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eMortgage Implementation Considerations

By Margo H. K. Tank and Frank J. Supik

Introduction

Many businesses have begun converting their operations to avail themselves of the enormous advantages offered by electronic records systems.¹ They are doing so by utilizing the Electronic Signatures in Global and National Commerce Act (“ESIGN”)² and the Uniform Electronic Transactions Act (“UETA”),³ the two primary statutes that permit the use of electronic records⁴ and electronic signatures.⁵ Enactment of ESIGN and the rapid state adoption of UETA has made possible the widespread replacement of paper documents with electronic records and the use of electronic signatures.

While ESIGN and UETA make it possible to present information and sign agreements and other documents electronically in circumstances where a written document and a “wet” signature would previously have been required, both laws require that electronic systems and processes meet specific standards for presentation of information, execution of signatures, record retention, printing and delivery. Failure to meet those standards will impair the enforceability of electronic records. Thus, the design of a system for signing electronic records, or delivering notices or disclosures electronically, requires a detailed understanding of the interaction between the electronic processes and the legal requirements.

However, eMortgage implementations are complex, requiring compliance with federal state and local laws, evolving industry standards and secondary market investor requirements. Advance planning and consideration of these and other factors is essential to successfully creating an eMortgage business process. However, careful analysis of the business and regulatory considerations applicable to the type of eMortgage implementation you plan to create, as well as consideration of investor requirements, can result in an eMortgage system that complies with applicable law while increasing quality and decreasing origination costs and processing time.

This article presents a range of issues associated with the development of an eMortgage program. Considering these issues up front will help ensure that your eMortgage implementation is done correctly, the first time. Below, we outline some considerations at certain stages in the mortgage life-cycle: (1) Application; (2) Closing; (3) Custody; (4) Secondary Market Sale. We also outline certain requirements for sellers/servicers interested in selling eNotes to the Government-Sponsored Enterprises (“GSEs”), Fannie Mae and Freddie Mac.⁶ The GSEs’ requirements apply only to those entities that

sell eMortgages to Fannie Mae or Freddie Mac, respectively; however, many industry participants are likely to review and consider their requirements when developing an eMortgage origination system.

eMortgage Implementation Considerations

1) Application

Using the Internet to electronically deliver information required to be provided by law "in writing" to Consumers⁷ (i.e., state and federal notices and disclosures) ("Required Information") will save record providers⁸ time and money. However, doing so requires careful design and implementation of the record delivery process. When considering the delivery of disclosures and other information to consumers in an eMortgage implementation, a record provider must consider:

- What kind of credential (such as a PIN, password, or other unique identifier) will appropriately be issued to the borrower, to identify the borrower when he or she accesses the lender's eMortgage system;
- Whether the borrower will be asked to sign any electronic records, and if so, what kind of electronic signature or electronic signature process will be used;
- How to effectively explain the use of electronic records and electronic signatures to borrowers so that they will understand the significance of their actions and adequately demonstrate their intent to create a legally binding signature;
- Obtaining the borrower's consent to use electronic records and signatures (including the timing and format of that consent);
- How to document the eMortgage processes so that the lender or service provider can prove that the borrower consented to use electronic records and signatures, as well as prove that the appropriate materials (including any required disclosures) were, in fact, provided to the borrower and that the borrower consented to receive information electronically in accordance with ESIGN and UETA;
- In what technological format (e.g., HTML, PDF) to present information and in by which method, email or Internet or both;
- How to present this information that meets all applicable regulatory requirements, including the technical format (e.g., HTML, PDF) and the document layout (e.g., the use of colors, hyperlinks, pop-up boxes and other methods of displaying information);
- If the preclosing process will system will support multi-borrower transactions, and if so, how to deliver the information to all borrowers at the appropriate time.

Developing legally sufficient processes for the delivery of opening package disclosures is a critical beginning to the eMortgage process. Failing to provide Required Information in the correct format, at the right time in the transaction or without obtaining all affected borrowers' consents could have legal consequences. Neither ESIGN nor UETA impose fines or other traditional penalties on record providers who provide Required Disclosures to Consumers without complying with ESIGN's consumer consent process. However, notwithstanding actual delivery of the Required Disclosures (e.g., Consumer acknowledged receipt), arguably a failure to comply with the ESIGN Consumer Consent Process could result in the ineffective delivery of Required Disclosures.

As such, the entity providing the Required Disclosures would be subject to the consequences that such a failure would have under the underlying substantive law. Thus, for example, if a lender electronically delivers certain Truth in Lending disclosures to a Consumer but does not validly obtain the Consumer's consent to the use of electronic records, then the disclosures will not be deemed to be provided to the Consumer, for Regulation Z's purposes. This would result in a statutory violation of the Truth in Lending Act. Accordingly, Regulation Z's time period for the right of rescission would not begin to run, providing the consumer with the right to void the transaction, recover all amounts paid to the creditor (including finance charges) and require the creditor to terminate its security interest in the debtor's property.⁹

Nevertheless, the failure to validly obtain the Consumer's consent to the electronic provision of Required Disclosures will not necessarily impair the effectiveness of the underlying contract. "The legal effectiveness, validity, or enforceability of any contract executed by a consumer shall not be denied solely because of the failure to obtain electronic consent or confirmation of consent by that consumer in accordance with paragraph [101(c)](1)(C)(ii)."¹⁰ Thus, in our previous example, the underlying loan would not be unenforceable simply due to a failure to have the Consumer properly complete the ESIGN Consumer Consent Process. However, as a practical matter, the failure to timely deliver material Truth in Lending Act disclosures could nonetheless render the transaction voidable at the Consumer's option.

2) Closing

The closing is the process by which borrowers and other transaction parties sign loan documents in order to take record ownership of a home. All parties to the transaction are interested in ensuring that the electronic closing transaction is enforceable. The closing of an eNote generally requires their use of a specialized platform, generally referred to as an eClosing System. An eClosing System is typically a web-based platform that allows transaction parties (i.e., lender, closing agent,

borrower, notaries) to electronically review, sign, store and transfer loan closing records.¹¹

There are many considerations in developing an eClosing system. Some of the significant issues that must be considered include the processes surrounding:

- Obtaining the borrower's consent to use electronic records and signatures at closing;
- Creating and executing an eNote and/or electronic security instrument;
- Applying a notary public's signature and seal, where necessary;
- Applying a tamper-evident seal to protect the signed eNote;
- Interfacing with other electronic systems, such as the MERS® eRegistry;
- Storing electronic records including the eNote in a secure location (commonly referred to an eVault") that are executed at closing;
- Ensuring that the eVault can enable a transfer of control (eNote ownership) as required under ESIGN and UETA;¹²
- Creating an audit trail for the transaction to prove the eNote's chain of custody;
- How title insurance requirements are affected by eClosing processes;¹³
- Addressing data privacy and ensuring the adequate safeguards for the security of consumer information are in place.¹⁴

3) Custody

After closing a loan, paper-based mortgage processes result in a mortgage loan file containing, at a minimum, the original promissory note¹⁵ and copies of supporting documentation.¹⁶ This creates a substantial volume of paper that must be stored by the lender or an approved document custodian. In order to realize further efficiencies during the lifetime of the loan, lenders and investors may wish to store the electronically-generated loan file in an electronic storage facility, or "eVault."

An eVault is a computer system, run by an eNote owner or his designated agent (commonly referred to as an "eCustodian"), that electronically stores eNotes and may store other loan file documents.¹⁷ Conceptually, an eVault consists of four components:¹⁸ 1) a secure data storage methodology; 2) a system of business functions designed to meet investor and GSE requirements; 3) system interfaces that integrate with the eVault's customers and other eVaults; and 4) integration with the MERS® eRegistry.¹⁹

Storing loan files in an eVault has many potential benefits. Electronic storage allows for secure storage of electronic records in smaller facilities. The use of electronic media allows custodians to easily create scalable custodial operations, maintain multiple backups and can enable lenders and investors to access their loan files 24/7. eVault operations can also be more efficient and may require fewer employees to operate. eVaults also enhance controls over the custody of eNotes, reducing opportunities for losing the files and providing additional options for tracking and auditing eMortgage files. Storing records in eVaults also provides investors and warehouse lenders with the ability to rapidly fund loan transactions, which can decrease the cost of making a loan.²⁰

When evaluating an eVault implementation, an eMortgage provider should consider a variety of factors, including:

- Measures for authenticating eVault system users and for providing different levels of access to those system users depending upon their roles;²¹
- Data security requirements and procedures, both for the eVault's physical plant and for its logical operations;²²
- Compliance with regulatory agency guidance and requirements governing record retention;²³
- How the eVault integrates with the MERS® eRegistry and supports its system of transactions and providing notice of transfers of eNote ownership;
- Secondary market requirements, particularly if the eNote is intended for resale;²⁴
- Data migration from one storage format to another, especially as these may change over time; and
- The structure of vendor contracts to ensure that the integrity, security and confidentiality of data stored in the eVault.

4) GSE eMortgage Requirement Documents

In addition to the general considerations outlined above, companies considering an eMortgage implementation must consider the secondary market investors' impact on the market. Many traditional paper-based notes are sold into the secondary market to other investors, who may in turn pool the notes into mortgage-backed securities. In order to do so, the secondary market investors have created a regime of representations, warranties, and standards that notes must meet before they are eligible for purchase by the particular investor. This regime will apply to eNotes as well as traditional mortgages, although eNotes will have slightly different requirements, due to their non-physical nature. Two of the biggest secondary market mortgage investors are Freddie Mac and Fannie

Mae. Both organizations have published their own eMortgage guidance, which are outlined below.

a) Fannie Mae

Fannie Mae today is purchasing a variety of eMortgages (including ARMs and fixed rate loans) on a daily basis and considers eMortgages to be “business as usual.” To enable seller/servicers more efficiently sell their eNotes, Fannie Mae published the Guide to Delivering eMortgage Loans to Fannie Mae v. 2.0 (June 2005) (“Fannie Mae eMortgage Guide”).²⁵

Fannie Mae lists the requirements for closing an eNote that is eligible for purchase.²⁶ Fannie Mae indicates that it is willing to purchase “[m]ost conventional first mortgages,”²⁷ provided that they contain the Fannie Mae/Freddie Mac uniform eNote,²⁸ are level one SMART Documents,²⁹ that all electronic documents are protected with a tamper-evident seal³⁰ and that all other requirements are met.

The Fannie Mae eMortgage Guide notes that Fannie Mae is leveraging the mortgage industry’s MERS® eRegistry to track ownership (or “control”) of eNotes that it purchases and to transfer control of such eNotes to Fannie Mae.³¹

Although Fannie Mae stores eMortgages in its own repository, it does not handle all of the servicing requirements. Accordingly, Fannie Mae also promulgated additional guidelines for servicers, which include implementing methods of identifying eMortgages, tracking their performance, ensuring that MERS® eRegistry records are and remain current, and that the servicer coordinate with Fannie Mae before beginning foreclosure on an eMortgage.³²

b) Freddie Mac

To help clarify its expectations for eMortgages, Freddie Mac published the Freddie Mac eMortgage Handbook.³³ The Freddie Mac eMortgage Handbook was designed to demonstrate Freddie Mac’s commitment to eMortgages and to provide their requirements to seller/servicers that intend to sell eMortgages to Freddie Mac.³⁴

The Freddie Mac eMortgage Handbook is a baseline document, providing Freddie Mac’s general conditions for eMortgage investments. Freddie Mac reserves the right to impose additional (or different) requirements on eMortgages it purchases from a particular seller/servicer³⁵ and has publicly invited its community of seller/servicers to engage it in discussions to determine how to sell eMortgages to Freddie Mac.

The Freddie Mac eMortgage Handbook provides “hard” requirements that are not present in other industry guidance.³⁶ These requirements cover a wide variety of topics. Because these are proposed contractual

requirements, Freddie Mac requires seller/servicers to provide extra representations and warranties regarding its eMortgages.³⁷

The eMortgage Handbook also imposes specific requirements on the method of originating eMortgages. For example, Freddie Mac specifies that all consumers expressly agree to the use of electronic records for the provision of certain disclosures, except in certain “hardship or emergency situation[s].”³⁸

Freddie Mac subsequently published the Single Family eMortgage Timeline (“eMortgage Timeline”).³⁹ The eMortgage Timeline is another useful guidance document that provides an overview of eMortgage implementation benefits, explains Freddie Mac’s involvement in various eMortgage initiatives and its “open standards” philosophy.⁴⁰ Perhaps most importantly, the eMortgage Timeline sets forth Freddie Mac’s vision for eMortgage adoption through 2008. By providing the mortgage industry with outlines of its planned activity for the next two years and its proposed lender next steps, Freddie Mac seller/servicers can properly plan and execute their own eMortgage programs.

Conclusion

eMortgage business processes and computer applications have been made possible by ESIGN and UETA. When developing an eMortgage implementation strategy, there are many issues to consider, including how eMortgages will be handled at the application stage and during eClosing. In addition, post-closing custodial issues must be considered, along with the requirements of secondary market investors. By carefully considering these issues, one can begin developing an eMortgage system can increase the quality of mortgage originations while simultaneously decreasing origination costs and processing time.

Resources

ESIGN

UETA – www.nccusl.org; <http://www.law.upenn.edu/blilulc/fnact99/1990s/ueta99.htm>

MISMO – www.mismo.org

SPeRS – www.spers.org

Fannie Mae – www.fanniemae.com

Freddie Mac – www.freddiemac.com

PRIA – www.pria.us

USNA – www.enotary.org

NNA – www.nna.org

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in serving the financial services industry. Ms. Tank and Mr. Supik specialize in the electronic delivery of financial services and represent, among others, the Electronic Financial Services Council ("EFSC"), the Electronic Signatures and Records Association ("ESRA") and the Standards and Procedures for Electronic Records and Signatures ("SPeRS") initiative. For more information, please contact Ms. Tank at mtank@buckleykolar.com or 202.349.8050 or Mr. Supik at fsupik@buckleykolar.com or 202.349.8039.

1. See Mortgage Industry Standards and Maintenance Organization, Cost Benefits of an eClosing Process 1.0 (Apr. 27, 2006), available at www.mismo.org (visited June 13, 2006). The Mortgage Industry Standards and Maintenance Organization ("MISMO") is a non-profit organization, founded in 1999 by the Mortgage Bankers Association ("MBA"). MISMO develops industry standards to facilitate adoption of eMortgage technologies. See www.mismo.org (visited June 13, 2006). MISMO seeks to obtain a wide range of views on eMortgage standards and invites participation from all segments of the mortgage industry. In addition to technical standards, MISMO has published expository materials that provide non-binding, but useful and broadly accepted, guidance, for eMortgage implementations, several of which are discussed in this article.
2. 15 U.S.C.A. § 7001 *et seq.*
3. The final draft of UETA as approved and recommended by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") in July 1999 is available from NCCUSL in conjunction with the University of Pennsylvania at <http://www.law.upenn.edu/bll/ulc/fnact99/1990s/ueta99.htm> (visited June 16, 2006).
4. An "Electronic Record" is "a record created, generated, sent, communicated, received, or stored by electronic means." UETA § 2(7); 15 U.S.C.A. § 7006(4). "Electronic" is defined as "relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities." UETA § 2(5); 15 U.S.C.A. § 7006(2). A "record" is defined as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." UETA § 2(13); 15 U.S.C.A. § 7006(9).
5. An "Electronic Signature" is an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record." 15 U.S.C.A. § 7006(5); UETA § 2(8).
6. eNote is defined as an electronic mortgage note. See, e.g., Freddie Mac eMortgage Handbook version 1.0 at iv ("Freddie Mac eMortgage Handbook").
7. Consumer is defined as "an individual who obtains, through a transaction, products or services which are used primarily for personal, family, or household purposes, and also means the legal representative of such an individual." 15 U.S.C.A. § 7006(1).
8. Record Provider is defined as a person or entitled that furnishes Required Information to consumers as part of the mortgage origination process.
9. See 12 C.F.R. § 226.23; 15 U.S.C.A. § 7001(c).
10. 15 U.S.C.A. § 7001(c)(3).
11. See MISMO, eMortgage Closing Guide v. 1.0 ("eClosing Guide") at § 2.2.
12. See eClosing Guide at § 3.
13. See eClosing Guide at § 3.1.
14. See eClosing Guide at § 3.9.
15. The promissory note is a negotiable instrument governed by UCC Articles 3 and 9.
16. The supporting documentation may vary, depending upon the type of loan involved. However, such documentation generally includes copies of the recorded security instrument, loan application and supporting documents, borrower's credit report, inspection reports (e.g., termite inspection, etc.), opening package disclosures, disclosures presented at closing, HUD-1 form, privacy notices, real estate sales contract, appraisal and other documentation.
17. Some eVault operators may combine their eVault operations with traditional loan file custodian operations, which store paper-based loan file documentation ("hybrid" custodian operations). See MISMO, eMortgage Vaulting Guide v. 3.0 ("eVault Guide") at 13. As with most steps of an eMortgage process, eVaults are analogous to their paper-based predecessors. Accordingly eVaults are designed to update the operations of traditional third-party document custodians, but are not intended to completely change the mortgage industry's methods of doing business.
18. eVault Guide at 19.
19. The MERS® eRegistry is a mortgage industry-wide computer system that allows eNote owners to provide notice of their ownership interest in a particular eNote and to transfer ownership and/or servicing rights in an eNote to another entity. The MERS eRegistry is designed to meet the requirements of Title II of ESIGN, 15 U.S.C.A. § 7021, and § 16 of UETA, which create a safe harbor for processes that provide a reliable method for determining who "controls" a "transferable record" such as an eNote. For more information, see www.mersinc.com; see also 15 U.S.C.A. § 7021, UETA § 16.
20. See, e.g., eVault Guide at 15-16.
21. For example, some system users may be authorized to enter eMortgages into the eVault, while others may have the authority to transfer them to other users. Still other system users might be limited to "read only" access, to handle auditing or other functions.
22. This is a broad-ranging category, which can include document-level details such as verifying whether data stored in the eVault has been modified without authorization; system level functions, such as intrusion detection and data encryption, and corporate level initiatives, such as physical plant security and multi-site disaster recovery protocols.
23. See, e.g., OCC Advisory Letter AL 2004-9, Electronic Record Keeping (June 21, 2004); Federal Financial Institutions Examination Council, IT Examination Handbook.
24. Secondary market investors may have their own unique requirements. Some examples of those requirements are set forth in section 4 below.
25. The Fannie Mae eMortgage Guide is available at <http://www.efanniemae.com/sf/guides/ssg/relatedsellinginfo/emtg/pdf/emtgguide.pdf>. Fannie Mae simultaneously published a Technical Appendix to the Fannie Mae eMortgage Guide, which is available at <http://www.efanniemae.com/sf/guides/ssg/relatedsellinginfo/emtg/pdf/emtgguideta.pdf>. Both documents can be accessed from <http://www.efanniemae.com/sf/guides/ssg/relatedsellinginfo/emtg/> (visited on June 9, 2006).
26. Fannie Mae recognizes that, at least until electronic recordation of security instruments is more widely available, that most eMortgages will in fact be "hybrid" transactions, consisting of both electronic and paper documents. Fannie Mae eMortgage Guide § 1.

27. Fannie Mae eMortgage Guide § 3.2.
28. Fannie Mae eMortgage Guide § 3.3.1.
29. Fannie Mae eMortgage Guide § 3.4.1.
30. Fannie Mae eMortgage Guide § 3.4.3.
31. Fannie Mae eMortgage Guide § 4. In addition, Fannie Mae often repackages notes and sells them on the secondary market in the form of Mortgage-Backed Securities (“MBS”). As part of the MBS underwriting process, certain entities review the notes involved in an MBS transaction and make certain certifications about the notes’ characteristics. Fannie Mae expects that the certification process will change somewhat, by allowing the certifiers to review the official copy (or “Authoritative Copy”) of an eNote while it remains in Fannie Mae’s possession in its storage facilities. The Fannie Mae eMortgage Guide addresses some of Fannie Mae’s expectations for the revised process. Fannie Mae eMortgage Guide § 5.
32. Fannie Mae eMortgage Guide § 6.
33. The Freddie Mac eMortgage Handbook is available at http://www.freddiemac.com/singlefamily/elm/pdf/eMortgage_Handbook.pdf (visited June 6, 2006), which can be accessed through Freddie Mac’s eMortgage resource page at <http://www.freddiemac.com/singlefamily/elm/index.html> (visited on June 6, 2006).
34. Freddie Mac eMortgage Handbook at § 1.2. The Glossary to the Freddie Mac Single Family Seller/Servicer Guide (Apr. 25, 2006), defines a seller/servicer as:
an institution approved to:
- Sell Mortgages to Freddie Mac, or
 - Service Mortgages purchased by Freddie Mac, or
 - Sell Mortgages and service Mortgages purchased by Freddie Mac...
- A Seller/Servicer must be an institution that meets all of the following conditions:
- It is a permanent organization and an ongoing concern
 - It is properly authorized to do business in each jurisdiction in which it engages in origination or Servicing
- It is
- Organized under federal law, or
 - Organized under the laws of one of the States, or
 - A United States-domiciled branch or subsidiary of a foreign entity.
35. Freddie Mac eMortgage Handbook at § 1.3.
36. For example, MISMO has publicly stated that its mission does not include providing hard industry requirements because it believes that this is the purview of the investor community. *See, e.g.* eVault Guide at 5 (stating that the eVault Guide “does not define requirements for electronic vaults because MISMO has no authority to publish requirements on behalf of investors.”) Moreover, it is important to note that the Freddie Mac eMortgage Handbook requirements are contractual obligations that only apply to seller/servicers that have entered into an agreement with Freddie Mac to sell eMortgages, and then only to the extent that Freddie Mac and the seller/servicer contractually agree to the handbook’s provisions.
37. Freddie Mac eMortgage Handbook at § 2.1.1.1.
38. Freddie Mac eMortgage Handbook at §§ 4.1, 4.1.3. This requirement exceeds ESIGN and UETA’s requirements, which would not preclude a duly authorized attorney-in-fact from agreeing to the use of electronic records on behalf of his principal. *See* 15 U.S.C.A. § 7006(1); UETA cmt. 1 to § 9.
39. The eMortgage Timeline is available at http://www.freddiemac.com/singlefamily/elm/pdf/emortgage_whitepaper.pdf (visited June 8, 2006), which can be accessed through Freddie Mac’s eMortgage resource page. *See supra* footnote 34.
40. eMortgage Timeline at 1-3.