On December 24, 2015, U.S. rules for risk retention\(^1\) took effect with respect to the issuance of residential mortgage-backed securities, and on December 24, 2016, these rules will take effect for securitizations of all other asset classes. The rules, which were adopted by multiple regulatory agencies pursuant to the requirements of the Dodd-Frank Act,\(^2\) represent a significant change in the offering of asset-backed securities, and impose substantial new regulatory obligations on “sponsors” or “securitizers”—essentially, the parties who organize and initiate the offering of asset-backed securities, and in many instances who also are “originators” of the securitized assets. Specifically, the new rules generally require certain parties to have and retain an “Eligible Vertical Interest” or an “Eligible Horizontal Residual Interest” or a combination thereof, generally representing at least 5% of the credit risk of the securitized assets, either directly or through certain affiliates, on an unhedged credit basis, for the duration of the transaction or a large portion thereof.

The Securitization and Structured Finance Committee and the Legal Opinion Committee of the American Bar Association’s Business Law Section have formed a joint task force (the “Task Force”)\(^3\) to discuss the issues regarding legal advice that the implementation of the risk retention rules will pose for all transaction participants. This report addresses the Task Force’s preliminary conclusions with respect to the delivery of third-party legal opinions related to risk retention in securitizations. It does not address the nature or form of legal advice that lawyers may give to their own clients. This report reflects only the views of its authors and has not been submitted for approval to the American Bar Association, the Business Law Section, the Securitization and Structured Finance and Legal Opinions Committees or to any other bar association or other organization. Further, this report does not necessarily reflect the views of the law firms with which the authors are associated.

Market participants and their counsel are actively considering in what form, and to what extent, legal advice with respect to compliance with the rules will be necessary or appropriate. Legal advice to clients, and the memorialization, if applicable, of such advice, can be tailored to meet the needs of the specific clients, reflecting among other considerations the clients’ sophistication, cost sensitivity and risk tolerance. However, the issuance of third-party legal opinions in the context of a nascent area of the law is often problematic for all concerned. A third-party legal opinion is intended to reflect the opinion giver’s professional judgment about

\(^{1}\) Credit Risk Retention; Rule, Federal Register, Vol. 79 No. 247 (December 24, 2014), pp.77602ff.

\(^{2}\) The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub.L. 111-203

\(^{3}\) [List of Task Force members to come.]
how the highest court in the applicable jurisdiction would appropriately resolve the issues addressed in the opinion.\footnote{1998 Tri-Bar Report (from Business Lawyer at 595-6); available at: http://apps.americanbar.org/buslaw/tribar/materials/20050303000003.pdf.} Third-party legal opinions also typically reflect the “customary practice” of opinion givers, which customary practice includes a common understanding of the language used in the opinion and expectations as to customary due diligence.\footnote{Id.} However, no judicial decisions have been issued with respect to any aspect of the risk retention rules, and there is as yet no customary practice or understanding—nor is there much by way of guidance, other than that contained in the preamble to the rules’ adopting release. Moreover, to the extent market participants noted ambiguities in the proposed rule text before its final adoption, in many cases those ambiguities were not addressed in the final rule and remain unresolved.

In addition, many of the key aspects of the analysis rely on facts—such as whether the sponsor has a controlling financial interest in the retention holder, whether the fair value determinations are appropriate, or whether assets that are purported to be qualifying assets satisfy the relevant criteria—that will be outside the expertise of the lawyer. Such facts would have to be assumed, and in many instances there would likely be little law remaining to be addressed after taking into account such assumptions.\footnote{In other circumstances where an analysis would rely heavily on facts outside the attorney’s expertise, common practice is generally not to give legal opinions. The Task Force notes fraudulent transfers as an example of a legal opinion not typically given by law firms due to the complexity of the factual analysis. The “bankruptcy exception,” the uniformly accepted qualification in third-party closing opinions, applies to exclude fraudulent transfers from the remedies opinion.} The problems presented by heavy reliance on factual assumptions would likely be compounded by questions of materiality, with neither lawyers nor those providing factual confirmations having much guidance as to what would be considered “material” in the context of the rules. As discussed below, the issues that affect risk retention compliance, and the factual circumstances on which compliance would be founded, differ so significantly from one structure to the next that Task Force members would find it extremely difficult, if not impossible, to develop a relatively standardized form of reasoned third-party opinion that could be tailored to specific situations, meaning that the cost of opinions would be high relative to their value.

The current state of the law and practice therefore makes it difficult to predict how the “highest court” in a jurisdiction would interpret the rules, and also means that there would be no baseline expectations that would inform either the opinion giver or the opinion recipient as to the scope or language of an opinion.

\textit{The Risk Retention Rules}

The risk retention rules place the responsibility on the sponsor or securitizer of a transaction to hold (or, in some circumstances, to cause to be held) risk in a permitted form, in a
minimum amount, and in compliance with certain restrictions on hedging and transfer. The rules include relatively complicated provisions about the form in which the retained interests have to be held, which persons are permitted holders of those interests, and the conditions under and duration for which the interests must be held. In many cases these provisions depend on the asset class and the structure of the related transaction, and include a number of tailored provisions for certain asset classes, as well as special rules for “qualifying” assets within certain asset classes. The rules also include requirements as to the value of the retained interest and certain disclosure and reporting obligations. While there are no specific penalties articulated in the rules for the failure to comply, since the statutory risk retention requirements have been codified in Section 15G of the Securities Exchange Act,7 the Task Force’s understanding is that regulators would be able to enforce such rules using their enforcement authority under Section 15G(f) of that Act as well as their general enforcement authority with respect to regulations they have appropriately adopted.

Ultimately, the application of these rules to a specific securitization is likely to be extremely fact-dependent. Some of the questions that may arise under the risk retention rules are the following:

- Is the transaction a securitization such that the rules apply?
- Who is the sponsor/securitizer?
- What categories of persons (e.g., majority-owned affiliates of the sponsor, wholly owned affiliates of the sponsor, an originator of the assets, a third-party investor who conducts independent diligence or a lead arranger) may hold the retained interest for a securitization for an asset class with a given structure?
- Does the person who will hold the retained interest meet the requirements to be considered a member of the category of permitted holders (e.g., is the person a majority-owned affiliate of the sponsor under relevant legal analysis and, if applicable, generally accepted accounting principles)?
- Does the interest satisfy the rules as to the form and amount of the interest that must be retained?
- If applicable, do the assets meet the requirements for classification as “qualifying” assets within a particular category?
- Are any financing structures or capital raising activities of the sponsor or its affiliates consistent with the prohibitions on hedging the retained interest?
- Is the disclosure with respect to the retained interests and who holds them compliant with the requirements of the rules?

7 Codified at 17 CFR 246.
The Task Force understands that clients will seek guidance with respect to these questions and others. No doubt there will be some transactions for which the answers to these questions are clear and can be provided with a high degree of certainty. However, for the reasons given above there will likely be numerous cases in which the clarity required for the delivery of a third-party legal opinion is not attainable until common practices develop and regulators or courts provide interpretive assistance. In the absence of such clarity, the Task Force believes that clients should receive and will need to rely on a range of guidance, analysis, structuring options and risk assessments. This would include advice as to how best to conduct due diligence on “qualifying” assets, on the types of factual support a client should obtain, and on the type of accounting conclusions (and how these are expressed) that will need to be reached by the client’s auditors (or in some cases, another accounting firm). It could also include reasoned analyses evaluating proposed structures and key areas of legal uncertainty (which may or may not be in writing), including legal assessments, so that clients will be able to make their own determination of the amount of legal risk inherent in a particular structure or approach with the full benefit of their lawyers’ analysis and conclusions. Lawyers will likely find it easier to identify circumstances in which the rules are not met, or in which there is sufficient uncertainty that proceeding with a transaction would be unwise, than to identify circumstances in which a transaction clearly and cleanly falls within the rules. Certainly Task Force members do not currently expect such transactions to be identified with the regularity that would allow the market to establish a convention in which lawyers would be expected to state, to their clients or others, something along the lines of “This transaction will comply with the risk retention rules.”

Third-Party Legal Opinions

In light of the uncertainty in this area, and the qualified nature of the advice lawyers expect to have to give to their clients, Task Force members have had extensive discussions about the appropriateness of third-party legal opinions relating to risk retention and whether third parties, such as the underwriters of the securities being issued, would need or have a right to expect such opinions. Except to the extent of the underwriters’ statutory due diligence defense, which is discussed in the following paragraph, the Task Force believes the answer is that generally they would not.

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8 The Task Force acknowledges that lawyers may have a higher degree of legal certainty with respect to some structures and circumstances than others. A vertical strip, for example, does not have the issues with respect to fair value that a horizontal interest presents. As another example, in structures where there is only a single entity that might be considered the sponsor and that entity holds the risk retention itself, rather than through an affiliate, lawyers will likely be fairly comfortable that the retained risk is held by an appropriate person. Transactions in which the sponsor obtained no financing to support the retained interests and had an enterprise-wide policy that prohibited hedging activity related to credit risk do not raise the same issues that are raised by comparable transactions in which financing is obtained or limited hedging—intended to be in compliance with the rule—is conducted. However, the Task Force believes that transactions that present few issues will be much rarer than those that present many, and a market standard regarding legal opinions should not be established based on what may be possible in the context of the simplest structures and least complicated facts.
Despite the general lack of clarity with respect to the detailed application of the risk-retention rules, the Task Force recognizes that underwriters may require customary assurances with respect to disclosures about risk retention to support their due diligence defense under the Securities Act. The risk retention rules generally require specific disclosures regarding the person holding the retained interests, the form in which those interests are being held, and certain fair value determinations and assumptions. The customary assurances provided to underwriters would generally be in the form of a negative assurance or so-called “10b-5” letter, in which the issuer’s attorneys confirm that no matters have come to their attention that have caused them to believe that the disclosures make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Such negative assurance or 10b-5 letters typically exclude financial and statistical information, as being outside the purview of the lawyers, and the Task Force would expect that exclusion to extend to and include any fair value calculations.

Negative assurance letters are not legal opinions. They are statements of belief, by the lawyers involved in preparing the relevant disclosure document and familiar with the relevant securities laws and other relevant legal matters. The 2008 revision to the report on negative assurance letters prepared by the Subcommittee on Securities Law Opinions of the Committee on Federal Regulation of Securities of the ABA Business Law Section noted that “[v]irtually all negative assurance letters state that counsel does not assume any responsibility for the accuracy, completeness, or fairness of the offering document, except to the extent that specific sections are addressed in a separate opinion or confirmation.”9 The report further notes that:

When other counsel has been retained to advise the issuer on a particular aspect of a transaction (e.g., tax, foreign law, intellectual property, or regulatory matters), such counsel usually addresses the portion of the offering document dealing with that matter by giving an opinion on the accuracy of the description rather than by providing negative assurance.10

Given these limits on the role and scope of a negative assurance letter, the general consensus of the Task Force was that risk retention disclosures generally would not need to be excluded from negative assurance letters. The Task Force further concluded that, in giving such negative assurance letters, the provider would not be giving any positive assurance as to compliance with the risk retention rules or as to any other regulatory matters. Rather, counsel would be confirming that nothing had come to their attention that caused them to believe that the disclosures with respect to risk retention contain any untrue statement of a material fact or omit to state a material fact necessary in order to make such statements, in the light of the circumstances under which they were made, not misleading. Consistent with the longstanding meaning of that confirmation, recipients should understand that they are not receiving an opinion as to compliance with law.


10 Id. At 404.
By contrast, the general consensus view of the Task Force was that third-party legal opinions would not be appropriate with respect to risk retention. Except as noted above with respect to disclosures, the obligation to comply, and the consequences of the failure to comply, generally falls entirely on the sponsor or securitizer. Accordingly, while disclosures about retained interests are important (and required under the rules) so that investors can better understand the alignment of interest between the sponsors and investors, the technical question of whether those retained interests are held as required under the rules does not have the same import. Thus, in light of the very significant issues discussed above, the Task Force is of the view that the uncertainty associated with giving third-party legal opinions—together with the lack of customary practice that would inform the recipient’s understanding of the scope and limits of such opinions—at the present time argues against providing such third-party legal opinions.11

Third-party closing legal opinions serve very specific and well understood purposes in transactions. Those purposes include providing comfort to the third party that the entity with which it is contracting has the legal standing to do so and has taken the steps necessary to enter into an enforceable agreement. Third-party legal opinions can also be used for a more focused analysis and make parties aware of areas of legal uncertainty with respect to a transaction. It is not, however, the lawyer’s role in giving third-party legal opinions to insure the recipient against legal uncertainty.

The Task Force notes that, beginning as of the effective date of the risk retention rules, it may be necessary for lawyers giving typical third-party closing legal opinions to ensure that their opinions do not inadvertently provide an opinion as to compliance with the risk retention rules. In particular, depending on the nature of current qualifications in their opinions, practitioners giving a “no violation of laws” opinion may wish to note expressly that they are not giving an opinion as to whether the transaction complies with the risk retention rules.

The Task Force expects practice with respect to risk retention opinions to develop over time, but believe that setting realistic baseline expectations regarding what is currently practicable may be helpful to all market participants.

11 The Task Force also expects to continue its discussions of third-party legal opinions in the context of the risk retention rules after the issuance of this report.