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STRUCTURED FINANCE SPECTRUM

MARCH 2018

Tech Update: eNotes and Electronic Registries

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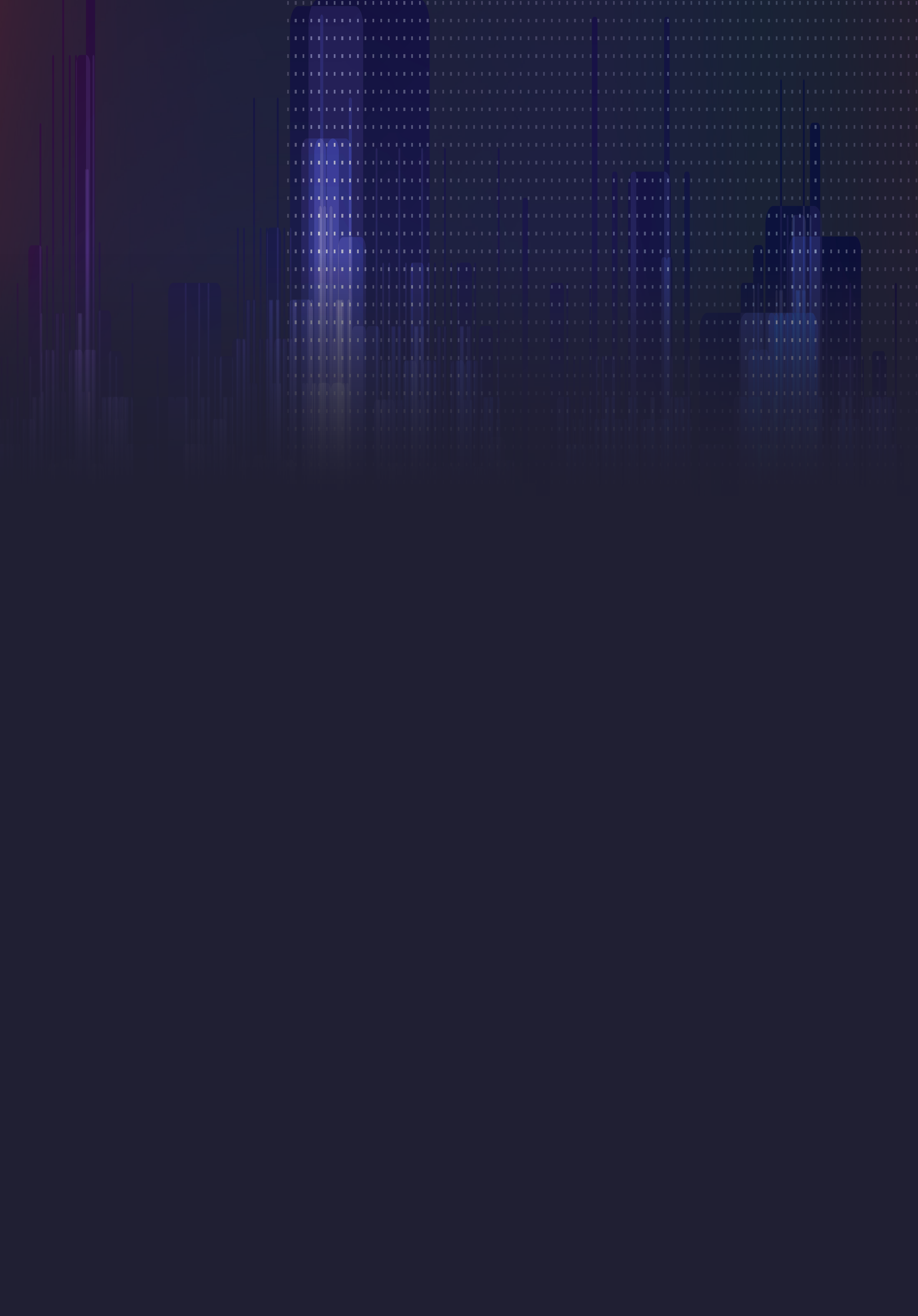

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Participants in the ABS market were early adopters of UETA and ESIGN and jettisoned paper loan documentation and promissory notes in favor of electronically executed documents held in an electronic vault. On the other hand, the mortgage market has been slow to transition origination practices to eliminate the physical promissory note and slower still to create a robust market for the trading and financing of electronic notes (eNotes) (other than Fannie Mae and Freddie Mac, both of which have eNote purchase programs). In an effort to boost the liquidity, transferability, and security of mortgage eNotes, in 2004 MERSCORP Holdings Inc. created the MERS eRegistry, which is a system for identifying and tracking the control and location of eNotes. Mortgage platforms that originate and sell eNotes to Fannie Mae or Freddie Mac are required to be integrated with the eRegistry either directly or through a third-party mortgage technology solution provider. Warehouse lenders financing eNotes similarly require the use of the eRegistry because that system provides the only current means of establishing control over the eNote in a manner similar to a lender's possessory control over a physical promissory note through a document custodian.

Notwithstanding the existence of UETA, ESIGN, and the MERS eRegistry, over the past few years the Federal Reserve Bank of New York has been developing a federal statute, the National Mortgage Repository Act of 2018, that would create a national repository for the housing and tracking of all mortgage notes, and the NCCUSL has been working on revisions to the Uniform Commercial Code, Articles 1, 3, and 9 to enable the transferability and enforceability of eNotes within the legal framework that exists for physical promissory notes. In the current draft of the federal statute, the Federal Housing Finance Agency would have oversight authority over the repository operator and the right to determine whether the repository operator should be established as a federally chartered entity or operated pursuant to a license. If the former, the repository operator would be a tax-exempt, federally chartered, not-for-profit corporate instrumentality of the United States. If the latter, existing repository operators, such as the MERS eRegistry, could have the ability to apply for a license to continue operating their current repository systems. These proposed laws would not replace or repeal UETA and ESIGN but rather would offer an alternative to the current paradigm for mortgage eNotes. The transferability and enforceability of non-mortgage eNotes could continue to be governed by UETA and ESIGN.

These proposed laws are in the drafting phase. Alston & Bird's subject-matter experts are actively participating on the ABA task force that is involved in these proposals and will be closely monitoring their progress.

Trend Watch: HELOCs

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Home price appreciation has been steadily on the rise for the past few years, and was at 6.48% as of the end of 2017, the highest annual HPA rate since April 2014. Rising prices have helped to reduce the number of mortgagors with negative equity by 37% (800,000) since January 2017, leaving only 2.7% percent of homeowners (1.36 million) with a mortgage owing more on their mortgages than their homes are worth. As of Q3 2017, approximately 42 million mortgagors have nearly $5.4 trillion in equity available to borrow against (assuming a maximum LTV of 80%) through a first-lien cash-out refinance loan or a HELOC.

Originating, servicing, purchasing, and/or financing open-ended HELOCs raises a number of complex legal and practical issues. It will be important for any originator, servicer, aggregator, and secondary market lender or investor to understand the federal and state regulatory and compliance landscape for HELOCs since these requirements differ from the rules that govern closed-end first-lien mortgage loans. Also important is understanding the mortgagee's ongoing funding obligation, related draw and repayment mechanics, and related rights and obligations that could attach to a securitization of HELOCs or may need to be assumed by a warehouse lender financing a pool of HELOCs. We will be publishing a separate article shortly that goes into greater detail about this asset class. ■

Spotlight on Consumer Finance: The Auto Finance Industry Grapples with Recent DoD Guidance

The Military Lending Act (MLA) and its implementing regulations were enacted in 2006 to provide certain consumer protections to active-duty members of the military and their dependents. Among other things, the MLA limits the military annual percentage rate to 36% and requires the delivery of certain disclosures with the origination of a loan. Consumer credit that violates the MLA is void, and the obligor may recover damages directly from the creditor of at least $500 for each violation. "Consumer credit" is defined broadly in the MLA, and the U.S. Department of Defense (DoD) has subsequently sought to refine its scope through implementing and interpretive rules.

The final implementing rules of the MLA adopted by the DoD in 2015 exempt from the definition the extension of credit relating to the purchase price of a motor vehicle when the credit is secured by the vehicle. On December 14, 2017, the DoD published an interpretive rule relating to the MLA clarifying (in what is known as FAQ #2) that when the extension of credit exceeds the vehicle purchase price, the extension of credit remains exempt if the excess credit is used to finance costs relating to an object securing the credit (e.g., optional leather seats), but is not exempt if such excess credit is used to finance credit-related costs (e.g., guaranteed asset protection insurance, credit life, and credit disability insurance). Instead of providing clarity, the interpretive rule has created further uncertainty in the auto finance industry particularly because the 2017 interpretive rule is retroactive and applies to all loans extended to covered persons originated on or after October 3, 2016.

This new guidance presents significant operational and compliance challenges for the auto finance industry because the retroactive application calls into question the enforceability of those loans made to active-duty servicemembers and their dependents on or after such date that financed these now non-exempt products. Further, the 2017 interpretive rule also presumes that, from a compliance standpoint, creditors have been effectively screening for and are in compliance with this aspect of the MLA or are in a position to quickly bring such legacy systems into compliance. If at the time of origination a creditor determined a loan to be exempt from the MLA, then that creditor may not have documented the active-duty status of an obligor or their dependents. Creditors must now determine how to best operationally restructure and document their vehicle loan origination process for the financing of non-exempt products.

From a market perspective, if not further clarified or repealed, this new guidance is potentially disruptive to auto loan securitizations that include a significant number of loans made to active-duty servicemembers or their dependents. The U.S. auto finance securitization market is very active, with approximately $68 billion in auto ABS issuance in 2017 alone. Securitized auto loans that are later determined to have not been in compliance with the MLA at origination could trigger repurchase obligations on the part of the originator and depositor parties, and significant repurchase obligations in any given deal with a significant concentration of these loans could have a material and adverse impact on the cash flows available to the related investors. To address these particular risks, issuers have been including appropriate risk factors in their offering documents. Additionally, this new guidance may have a chilling effect on the financing of credit insurance products for servicemembers, making it much less likely that they will be able to afford such insurance.

This type of sea-change guidance is precisely why a notice and comment process exists for official agency rulemaking. Unfortunately, the DoD circumvented that requirement through interpretive guidance, rather than a new rulemaking. It is imperative that industry group participants continue to engage directly with the DoD to explain the challenges to the auto lending and securitization markets arising out of this new guidance and call for the clarification or repeal of FAQ #2. The DoD needs to understand the potentially disruptive impact of this new guidance on auto dealers, lenders, the securitization market, and ultimately the servicemembers that the MLA was meant to protect. ■

Politics and the Market: The CFPB Shuffle

Since the beginning of this year, the Consumer Financial Protection Bureau (CFPB) under acting director Mick Mulvaney has been clearly telegraphing changes to the way it regulates and monitors the financial industry. In a recent speech to the National Association of Attorneys General, Mulvaney outlined the CFPB's strategic plan, which entails reining in its past practice of regulating through enforcement actions and relying more heavily on state regulators and state attorneys general to enforce consumer protection laws. This comes on the heels of Mulvaney's January 24 internal memo to CFPB staff and op-ed article published in *The Wall Street Journal* in late January in which he directed the CFPB to focus on more formal rulemaking and to prioritize areas of enforcement and declared that "the days of aggressively 'pushing the envelope' … are over." Mulvaney noted that a third of the complaints received by the CFPB in 2016 related to debt collection, and of those, 0.9% related to prepaid cards and 2% related to payday lending; he asserted that "data like that should, and will, guide [the CFPB's] actions."

The CFPB has wasted no time in implementing this new approach. On January 16, the CFPB put the Payday, Vehicle Title, and Certain High-Cost Installment Loans rule on hold on the date the rule was to become effective so that it can reconsider the rule. Designed to protect consumers from payday lending debt traps and finalized just this past October, this rule required lenders to conduct a "full-payment test" to determine whether a borrower has the ability to repay the loans without needing to reborrow or to offer a principal-payoff option for certain short-term, small balance loans that allow the borrower to pay down the debt more gradually.

In the same week, the CFPB filed a notice of voluntary dismissal in its case against Golden Valley Lending, Silver Cloud Financial, Mountain Summit Financial, and Majestic Lake Financial, four online payday lenders affiliated with a Northern California Native American tribe, that accused them of violating federal consumer protection laws by making and collecting on loans with annual interest rates between 440% and 950% in at least 17 states. The CFPB also dropped a four-year investigation into World Acceptance Corporation, one of the largest installment loan consumer finance companies, without any enforcement action.

In early February, the CFPB announced the transfer of the Office of Fair Lending and Equal Opportunity (OFLEO) from the Supervision, Enforcement & Fair Lending Division to the Office of the Director, where it will become part of the Office of Equal Opportunity and Fairness. The OFLEO had focused on pursuing discrimination law violations against financial companies and is now charged with focusing on advocacy, coordination, and education. The restructuring appears to signal a shift away from CFPB fair lending enforcement activities.

Since Mulvaney was named the acting director last November, the CFPB has issued no new enforcement actions and has requested no new funds for the CFPB from the Federal Reserve for 2018 Q2. This stands in stark contrast to the CFPB under Richard Cordray, in which 36 enforcement actions were issued in 2017, and \$86.6 million and \$217.1 million in funding was requested for 2017 Q4 and 2018 Q1, respectively. Mulvaney projected \$145 million in quarterly expenditures and noted that the CFPB has sufficient funds at the Federal Reserve Bank of New York to cover these amounts.

Lastly, the CFPB has begun issuing a series of Requests for Information (RFIs) seeking both input from the public on certain processes and suggestions on ways to improve the outcomes for consumers and covered entities. The scope of these RFIs include:

- The discretionary aspects of the various stages of the CFPB's rulemaking processes, including initial outreach and information gathering, Notices of Proposed Rulemakings, and final rules (March 9).
- The CFPB's public reporting practices of consumer complaint information (March 6).
- The CFPB's information collection activities, including whether the collection of information is necessary for the CFPB's proper performance of its functions, whether the information will have practical utility, and ways to minimize the burden of the collection of information on respondents (February 28).
- The CFPB's engagement with its external stakeholders, the transparency of information, and the means of soliciting public and private perspectives on the CFPB's work (February 26).
- Assessing the efficiency and effectiveness of the CFPB's supervision program, including the timing, frequency, and scope of supervisory exams, efficiency and effectiveness of onsite examination work, the process for appealing supervisory findings, and manner and extent to which the CFPB should coordinate its supervisory activity with federal and state supervisory agencies, including through the use of simultaneous exams (February 20).
- Assessing the efficiency and effectiveness of the CFPB's enforcement processes, including the timing and frequency of communications between the CFPB and the subjects of its investigations, length of its investigations, CFPB's Notice and Opportunity to Respond and Advise process, calculation of civil money penalties including whether the CFPB should adopt a civil money penalty matrix, and manner and extent to which the CFPB can and should coordinate its enforcement activity with other federal and/or state agencies that may have overlapping jurisdiction (February 12).
- The exercise of the CFPB's authority to issue civil investigative demands (January 26).

While all of this has been unfolding, the question of the proper legal successor to Richard Cordray as the director of the CFPB – Leandra English, named by Cordray, or Mick Mulvaney, named by President Trump – remains open. The matter is currently before the U.S. Court of Appeals in the D.C. Circuit, with oral arguments to be heard in April. Thus far, three amicus briefs have been filed in support of President Trump and Mulvaney, including a brief filed on March 2 by 38 Republican Senators and 75 Republican House members. Unless and until this question is decided in favor of Leandra English, we anticipate the CFPB will continue to take steps to reverse its hold on the financial industry, and we will continue to track its progress. ■

Bankruptcy Beat: *In re Franchise Services of North America Inc.*

The recently certified appeal to the Fifth Circuit of *In re Franchise Services of North America Inc.*, No. 17-02316, a Chapter 11 case emanating out of the U.S. Bankruptcy Court for the Southern District of Mississippi, is an important case to watch. It addresses the enforceability of "blocking provisions" and "golden shares," which are provisions embedded in the organizational documents of an entity that prohibit the entity from instituting a voluntary or involuntary bankruptcy proceeding without first obtaining the written consent of some or all of the equity holders.

The general premise of bankruptcy law is that the waiving or contracting away the right to file for relief under the Bankruptcy Code is contrary to public policy. Courts have generally upheld these provisions to the extent they are held by an equity holder, and they have found these provisions invalid and against public policy to the extent they are held by a creditor. Less clear is whether these provisions are valid and enforceable if held by a creditor that is also an equity holder (i.e., the holder of one share). There are currently no controlling decisions on these points by the Fifth Circuit, the U.S. Supreme Court, or any other courts of appeals. The broad legal questions that have been certified for appeal are:

- Is a blocking provision or golden share valid and enforceable or is it contrary to federal public policy?
- If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?
- Under Delaware law, may a certificate of incorporation contain a blocking provision or golden share? If the answer is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise the provision in the best interests of the corporation?

In the asset-based deal world, there exists a continuum of protections against voluntary and involuntary bankruptcy filings. On the one end are default or amortization provisions that are triggered upon a bankruptcy event, and on the other end are outright creditor controls over the decision of whether to file. Somewhere in the middle are provisions requiring the consent of an independent director or manager for any such bankruptcy action, which are commonly employed in structures that are looking to achieve bankruptcy remoteness. These blocking provisions or golden share provisions are variations on that theme, and accordingly, we are keeping our eye on this case. ■

Banking Regulatory Report: New Limitations on Qualified Financial Contracts

The FDIC recently adopted a final rule that, among other things, restricts the ability to terminate or cancel a qualified financial contract (QFC) if an FDIC-supervised institution (FSI) or its subsidiary has entered into a bankruptcy or resolution proceeding. QFCs are equivalent to contracts that are eligible for the safe harbor from the automatic stay under the Bankruptcy Code, such as derivatives, repurchase agreements and reverse repurchase agreements, commodities forward contracts, and securities lending and borrowing agreements. Covered entities under the rule include certain state-chartered banks that are not members of the Federal Reserve System, state-chartered savings associations, and state-licensed branches of foreign banks, as well as their subsidiaries.

Specifically, the rule partially defangs standard cross-default provisions by prohibiting default rights under a QFC (i.e., the right to liquidate, terminate, or accelerate the contract) that are related to an affiliate of the direct party to the QFC becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding, whether domestic or foreign. However, the rule expressly permits the exercise of default rights under a QFC that arise as the result of (1) the direct party to the QFC becoming subject to a receivership, insolvency, liquidation, resolution, or similar proceeding; (2) the direct party to the QFC not satisfying a payment or delivery obligation under the QFC or another contract between the same parties; or (3) the affiliate of the direct party to the QFC failing to satisfy a payment or delivery obligation under an agreement that provides credit support to the QFC. In other words, cross-default provisions that are triggered by defaults under other arrangements between the same parties, or by defaults under guarantees or other agreements providing credit enhancement or support to the QFC, are clearly permitted. Although the rule took effect on January 1 of this year, compliance with the rule will be phased in over the next two years.

The overarching purpose of the rule is to facilitate the orderly resolution of a failed institution to avoid another "Lehman" situation where the bankruptcy of the parent holding company triggered cross-defaults across the many financial contracts entered into by subsidiaries of the holding company. As the counterparties sought to exercise remedies, the subsidiaries scrambled for cash and collateral to post margin with and satisfy the outstanding obligations. This of course had a significant destabilizing effect on the company and the subsidiaries and the financial system in general, and resulted in the fire sale of collateral and the ultimate bankruptcy of the subsidiaries.

This rule is substantially identical to the QFC rules finalized by both the Federal Reserve and the Office of the Comptroller of the Currency that apply to institutions supervised by those agencies, such as U.S. global systemically important banking organizations (GSIBs) and their subsidiaries and the U.S. subsidiaries and certain branches and agencies of foreign GSIBs. ■

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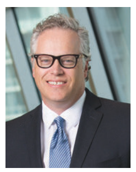

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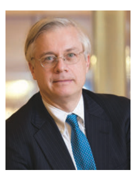

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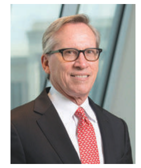

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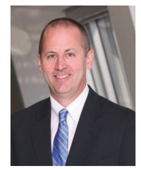

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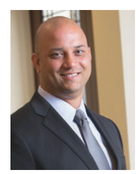

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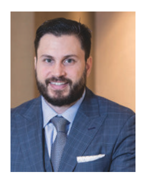

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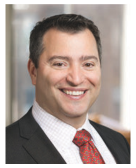

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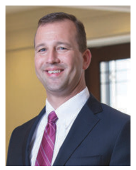

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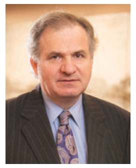

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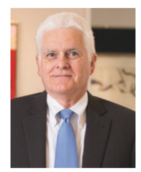

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