset-backed security described in section 3(a)(77)(A)(i))," and 'ground-level' may then be inserted, throughout the remainder of § 941(b), before each token of 'asset-backed security.'

- ❑ Subsection (a)(3)(A) of § 15G (1046, 1–2), which subsumes an ABS issuer within the definition of 'securitizer,' should be stricken.

  - The issuer of either a ground- or second-level ABS, whether corporation or trust, already bears 100% of the credit risk. Recognizing this, the SEC in proposed amended Regulation AB would impose credit risk retention only on the 'sponsor,' the SEC's term for the party described in subsection (a)(3)(B) of § 15G (1046, 3–7).[28] The House imposes credit risk retention only on the sponsor (there called a 'securitizer') and

[28] See 75 Fed. Reg. 23331, n. 47, 23339, 23444, 23446; 17 C.F.R. § 229.1101(l).

originator (called a 'creditor').[29]

- The notion of transferring assets "through the issuance of an asset-based security" (1046, 18–20) requires either metaphorical or metaphysical interpretation to gain purchase on a ground-level ABS. The text would be more straightforward if after "credit risk for" appeared "the assets collateralizing an asset-based security described in section 3(a)(77)(A)(i))."

2.2 *Disclosure Provisions*

We come to the remaining provisions of Title IX, Subtitle D (§§ 942–945) of S. 3217 and their correspondents in H.R. 4173. These confer authority on the SEC to issue rules concerning disclosure.

2.2 [i] Inapplicability to CDOs

In neither of the subtitles does a provision tailored to CDOs or other higher-level ABSs appear. Starting with S. 3217, we observe that where the topical references are specific, they concern ground-level ABSs. The topics include data relating to loan brokers, compensation of brokers and originators, originator risk retention, sponsor repurchase requests, and originator deficiencies in underwriting.[30] The bill provides for repeal of the exemption from the registration requirements of the Securities Act for offerings of mortgage-backed participation certificates, which are ground-level ABSs.[31]

The foregoing is consistent with the Senate committee report. Except for a reference to the harm that occurred when ground-level ABSs "were resecuritized,"[32] the report's discussion of Subtitle D dwells on ground-level ABSs. The explanation of such confined scope may lie in the fact that CDO vagaries did not draw general attention until the hearing of April 27.

[29] H.R. 4173, §1502, (312, 20–23), (319, 5–20). The issuer is called the "securitization vehicle."

[30] S. 3217, § 942, (1054, 5–10); § 943, (1055, 4–10).

[31] S. 3217, § 944, (1055, 13–18).

[32] Senate Committee on Banking, Housing, and Urban Affairs, Report 111–176, April 30, 2010, p. 128.

The House bill contains nearly the same provisions. None of them reach second- or higher-level ABSs.[33]

One provision in S. 3217 specific to ground-level ABSs contains a clause that reaches second-level, and untenably so.

- The provision of § 942 requiring disclosure of "asset-level or loan-level data" (1053, 23ff.) should be restricted to ground-level ABSs, this on pain of imposing an unreasonable demand on second-level issuers, who have no contact with originators or servicers of SLOFs. The restriction may be accomplished as described in ¶2.1 by beginning the section with a restrictive opening sentence, or by inserting the modifier 'ground-level.'

One other provision in S. 3217 possesses sufficient generality to reach second-level ABSs. It provides for rulemaking to require that an ABS issuer "perform a due diligence analysis of the assets underlying the asset-backed security" and "disclose the nature of the analysis."[34] This is a wise requirement. But a transactional party may, and often does, perform a due diligence review perfunctorily. In any case, a requirement for this exercise seems unlikely to remove a CDO's underwriter's incentive to earn a profit when presented with the opportunities for adverse portfolio selection to serve either its own interest in maintaining a short position in the portfolio or that of a tenacious short side counterparty.

Another provision states that "The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security."[35] This lone sentence appears general. But the fact that the practice of allocating collateral across tranches occurs in some ground-level ABSs, but not in

[33] H.R. 4173, §§ 1503–1506, (320, 19 to 324, 21). As noted, the House bill is predicated on <*SEC ABS*>.

[34] § 945, (1056, 6–17). There is no counterpart of this in H.R. 4173.

[35] § 942, (1053, 10–14).

higher-level ABSs, conjoined with the specificity of the passages that follow, confirm that the drafters had only ground-level ABSs in mind.[36]

2.2 [ii] Pending Rules Affirm Disclosure, No Constraints

In any case, the SEC has already issued the rules it thinks pertinent. These rules concentrate on ground-level ABSs. For some categories of underlying assets, they require extensive disclosures.[37]

The SEC goes on to make some provision for second-level ABSs. Its analysis starts from the recognition that most CDOs are not sold in registered offerings. So the SEC proposes to affirm that in private placements of secured finance products pursuant to Rule 144A or Rule 506, issuers shall disclose—if investors request it—the information that would be required were the offerings registered.[38] In its release though not in the rules, the SEC mentions that in a CDO offering, it "would expect" disclosure of information "about asset and collateral managers, including fees and related party transaction information, their objectives and strategies, any interest that they have retained in the transaction or underlying assets . . . ," and in a synthetic CDO offering, "the process for obtaining the credit default swap or other synthetic assets . . . ."[39] The Commission's proposal does not extend the foregoing policy to private placements pursuant to § 4(2) of the Securities Act or Regulation S.[40]

That an investor must ask for an extent of disclosure seems peculiar, but we may leave that aside. Instead let us observe the following. Disclosure in CDO transactions is already prolix. Offering memoranda routinely exceed 100 pages. So a

[36] This sentence also appears in H.R. 4173, § 1503, (321, 15 to 322, 10), but there its reach has already been confined, by § 1502, (318, 16–19), to ground-level ABSs.

[37] 75 Fed. Reg. 23354ff., 23395, 23357, 23422ff.

[38] 75 Fed. Reg. 23395–23396, 23435–6, 23439, 23496 concerning proposed amendments of 17 C.F.R. § 230.144A and 17 C.F.R. § 230.502 and addition of 17 C.F.R. § 230.192. The amended Rule 144 would also require disclosure of supplementary and periodic information such as would be required by Exchange Act § 15(d) were the offering registered. This requirement would not avail in the present context—this because satisfaction of the requirement would invariably occur too late to prevent harm from the conflict of interest that threatens (as identified in ¶4 below). Once the portfolio has been selected, the harm of adverse selection, if such has occurred, is done.

[39] 75 Fed. Reg. 23396.

[40] 75 Fed. Reg. 23417.

question arises. We should like to know the probable efficacy of disclosing, in documents of such girth, "any interest . . . retained in the transaction or underlying assets" by asset and collateral managers—or by underwriters, which escape mention in the SEC's comments. Would disclosure, without more, be likely to avert damage from the underwriter's conflict of interest? We shall take up this question in ¶3, after we have first specified that conflict of interest.

For now, we observe that the pending rules provide only for disclosure. They do not include any transactional constraint pertinent to an incentive of an underwriter to subvert a CDO portfolio if the underwriter wishes to maintain, or favor, a short position in the portfolio or notes.

2.3 *Summary of Legislative, Rulemaking Effects*

We may summarize what has been canvassed thus far, to wit, the omission of synthetic ABSs from the opening definition, the contradictions within the legislative and agency definitions of an ABS attempting inclusion of second-level ABSs, imposition of credit risk retention for ground-level ABSs, promulgation of disclosure requirements of great specificity about ground-level ABSs, and affirmation that in private placements pursuant to Rule 144A or Rule 502, issuers must make available on request the extent of information disclosed in registered offerings. In consequence, we observe the following.

1. Pending legislation does not regulate synthetic securities.

2. Credit risk retention is prescribed for offerings of ground-level ABSs, but nothing like it appears for offerings of second-level ABSs.

3. The combined effect of the bills and proposed regulations as to CDOs and other higher-level ABSs consists only in requiring that in some but not all private placements, issuers shall make available the extent of information provided in registered offerings.

(a) The foregoing assumes that the contradictions in the definition of 'asset-backed security' have been eliminated.

(b) In private placements, issuers already provide prolix disclosures.

(c) The disclosure requirement within the proposed regulations applies to synthetics.

4. The pertinent provisions want for any constraint, any inducement, any mechanism that would successfully remove or counteract an incentive that has punctured the integrity of the huge CDO market. That is the incentive to influence adversely the selection of portfolio obligations so as to avail a short position. The pending legislation and rules do not contain an effective counterincentive.

3. Disclosure of Conflict of Interest Insufficient to Prevent Harm

In a commentary on the present subject, I have undertaken to specify the conflict of interest that arises in CDO transactions. I begin there from a definition of a conflict of interest, then take account of the structure of a CDO transaction. I shall not try to recount here what is said there. Instead I limit the following to stating the conflict of interest, then replying to one argument pertinent to the situation just described in ¶2.2. This argument states that disclosure of a conflict of interest and the portfolio contents suffices to prevent harm, that disclosure in CDO offerings is feasible, and therefore that no legal constraint on conduct need be imposed. I sketch the reasoning to the contrary conclusion that a conflict obtains here for which disclosure will not suffice, and that a suitable constraint therefore should be sought.

1. Inherent in any CDO offering in which the underwriter wishes to maintain, or elects to favor, a short position in the portfolio or notes is a conflict of interest consisting in the intrinsic incompatibility between, on the one hand, the duty not to mislead investors in any material respect concerning the method and criteria used by the underwriter, or by a portfolio selection agent chosen by the underwriter, to select the issuer's portfolio obligations, and, on the other hand, a self-benefiting interest in crippling the portfolio while still attracting purchasers of the notes. An underwriter who chooses to exploit the opportunity presented has been compared to a promoter who fixes a boxing match, then bets on it.

2. In imagining the effects of disclosure, we have two sets of parties whose behavior matters, the set of transactional parties other than investors, and the set of investors. It is implausible that mere disclosure of a conflict of interest facing a member of the first set would suffice to suppress that party's behavior in response to incentives outside the transaction, and for years thereafter. It seems

no more likely that disclosures can be counted upon to suppress the response to powerful financial incentives than that Canute could command the tides. Disclosing an appetite does not quench an appetite—especially when a transaction dangles the prospect of huge profits.

3. So we turn to the question whether disclosing the instant conflict of interest and portfolio contents to investors would reliably result in their avoiding harm from that conflict. The market in CDOs is, in respect of information, far from efficient. A prospective institutional investor's window of time to consider a pending offering is small, often a matter of days. The SEC stresses how small that window is and expresses its concern about the adequacy of disclosure when CDOs are offered to sophisticated institutions. It voices this concern as to general disclosures even without considering the conflict of interest.[41]

4. Requiring the level of disclosure requisite for a registered offering will not effect any great boon in information about CDOs. The customary offering memoranda provided in CDO deals are already prolix. No express requirement obtains to discuss the portfolio selection process. A requirement could be added. But disclosure of the possibility of an underwriter's taking a short position has become so routine in prospectuses that it may not draw a reader's attention. (In respect of disclosing influence by credit default swap counterparties, the gravamen of *SEC v. Goldman, Sachs & Co.*[42], Goldman Sachs has argued that a broker-dealer is not permitted to disclose its customer's identities or transactions.) In all events, investors who read a description of the process of portfolio selection, accompanied by a disclosure of the underwriter's preserved opportunity to take a short position, will not likely learn enough from those passages to infer something reliable about the worth of the offered security. They might not even infer an effect of bias. A rational reader would infer from the typical description of credit expertise deployed,

[41] 75 Fed. Reg. 23330, 23331, 23333.

[42] In this case, the credit default swap counterparty allegedly profited from its influence on selection of the CDO reference portfolio. The conflict of interest described in the text arises and is objectionable if either the counterparty or the underwriter profits. An underwriter, if so inclined, can adversely influence the portfolio for its own benefit.

and the impression of alignment of economic interest with investors, stated or contextually implied, that the portfolio was composed to serve that common interest.

5. Should a security's worth lie under a cloud for the sake of allowing an underwriter a shorting opportunity that, for the integrity of the transaction and the markets, the underwriter could easily forego? The question seems to answer itself.

6. A short side counterparty may initiate a CDO deal by contacting an underwriter, and may have the time, leverage, and proximity to the underwriter with which to influence the portfolio. Investors usually lie remote from the underwriter. They do not act in concert, hence all are not bound by what some may say. A negotiation fully involving investors and a short side counterparty may be infeasible. The securities laws are designed to protect prospective investors regardless whether remote from the organizers of an offering. Why should the short side gain the inside track?

7. Even if an underwriter effects disclosure of transactional circumstances, a net short position presents an incentive to mislead. No one with a stake in the outcome is likely to serve well both short and long interests.

8. An offering of ground-level ABSs may not afford a transactional party an opportunity to buy protection in a credit default swap—i.e., to acquire a short position—in a pool of mortgages or other SLOFs. The sheer number of pooled assets will make their respective performance difficult to monitor. Such assets are not given credit ratings whose changes could be used to gauge performance, and a counterparty willing to sell credit protection may be difficult to find. The incentive that threatens in the case of ground-level ABSs is the incentive to originate loans and other SLOFs improvidently in the belief that they can be transferred and transferred again, at no risk to the originator or securitizer, while collecting transaction fees amounting to some small proportion of the principal amount. A requirement for credit risk retention establishes a countervailing incentive of considerable force. Second-level ABSs, though they inherit effects of improvident origination of assets collateralizing their collateral, pose an opportunity

for mischief not present in a ground-level offering. In a second-level offering, an opportunity arises for the underwriter acting as credit protection buyer to acquire, and thereafter maintain if it wishes, a short position that could result in collecting as much as the entire principal amount. Because the opportunity to short does not typically arise in ground-level offerings, it is small wonder that disclosure policies targeted at ground-level offerings do not protect against the conflict of interest posed in second-level deals.

9. The bills' requirement that credit default swaps trade through clearinghouses has been imagined to provide a way to expose a CDO underwriter's position. But it may be replied that exposure after the fact will not suffice to protect investors. Investors need protection against bias in putting a CDO portfolio together. The same may be said about the listing, if it occurs, of synthetic CDOs on exchanges. Descriptions of portfolio selection of the sort that issuers would likely publish would not give busy secondary investors a much better basis for inferring something reliable about the worth of a security than was had by those who received the offering memorandum.

Even if the process of portfolio selection were fully disclosed, to allow the inherent conflict of interest bruited here would be to place the risk of a skewed selection upon investors. The conclusion to be drawn is not that a bias is tolerable upon disclosure, but that given the duty not to mislead, a party should not presume to select securities for others whilst betting that the securities will decline.

4. Proposed Protective Incentive Against Adverse Portfolio Selection

If, for the protection of investors and the integrity of the markets, we insist that anyone who organizes a sale of securities backed by pooled financial assets must bear some of the credit risk borne by an investor in the assets, and therefore we endorse §941(b) as an counterincentive against carelessness in originating and transferring such assets, *a fortiori* should we insist on establishing such a counterincentive in those transactions that, by virtue of the credit default swap market, present the underwriter with a convenient way to short the pool. A CDO issuance is such a transaction. In the absence of constraint, a CDO underwriter may adversely influence the portfolio, then bet against the noteholders. This is an unsolved regulatory problem. Given the contretemps that an underwriter presently has the opportunity to use a CDO offering to others as a hedging instrument for itself, and the history in which underwriters have occasionally appeared to profit from what appeared to be adverse selection of what they sold, we have good reason to expect Congress and the SEC to do something about it.

We should clarify that in a typical public offering, one does not expect an underwriter to align in economic interest with the issuer. But in a typical offering, the underwriter has not selected the assets of the issuer. The underwriter of Alpha Automotive Corporation common stock has not told Alpha what plants to build or parts to buy. On the other hand, in a transaction in which the issuer is a shell corporation and the underwriter has an opportunity to influence selection of the issuer's assets *in toto*, the conflict of interest above specified arises when the underwriter is also afforded an opportunity to take a short position in that portfolio. For a transaction of this special sort, good reasons obtain to insist that an underwriter and selection agent align in economic interest with investors. To achieve this, we shall need some regulatory innovation.

The following presents a scheme of rules constructed so as to preclude one of the circumstances that bring to bear the instant conflict of interest. It may be thought of as imposing a constraint on transactional structure. The scheme works by removing the short side incentive. It thereby aligns the incentives of transactional parties with the interests of investors.

SEC. 946. ALIGNMENT WITH INVESTORS IN PORTFOLIO SELECTION.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 15G, as added by this Act, the following:

SEC. 15H. ALIGNMENT WITH INVESTORS IN PORTFOLIO SELECTION.

(a) An underwriter of collateralized debt obligations, an initial purchaser of collateralized debt obligations who enters into a transaction pursuant to 17 C.F.R. § 230.144A , any other party acting as protection buyer from the issuer, and any party acting as portfolio

> selection agent must, prior to the offering of such securities, obligate itself by contract to the indenture trustee for benefit of the noteholders that it will maintain an investor-aligned position in the issuer's portfolio obligations and in the notes until maturity of the notes, and that if it does not do so, it will disgorge to the trustee any profit from a net short position. An 'investor-aligned position' shall be a net long position of at least such magnitude, relative to the notional size of the offering, as the Commission by rule determines to be requisite so as to provide sufficient disincentive against effecting or favoring adverse selection of the portfolio. The Commission may elect to establish a higher such magnitude for offerings of synthetic securities.
>
> (b) An underwriter, initial purchaser, protection buyer, or portfolio selection agent shall disclose for benefit of prospective investors any attempt to influence selection of the issuer's portfolio obligations by any prospective or actual short side counterparty of any party acting as protection buyer, or by any other party believed to be interested in taking a short position in the notes or in any part of the portfolio. Such disclosure shall include the identities of any securities proposed by any such party for inclusion in the portfolio.
>
> (c) For structured finance securities (as defined in section 3(a)(78)) other than collateralized debt obligations, the Commission shall have the authority to establish by rule such provisions corresponding to subsections (a) and (b) as the Commission determines to be appropriate so as to provide sufficient disincentive against adverse selection of the issuer's portfolio.

I mention the following by way of explanation.

1. The goal of subsection (a) is to require an alignment of interests with investors sufficient to preclude action contrary to their interests, but not more. Just as the selection of 5% as the minimum extent of credit risk protection involves the exercise of judgment in light of empirical observations about incentive effects, a prudent selection of a minimum net long position will involve an assessment of expected incentive effects and a consideration of the effect of such rule on markets.

2. A net long rather than net neutral position is required because if the underwriter were to have no stake in the portfolio, it would lack sufficient incentive to promote the long interest of investors against the predictably insistent demands of the short side counterparty—the party that commonly initiates a CDO offering.

3. As is widely understood, in reckoning a party's net position one takes account of all pertinent holdings and credit default swaps. The bill or rulemaking could define a net position, although the Exchange Act elsewhere uses 'long or short position' without providing a definition (§ 11(a)(1)(D)).

4. The underwriter of a CDO will commonly act as credit protection buyer, thus acquiring a short position in the portfolio at the outset. But it can and, by virtue of (a), must offset that position. This imposes no objectionable restraint on an underwriter. The portfolio obligations of a CDO are not listed securities, are not requisites of an institutional investor's portfolio. There exist thousands of other securities in which the underwriter may invest, including CDOs. If the underwriter wants "exposure to" the short side of an economic sector, including precisely the sector represented by the offered CDO, the underwriter may buy credit protection from a stranger to the transaction. It might, for example, buy credit protection from another firm acting as protection buyer in another CDO offering.

5. A CDO underwriter's preclusion from maintaining a net short position in various ABSs may encumber its ability to act as market maker in those securities. In such case, other firms may step in to perform that function.

6. The foregoing provision may be thought of as the counterpart for higher-level ABSs of the credit risk retention rule imposed for ground-level ABSs.

7. This provision applies to synthetic CDOs by virtue of Exchange Act § 3(a)(77)(A)(ii)–(iv) as set forth in *<Senate ABS rev.>*.

8. The notion of achieving an alignment of interests is generalizable. Hence (c). Alignment with investors might be mandated for synthetic ground-level ABSs to which credit risk retention does not on its terms apply. The requirement might be imposed in any offering in which an underwriter has an opportunity both to compose and short the exclusive source of investor returns.

I offer the foregoing provision in the public interest so that the public may have confidence that, in a corner of the securities markets that rightly gives pause about conflicts of interest, our laws and regulations have intervened appropriately in service of the public interest and the protection of investors.

5. Commission Regulation of CDOs

We may summarize the regulatory effect on ground-level ABSs of the legislation and rulemaking presently in process by saying that they require disclosure and credit risk retention. Suppose now that legislation incorporates the encompassing definition <*Senate ABS rev.*> and the provision proposed in ¶4. We could then summarize the regulatory effect of legislation and rulemaking on second-level ABSs by saying that they require disclosure and alignment with investors in portfolio selection.

May we assume that those two rules exhaust the universe of appropriate policies? That assumption seems unwarranted—especially when we consider the havoc wreaked by securities of the sort in question. We should therefore not rest without searching for other prudent precautions.

It might be argued, for example, that insofar as investing in a structured finance security operates as economically akin to lending, banks and other regulated financial institutions should be required to count their investments therein as loans, and to maintain adequate reserves against such. It may also be observed that requirements for risk-based capital as to agency ABSs have at times been significantly lower than for other investments. So it might be urged that, in view of the higher risk of such securities than what had previously been supposed, risk-based capital requirements for such securities should be raised. More demanding reserve and risk-based capital rules could impose a salutary drag on proliferation of transactions posing systemic risk. The foregoing is a matter for the Federal Reserve, FDIC, and other banking authorities, concerning which S. 3271, § 112 provides for recommendations from the Financial Stability Oversight Council.

So far as securities regulation is concerned, rulemaking presents a path to achieving suitable constraints borne of the SEC's expertise. Hence the following proposed addition.

SEC. 947. FURTHER REGULATION FOR THE PROTECTION OF INVESTORS.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 15H, as added by this Act, the following:

SEC. 15I. OTHER PROTECTIONS OF INVESTORS IN STRUCTURED FINANCE SECURITIES.

The Commission shall have the authority to promulgate such rules governing transactions in structured finance securities (as defined in section 3(a)(78)) as the Commission deems appropriate in the public interest and for the protection of investors.

This provision would invite rulemaking that takes account of recent experience, changes in practices, and securities that future innovations introduce.

Appendix A

S. 3217

The Restoring American Financial Stability Act of 2010

as set forth in Amendment No. 3739

Title IX, Subtitle D

cial Services of the House of Representatives a report on the results of the study conducted under subsection (a).

Subtitle D—Improvements to the Asset-Backed Securitization Process

SEC. 941. REGULATION OF CREDIT RISK RETENTION.

(a) DEFINITION OF ASSET-BACKED SECURITY.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:

"(77) ASSET-BACKED SECURITY.—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.''.

(b) CREDIT RISK RETENTION.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 15F, as added by this Act, the following:

''SEC. 15G. CREDIT RISK RETENTION.

''(a) DEFINITIONS.—In this section—

''(1) the term 'Federal banking agencies' means the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation;

''(2) the term 'insured depository institution' has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c));

''(3) the term 'securitizer' means—

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

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

"(4) the term 'originator' means a person who—

"(A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and

"(B) sells an asset to a securitizer.

"(b) IN GENERAL.—Not later than 270 days after the date of enactment of this section, the Federal banking agencies and the Commission shall jointly prescribe regulations to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.

"(c) STANDARDS FOR REGULATIONS.—

"(1) STANDARDS.—The regulations prescribed under subsection (b) shall—

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

“(B) require a securitizer to retain—

“(i) not less than 5 percent of the credit risk for any asset that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer; or

“(ii) less than 5 percent of the credit risk for an asset that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if the originator of the asset meets the underwriting standards prescribed under paragraph (2)(B);

“(C) specify—

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

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

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

“(E) provide for—

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

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

"(2) ASSET CLASSES.—

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

"(B) CONTENTS.—For each asset class established under subparagraph (A), the regulations prescribed under subsection (b) shall establish underwriting standards that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a reduced credit risk with respect to the loan.

"(d) ORIGINATORS.—In determining how to allocate risk retention obligations between a securitizer and an originator under subsection (c)(1)(E)(ii), the Federal banking agencies and the Commission shall—

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

"(2) consider—

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

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

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

"(e) EXEMPTIONS, EXCEPTIONS, AND ADJUSTMENTS.—

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

"(2) APPLICABLE STANDARDS.—Any exemption, exception, or adjustment adopted or issued by the Federal banking agencies and the Commission under this paragraph shall—

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

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

"(3) FARM CREDIT SYSTEM INSTITUTIONS.—A Farm Credit System institution, including the Federal Agricultural Mortgage Corporation, that is chartered and subject to the provisions of the Farm

Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.), shall be exempt from the risk retention provisions of this subsection.

"(f) ENFORCEMENT.—The regulations issued under this section shall be enforced by—

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

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

"(g) AUTHORITY OF COMMISSION.—The authority of the Commission under this section shall be in addition to the authority of the Commission to otherwise enforce the securities laws.

"(h) EFFECTIVE DATE OF REGULATIONS.—The regulations issued under this section shall become effective—

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

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

SEC. 942. DISCLOSURES AND REPORTING FOR ASSET-BACKED SECURITIES.

(a) SECURITIES EXCHANGE ACT OF 1934.—Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)) is amended—

(1) by striking ''(d) Each'' and inserting the following:

''(d) SUPPLEMENTARY AND PERIODIC INFORMATION.—

''(1) IN GENERAL.—Each'';

(2) in the third sentence, by inserting after ''securities of each class'' the following: '', other than any class of asset-backed securities,''; and

(3) by adding at the end the following:

''(2) ASSET-BACKED SECURITIES.—

''(A) SUSPENSION OF DUTY TO FILE.—The Commission may, by rule or regulation, provide for the suspension or termination of the duty to file under this subsection for any class of asset-backed security, on such terms and conditions and for such period or periods as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

"(B) CLASSIFICATION OF ISSUERS.—The Commission may, for purposes of this subsection, classify issuers and prescribe requirements appropriate for each class of issuers of asset-backed securities.".

(b) SECURITIES ACT OF 1933.—Section 7 of the Securities Act of 1933 (15 U.S.C. 77g) is amended by adding at the end the following:

"(c) DISCLOSURE REQUIREMENTS.—

"(1) IN GENERAL.—The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.

"(2) CONTENT OF REGULATIONS.—In adopting regulations under this subsection, the Commission shall—

"(A) set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes; and

"(B) require issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data necessary for investors to independently perform due diligence, including—

"(i) data having unique identifiers relating to loan brokers or originators;

"(ii) the nature and extent of the compensation of the broker or originator of the assets backing the security; and

"(iii) the amount of risk retention by the originator and the securitizer of such assets.".

SEC. 943. REPRESENTATIONS AND WARRANTIES IN ASSET-BACKED OFFERINGS.

Not later than 180 days after the date of enactment of this Act, the Securities and Exchange Commission shall prescribe regulations on the use of representations and warranties in the market for asset-backed securities (as that term is defined in section 3(a)(77) of the Securities Exchange Act of 1934, as added by this subtitle) that—

(1) require each national recognized statistical rating organization to include in any report accompanying a credit rating a description of—

(A) the representations, warranties, and enforcement mechanisms available to investors; and

(B) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities; and

(2) require any securitizer (as that term is defined in section 15G(a) of the Securities Exchange Act of 1934, as added by this subtitle) to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.

SEC. 944. EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933.

(a) EXEMPTION ELIMINATED.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended—

(1) by striking paragraph (5); and

(2) by striking ''(6) transactions'' and inserting the following:

''(5) transactions''.

(b) CONFORMING AMENDMENT.—Section 3(a)(4)(B)(vii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(vii)(I)) is amended by striking ''4(6)'' and inserting ''4(5)''.

SEC. 945. DUE DILIGENCE ANALYSIS AND DISCLOSURE IN ASSET-BACKED SECURITIES ISSUES.

Section 7 of the Securities Act of 1933 (15 U.S.C. 77g), as amended by this subtitle, is amended by adding at the end the following:

"(d) REGISTRATION STATEMENT FOR ASSET-BACKED SECURITIES.—Not later than 180 days after the date of enactment of this subsection, the Commission shall issue rules relating to the registration statement required to be filed by any issuer of an asset-backed security (as that term is defined in section 3(a)(77) of the Securities Exchange Act of 1934) that require any issuer of an asset-backed security—

"(1) to perform a due diligence analysis of the assets underlying the asset-backed security; and

"(2) to disclose the nature of the analysis under paragraph (1).".

Subtitle E—Accountability and Executive Compensation

SEC. 951. SHAREHOLDER VOTE ON EXECUTIVE COMPENSATION DISCLOSURES.

The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 14 (15 U.S.C. 78n) the following:

Appendix B

H.R. 4173

The Wall Street Reform and Consumer Protection Act of 2009

Title I, Subtitle F

"(B) MINIMUM RESERVE RATIO.—The reserve ratio designated by the Board of Directors for any year may not be less than 1.15 percent of estimated insured deposits, or the comparable percentage of the assessment base set forth in paragraph (2)(C).".

(b) Section 3(y)(3) of the Federal Deposit Insurance Act is amended by inserting ", or such comparable percentage of the assessment base set forth in section 7(b)(2)(C)" before the period.

(c) For a period of not less than 5 years after the date of the enactment of this title, the Federal Deposit Insurance Corporation shall make available to the public the reserve ratio and the designated reserve ratio using both estimated insured deposits and the assessment base under section 7(b)(2)(C) of the Federal Deposit Insurance Act.

Subtitle F—Improvements to the Asset-backed Securitization Process

SEC. 1501. SHORT TITLE.

This subtitle may be cited as the "Credit Risk Retention Act of 2009".

SEC. 1502. CREDIT RISK RETENTION.

(a) AMENDMENT.—The Securities Act of 1933 (15 U.S.C. 77a et seq.) is amended by inserting after section 28 the following new section:

"SEC. 29. CREDIT RISK RETENTION.

"(a) IN GENERAL.—

"(1) INTEREST IN LOANS MADE BY CREDITORS.—Within 180 days of the date of the enactment of this section, the appropriate agencies shall prescribe regulations to require any creditor that makes a loan to retain an economic interest in a material portion of the credit risk of any such loan that the creditor transfers, sells, or conveys to a third party, including for the purpose of including such loan in a pool of loans backing an issuance of asset-backed securities.

"(2) INTEREST IN ASSETS BACKING ASSET-BACKED SECURITIES.—The appropriate agencies shall prescribe regulations to require any securitizer of asset-backed securities that are backed by assets not described in paragraph (1) to retain an economic interest in a material portion of any such asset used to back an issuance of securities.

"(b) ALTERNATIVE RISK RETENTION FOR CREDIT SECURITIZERS.—The appropriate agencies may apply the risk retention requirements of this section to securitizers of loans or particular types of loans in addition to or in substitution for any or all of the requirements that apply to creditors that make such loans or types of loans, if the agencies determine that applying the requirements to such securitizers would—

"(1) be consistent with helping to ensure high quality underwriting standards for creditors, taking into account other applicable laws, regulations, and standards; and

"(2) facilitate appropriate risk management practices by such creditors, improve access of consumers to credit on reasonable terms, or otherwise serve the public interest.

"(c) STANDARDS FOR REGULATION.—Regulations prescribed under subsections (a) and (b) shall—

"(1) prohibit a creditor or securitizer from directly or indirectly hedging or otherwise transferring the credit risk such creditor or securitizer is required to retain under the regulations;

"(2) require a creditor or securitizer to retain 5 percent of the credit risk on any loan that is transferred, sold, or conveyed by such creditor or securitized by such securitizer except—

"(A) an appropriate agency may specify that the percentage of risk may be less than 5 percent of the credit risk, or exempt such creditor or securitizer from the risk retention requirement, if—

"(i) the credit underwriting by the creditor or the due diligence by the securitizer meets such standards as an appropriate agency prescribes; and

"(ii) the loan that is transferred, sold, or conveyed by such creditor or securitized by such securitizer meets terms, conditions, and characteristics that are determined by an appropriate agency to reflect loans with reduced credit risk, such as loans that meet certain interest rate thresholds, loans that are fully amortizing, and loans that are included in a securitization in which a third-party purchaser specifically negotiates for the purchase of the first-loss position and provides due diligence on all individual loans in the pool prior to the issuance of the asset-backed securities, and retains a first-loss position; and

"(B) an appropriate agency may specify that the percentage of risk may be more than

5 percent of the credit risk if the underwriting by the creditor or due diligence by the securitizer is insufficient;

"(3) specify that the credit risk retained must be no less at risk for loss than the average of the credit risk not so retained; and

"(4) set the minimum duration of the required risk retention.

"(d) EXEMPTIONS AND ADJUSTMENTS.—

"(1) IN GENERAL.—The appropriate agencies shall have authority to provide exemptions or adjustments to the requirements of this section, including exemptions or adjustments relating to the percentage of risk retention required to be held and the hedging prohibition.

"(2) APPLICABLE STANDARDS.—Any exemptions or adjustments provided under paragraph (1) shall—

"(A) be consistent with the purpose of ensuring high quality underwriting standards for creditors, taking into account other applicable laws, regulations, or standards; and

"(B) facilitate appropriate risk management practices by such creditors, improve access for consumers to credit on reasonable terms, or otherwise serve the public interest.

"(e) APPROPRIATE AGENCY DEFINED.—For purposes of this section, the term 'appropriate agency' means any of the following agencies with regard to the respective loans and asset-backed securities:

"(1) BANKING AGENCIES.—The Federal banking agencies, the National Credit Union Administration Board, and the Commission, with respect to any loan or asset-backed security for which there is no appropriate agency under paragraph (2).

"(2) OTHER AGENCIES.—

"(A) With regard to any mortgage insured under title II of the National Housing Act, the Secretary of Housing and Urban Development.

"(B) With regard to any loan meeting the conforming loan standards of the Federal National Mortgage Corporation or the Federal Home Loan Mortgage Corporation or any asset-backed security issued by either such corporation, the Federal Housing Finance Agency.

"(C) With regard to any loan insured by the Rural Housing Service, the Rural Housing Service.

"(f) JOINT APPROPRIATE AGENCY REGULATIONS.—All regulations prescribed by the agencies identified in subsection (e)(1) shall be prescribed jointly by such agencies.

"(g) ENFORCEMENT.—

"(1) Compliance with the requirements imposed under this section shall be enforced under—

"(A) section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), in the case of—

"(i) national banks, and Federal branches and Federal agencies of foreign banks, by the Office of the Comptroller of the Currency;

"(ii) member banks of the Federal Reserve System (other than national banks), branches and agencies of foreign banks (other than Federal branches, Federal agencies, and insured State branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under section 25 or 25A of the Federal Reserve Act, bank holding companies, and subsidiaries of bank holding companies (other than insured depository institutions), by the Board; and

"(iii) banks insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System) and insured State branches of foreign banks, by the Board of Directors of the Federal Deposit Insurance Corporation;

"(B) section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), by the Director of the Office of Thrift Supervision, in the case of a savings association the deposits of which are insured by the Federal Deposit Insurance Corporation and a savings and loan holding company and to any subsidiary (other than a bank or subsidiary of that bank); and

"(C) the Federal Credit Union Act (12 U.S.C. 1751 et seq.), by the National Credit Union Administration Board with respect to any Federal credit union.

"(2) Except to the extent that enforcement of the requirements imposed under this section is specifically committed to some other Federal agency under paragraph (1), the Commission shall enforce such requirements.

"(3) The authority of the Commission under this section shall be in addition to its existing authority to enforce the securities laws.

"(h) EXCLUSIONS.—Notwithstanding any other provision of this section, the requirements of this section shall not apply to any loan—

"(1) insured, guaranteed, or administered by the Secretary of Education, the Secretary of Agriculture, the Secretary of Veterans Affairs, or the Small Business Administration; or

"(2) made, insured, guaranteed, or purchased by any person that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation.

"(i) DEFINITIONS.—For purposes of this section:

"(1) The term 'asset-backed security' has the meaning given such term in section 229.1101(c) of title 17, Code of Federal Regulations, or any successor thereto.

"(2) The term 'Federal banking agencies' means the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation.

"(3) The term 'insured depository institution' has the meaning given such term in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

"(4) The term 'securitization vehicle' means a trust, corporation, partnership, limited liability entity, special purpose entity, or other structure that—

"(A) is the issuer, or is created by the issuer, of pass-through certificates, participation certificates, asset-backed securities, or other similar securities backed by a pool of assets that includes loans; and

"(B) holds such loans.

"(5) The term 'securitizer' means the person that transfers, conveys, or assigns, or causes the transfer, conveyance, or assignment of, loans, including through a special purpose vehicle, to any securitization vehicle, excluding any trustee that holds such loans for the benefit of the securitization vehicle.".

(b) STUDY ON RISK RETENTION.—

(1) STUDY.—The Board, in coordination and consultation with the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Securities and Ex-

change Commission, shall conduct a study of the combined impact by each individual class of asset-backed security of—

(A) the new credit risk retention requirements contained in the amendment made by subsection (a); and

(B) the Financial Accounting Statements 166 and 167 issued by the Financial Accounting Standards Board.

(2) REPORT.—Not later than 90 days after the date of enactment of this title, the Board shall submit to Congress a report on the study conducted under paragraph (1). Such report shall include statutory and regulatory recommendations for eliminating any negative impacts on the continued viability of the asset-backed securitization markets and on the availability of credit for new lending identified by the study conducted under paragraph (1).

SEC. 1503. PERIODIC AND OTHER REPORTING UNDER THE SECURITIES EXCHANGE ACT OF 1934 FOR ASSET-BACKED SECURITIES.

Section 15(d) of Securities Exchange Act of 1934 (15 U.S.C. 78o(d)) is amended—

(1) by inserting ", other than securities of any class of asset-backed security (as defined in section

229.1101(c) of title 17, Code of Federal Regulations, or any successor thereto),'' after ''securities of each class'';

(2) by inserting at the end the following: ''The Commission may by rules and regulations provide for the suspension or termination of the duty to file under this subsection for any class of issuer of asset-backed security upon such terms and conditions and for such period or periods as it deems necessary or appropriate in the public interest or for the protection of investors. The Commission may, for the purposes of this subsection, classify issuers and prescribe requirements appropriate for each class of issuer of asset-backed security.''; and

(3) by inserting after the fifth sentence the following: ''The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security. In adopting regulations under this subsection, the Commission shall set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes. The Commis-

sion shall require issuers of asset-backed securities at a minimum to disclose asset-level or loan-level data necessary for investors to independently perform due diligence. Asset-level or loan-level data shall include data with unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or the securitizer of such assets.''.

SEC. 1504. REPRESENTATIONS AND WARRANTIES IN ASSET-BACKED OFFERINGS.

The Commission shall prescribe regulations on the use of representations and warranties in the asset-backed securities market that—

(1) require credit rating agencies to include in reports accompanying credit ratings a description of the representations, warranties, and enforcement mechanisms available to investors and how they differ from representations, warranties, and enforcement mechanisms in similar issuances; and

(2) require disclosure on fulfilled repurchase requests across all trusts aggregated by originator, so that investors may identify asset originators with clear underwriting deficiencies.

SEC. 1505. EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933.

(a) IN GENERAL.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended—

(1) by striking paragraph (5); and

(2) by redesignating paragraph (6) as paragraph (5).

(b) CONFORMING AMENDMENT.—Section 3(a)(4)(B)(vii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(vii)(I)) is amended by striking ''4(6)'' and inserting ''4(5)''.

SEC. 1506. STUDY ON THE MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS.

(a) STUDY REQUIRED.—The Chairman of the Financial Services Oversight Council shall carry out a study on the macroeconomic effects of the risk retention requirements under this subtitle, and the amendments made by this subtitle, with emphasis placed on potential beneficial effects with respect to stabilizing the real estate market. Such study shall include—

(1) an analysis of the effects of risk retention on real estate asset price bubbles, including a retrospective estimate of what fraction of real estate losses may have been averted had such requirements been in force in recent years;

(2) an analysis of the feasibility of minimizing real estate price bubbles by proactively adjusting the percentage of risk retention that must be borne by creditors and securitizers of real estate debt, as a function of regional or national market conditions;

(3) a comparable analysis for proactively adjusting mortgage origination requirements;

(4) an assessment of whether such proactive adjustments should be made by an independent regulator, or in a formulaic and transparent manner;

(5) an assessment of whether such adjustments should take place independently or in concert with monetary policy; and

(6) recommendations for implementation and enabling legislation.

(b) REPORT.—Not later than the end of the 180-day period beginning on the date of the enactment of this title, the Chairman of the Financial Services Oversight Council shall issue a report to the Congress containing any findings and determinations made in carrying out the study required under subsection (a).