

HAWKINS ADVISORY

SEC PROPOSES TO EXEMPT MUNICIPAL SECURITIES FROM RISK RETENTION RULES

The Securities and Exchange Commission (the “SEC”) today approved for public comment proposed rules implementing the risk retention provisions (Section 941) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). **The proposed rules would provide a complete exemption for municipal securities.** The proposed rules also provide a complete exemption for qualified scholarship funding bonds as defined in the federal tax code. This Advisory supplements and updates the Hawkins Advisory of January 25, 2011, entitled “SEC ADOPTS RULES FOR ASSET-BACKED SECURITIES.” In that Advisory, we noted that whether Section 941 would apply to municipal securities would be determined by subsequent rulemaking.

Section 941 directed the SEC and the Federal banking agencies (Comptroller of the Currency, Federal Reserve, and the Federal Deposit Insurance Corporation) to adopt regulations to require a securitizer¹ to “retain an economic interest in a portion of the credit risk for any asset that the securitizer” uses to secure an asset-backed security. The concerns expressed by Congress² were two: (1) because loans were being made expressly to be sold into securitization pools, the lenders did not expect to bear the credit risk of borrower default, which led to significant deterioration in credit and loan underwriting standards and (2) it was very difficult for investors in asset-backed securities to assess the risks of the underlying assets. Congress recognized, however, that municipal securities were not in general subject to these concerns, and accordingly directed the SEC and the Federal banking agencies to provide a total or partial exemption for asset-backed securities that were municipal securities.³ In proposing the exemption, the SEC⁴ explained as follows:

In light of the special treatment afforded such securities by Congress, the directive in section 15G(c)(1)(G)(iii), and the role of the State or municipal entity in issuing, insuring, or guaranteeing the ABS or collateral, the Agencies are proposing to exempt such

ABS from the risk retention requirements of the rule as an exemption that is appropriate in the public interest and for the protection of investors.

There are a number of general exemptions in the proposed rules, including:

(3) Any asset-backed security that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2)); and

(4) Any asset-backed security that meets the definition of a qualified scholarship funding bond, as set forth in section 150(d)(2) of the Internal Revenue Code of 1986 (26 U.S.C. 150(d)(2)).

For those asset-backed securities that are subject to the proposed rules, in general the securitizer will be required to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities.

The proposed rules are out for comment, and comments are due by June 10, 2011. In requesting comments, the following questions were asked:

Is the proposed exemption for ABS issued or guaranteed by a State or municipal entity appropriate?

Is it under or over-inclusive? There may be some ABS in which the sponsor is a municipal entity (i.e., a State or Territory of the United States, the District of Columbia, any political subdivision of any State, Territory or the District of Columbia, or any public instrumentality of one or more States, Territories or the District of Columbia), however, the ABS are issued by a special purpose entity, that is created at the direction of the municipal entity, but are not issued or

¹ The term “securitizer” includes any issuer of an asset-backed security and a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets to the issuer.

² S. Rep. No. 111-176, at 128 (2010).

³ Section 15G(c)(1)(G)(iii) of the Securities Exchange Act of 1934, as added by the Dodd-Frank Act, directed the SEC and the Federal banking agencies to provide: a total or partial exemption for any asset-backed security that is a security issued or guaranteed by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act . . . as may be appropriate in the public interest and for the protection of investors.

⁴ The proposed rules are set forth in a joint release of the Department of the Treasury, the Federal Reserve System, the Federal Deposit Insurance Corporation, the SEC, the Federal Housing Finance Agency, and the Department of Housing and Urban Development (defined collectively in such release as the “Agencies”). The SEC proposal was approved for comment on March 30, 2011. The proposed rules are available from the Federal Reserve website through this link: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110329a1.pdf>

guaranteed by the municipal entity. Should the rules also exempt from the risk retention requirements asset-backed securities where the sponsor is a municipal entity?

There are some municipal ABS that are issued by a municipal entity and exempt by reason of Section 3(a)(2) of the Securities Act but may include assets originated using the same underwriting criteria as private label securitizations. Should the rules, as proposed, exempt them?

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